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**THE DYNAMICS OF INTERVENTION:  
REGULATION AND REDISTRIBUTION  
IN THE MIXED ECONOMY**

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# PROFESSOR TULLOCK ON AUSTRIAN BUSINESS CYCLE THEORY

William Barnett, II and Walter Block

## 1. INTRODUCTION

In "Why the Austrians Are Wrong About Depressions," Professor Tullock (1987, p. 73) makes some statements that are incorrect and others which, properly interpreted, refute or at least, fail egregiously to support, his thesis that the Austrian theory of the trade cycle is incorrect. We begin by considering one of Tullock's minor points in Section 2 and then consider his major point in Section 3. In Section 4 we take to task Tullock (1989), also on this same topic, and conclude in Section 5.

## 2. TULLOCK'S MINOR POINTS

His: "... second nit has to do with Rothbard's apparent belief that business people never learn. One would think that business people might be misled in the first couple of runs of the Rothbard cycle and not anticipate that the low interest rate will be raised later. That they would continue unable to figure this out, however, seems unlikely. Normally, Rothbard and the other Austrians argue that entrepreneurs are well informed and make correct judgments. At

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the very least, one would assume that a well-informed business person interested in important matters concerned with the business would read Mises and Rothbard and, hence, anticipate the government's action" (Tullock, 1987, p. 73).

There are several problems with this line of reasoning. The first, which is typical of much non-Austrian analysis, is implied by Tullock when he refers to "business people" as though they are a homogeneous group. In reality, however, businessmen are a diverse lot, many, if not most of whom have little in common, save for the very fact of their *being* businessmen. Further, the composition of the group is changing continuously.

Second, given the fact that professional economists are unable to agree about the nature and cause(s) of business cycles, it is unreasonable to argue that the failure of businessmen to adopt a particular theory thereof is proof that any given theory is incorrect.

Third, Tullock seems to have adopted some form of (weak?) rational expectations theory (Salerno, 1989, p. 144). Of course, if expectations really were rational, there would be no way to explain many other economic phenomenon apart from business cycles, e.g., asset price bubbles.

Fourth, monetary-policy-induced fluctuations in interest rates are unpredictable, at least in details specific enough to be useful for many business decisions. Therefore, even when some businessmen do anticipate that an artificially low interest rate will eventually rise, they cannot *possibly* know when and by how much.

Fifth, even if a "well-informed" businessman "interested in important matters concerned with the business" who had "read Mises and Rothbard" could predict the Fed's policy actions in advance, and the effects thereof on future short-term interest rates, he would have no reliable way of predicting the effects thereof on long-term interest rates, or of the effects of interest rate changes on those variables relevant to his decisions. How can we expect businessmen to predict the Fed's actions better than professional "Fed watchers," when even they are not all of the same mind. And, how can we expect businessmen to understand the economy better than professional economists, given that the latter certainly do not agree on such matters.

Sixth, even the Fed's policy makers can not explain in detail: (1) how they make their decisions; and, (2) what effects they expect their policies to have. Moreover, because of that, they speak in jargon, metaphors, etc. Anything but plain English; and for good reason – they avoid specificity in order to evade accountability.

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Seventh, even apart from the foregoing, there is the fact that according to Austrian Business Cycle Theory (ABCT) not only is the business community in effect *fooled* into making investments, which only later are shown to be mistaken, they are also *subsidized* into undertaking these profoundly misallocative activities.<sup>1</sup> When expansive monetary policy lowers interest rates below the levels that would otherwise have obtained, investments at the higher order stages of production come about not only as a result of the lack of information mentioned in the six points above, but *also* as a matter of pure self-interest.

Suppose, *arguendo*, despite the completely valid six objections above, that the entire business community was well versed in the niceties of ABCT. Suppose, further, again *arguendo*, that none of the six objections mentioned above had any validity; that is, that all businessmen knew, full well, that they were engaging in malinvestments; and, suppose, even more heroically, that they could predict, without the possibility of failure, the exact timing of the downturn. Under these maniacally unlikely assumptions, would the Austrian Business Cycle (ABC) still take place? Yes. For as long as the extant entrepreneurs relied upon the fact that a "sucker is born every minute," they could get in while the "getting was good" and then, also, get out right before the recession began, provided, only, that there were at least some new investors who were not fully cognizant of ABCT. But this scenario is still consistent with the assumption that *all* businessmen, every last one of them, completely understood ABCT at the time of the initial monetary interference, and, despite this fact, rationally decided upon investing in the higher orders of production, even in the face of perfect knowledge that these investments were unsustainable.

Consider the following analogy in this regard. Suppose that the optimal ratio of spoons and socks is one-to-one; that is, on average, a marginal dollar's worth of these two items yields identical utility when consumed in the ratio of one spoon for every pair of socks. Now, along comes dirigiste government with a tax on the former, and a subsidy for the latter. *Arguendo*, all extant businessmen know with absolute certainty that this weird policy will create misallocations, and the political realities will force government to rescind it in exactly 5 years. Will profit considerations, nevertheless, dictate fewer investments in spoon production, and more for socks? Yes, provided only that in 5 years minus one day they will be able to unload their soon to be unprofitable sock factories on people who are not now members of the business community. They would, of course, invest the proceeds in the soon to be more profitable spoon factories.

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### 3. TULLOCK'S MAJOR POINT

Tullock's (1987, p. 74) major objection, putting it quite bluntly, is that "if the process Rothbard describes did occur there would be many corporate bankruptcies and business people jumping out of the windows of office buildings, but there would be only minor transitional unemployment. In fact, measured GNP would be higher as a result."

Tullock is certainly correct about the effect of the Rothbard's process on corporate bankruptcies, though he failed to note a similar effect on personal bankruptcies. And, given the existence of a legal bankruptcy process, the more onerous it is, that is, the more protection it provides debtors at the expense of creditors, the slower the adjustment process. For a case in point, witness recent events in Indonesia.<sup>2</sup> (We ignore the suicides as hyperbole.)

As to the subsequent increases in interest rates having only minor, transitional effects on unemployment, several points should be made. The implication that labor markets make rapid adjustments to changes in market conditions is clearly erroneous. At best, markets for free labor are among the most slowly adjusting of free markets.<sup>3</sup> Moreover, labor markets are patently *not* free. Very much to the contrary, they are among the most highly regulated of markets. And, the more intervention there is, the less rapidly will the necessary wage adjustments be made, and the more severe will be the unemployment. Conversely, the less intervention, the more rapid the adjustment, and the less severe the unemployment. Further, the effects vary from historical case to case, depending upon the extant institutions and the specifics of the situation. That other markets are hampered as well means that the necessary price and interest rate adjustments in those markets also will be slow, with concomitant effects on the unemployment of other resources.

As to measured GNP being higher, does an elevated measurement for this statistical aggregate constitute accurate evidence of more valuable economic activity?<sup>4</sup> Obviously, the owners of the resources who, because of artificially low interest rates, unwittingly diverted them to sub-optimal uses; e.g., the construction of uneconomic and unneeded factories, must have had alternative uses for these resources. These alternative uses must have been considered to be of more value, else it would not have taken artificially low interest rates to divert them to their new, less valuable uses.

Moreover, measured GNP includes transaction costs in the form of the bankruptcy process; that is, legal, accounting, etc. costs which measure the expenses of trying to rectify the mistakes of the unsustainable boom: the misallocation of resources. However, perhaps the most important problem

with measurements of GNP is caused by including the value of misallocated resources at the market price at the time of the misallocation, precisely that point in time when their value in the sub-optimal use registers most highly, because the market has not yet discovered that such use is a misallocation, and then failing to subtract the reduction in value from measured GNP when the discovery is finally made. That is, inflation distorts both the level and structure of prices that are used to measure the value of GNP in such ways as to artificially overstate it.

That is, there are three possibilities re measured GNP: (1) it would be higher, accurately reflecting an increase in the production of valuable goods; (2) it would be higher, even though valuable goods are being destroyed, and thus, if for no other reason (and there are many), because measured GNP is based, almost always, on false prices and interest rates, it is a virtually useless artifact; or (3) it would reflect, accurately, the destruction of valuable goods, in which case it would not be higher but, rather, lower. Although Tullock seems to choose the first alternative, either of the latter two would appear to be the better choice.

Let us put this into other words. Even supposing that unemployment effects will be at worst only marginal due to virtually instantaneous adjustments, still, this analysis focuses only on the tip of the iceberg of problems. For, according to ABCT, unemployment is not the only, or even, necessarily, the most important negative consequence of a monetary induced artificial-boom-bust cycle. There is also that small matter of loss of productivity because of the misallocation of scarce capital goods, including not least human capital. Suppose that as a result of Fed activity 90% of the labor force were assigned to the proverbial Keynesian task of "digging ditches and then filling them up again," but that not a single solitary man were thereby unemployed (due to stipulated instantaneous labor force adjustments). Tullock's concerns about unemployment would be assuaged in one fell swoop, but the economy as a whole would be in virtually total disarray. Now, no one is stating that the business cycle is *that* devastating. We merely content ourselves, here, pointing out that the misallocative effects of the ABCCT can be very serious indeed *even if* unemployment does not thereby increase by even one iota.

Salerno (1989) made a Herculean attempt to correct Tullock's (1987) misunderstanding of ABCT in this regard. Despite Salerno's best efforts, Tullock (1989) shows no evidence of having understood those lessons. Instead, Tullock (1989, p. 147) accuses Salerno of playing fast and loose with the definition of the word 'depression.' In Tullock's (1989, p. 147) view: "The standard meaning of the word "depression" is a situation in which

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general conditions are very bad and, most importantly, there is very high unemployment." Tullock (1989, p. 147) is of the opinion that the misallocations created by Fed induced non-market interest rates "could not create the kind of massive unemployment we saw in 1929-1933." Tullock is undoubtedly correct that *if* we posit instantaneous wage adjustments; that is, inter alia, there are no governmental interventions in labor markets such as minimum wages, unemployment insurance, etc., then "mere" interferences with interest rates need not logically compel *any* unemployment at all, certainly not the horrendous levels of the Great Depression (they would only imply loss of capital value, as discussed above). However, the real world is not characterized by this "frictionless" system. And, despite his claims to the contrary, it is certainly conceivable that market interferences with interest rates that lead to unsustainable investments in the higher orders of the structure of production, *coupled* with interferences with downward wage adjustments, could well and actually *did* lead to massive unemployment during the Great Depression.<sup>5</sup>

But are Austrians guilty of utilizing a stipulative definition of the word "depression?" After all, praxeologists, but no one else, would characterize as a depression (or recession) a situation without massive or indeed any unemployment provided only (*per impossibile*) that there were instantaneous adjustments in the labor market.

In our view, although the Austrian and the "man in the street" understanding of "depressions"<sup>6</sup> is somewhat different, the praxeologist's perspective is compatible with the essence of this phenomenon, while the alternative is not.

Suppose the government in its wisdom passed a minimum wage law pegged at \$1,000 per hour. Or posit that a hurricane, more destructive than any we have before experienced, struck the US. Either of these would devastate the economy, bringing vast unemployment in its wake (assuming, realistically, no rational expectations, no full knowledge, and non-instantaneous adjustments). But would they constitute a "depression"? The Tullocks of the world, would, presumably, answer in the affirmative. But the Austrians would not. They, in contrast, reserve this word for massive disruptions of the economy, whether or not also characterized by "large scale unemployment," but only if there is an artificial cyclicality involved, which is patently absent in these two cases.

Although, the period from the collapse of the stock market in October 1929 until the war stimulated recovery of production<sup>7</sup> is known as "The Great Depression," this is strictly speaking, from the point of view of Austrian analysis, a misnomer.<sup>8</sup> Historically, depressions referred to the sharp, but short, contraction of production and employment subsequent to an unsustainable

boom, during which the economy was purged of the excesses of the boom; that is, during which the array of relative prices was restructured to accord more closely with the preferences of consumers, with attendant reallocations of resources. By this definition, the Great Depression was a *depression plus*. That is, the fiat money/credit expansion of the 1920s caused an artificial and, therefore, unsustainable boom composed of a speculative bubble in asset prices and a massive misallocation of resources. Toward the end of 1928 or the beginning of 1929 the money/credit expansion of the 1920s ended, setting the stage for the collapse of the boom, or the cleansing recession. The crisis occurred in October of 1929, though the "real" economy had been sliding for some 6 months before that time. Were that the end of the story, in all likelihood the economy would have been in the recovery phase of the cycle by 1932. Instead, the economy was in the pits then, after which there was some improvement until 1937 (improvement that did not bring the economy even back to the level of 1929) despite which thereafter the economy contracted again. That is, what should have been a sharp, but short depression turned into the Great Depression. Why?

There were several factors – each and every one of which was either a governmental policy error or the consequence of such an error. First, the Smoot-Hawley tariff that raised tariff rates to the highest level in American history was enacted and took effect in mid-1930. Second, the Fed failed to prevent massive "secondary deflation" and bank failures on an unprecedented scale that ultimately led to the "bank holiday" of 1933. Third, the government induced and coerced as necessary the cartelization of industries, and of labor in unions. Fourth, leading politicians beat the drums incessantly against allowing wages to fall, threatening, browbeating and "jaw-boning." All of these factors combined to keep money prices and wages above market clearing levels, given the collapse of the money supply; they also militated against declines in real wage rates necessary for the re-employment of labor. Fifth, terminating the gold standard domestically along with other assaults on property rights created what Higgs (1997) refers to as "regime uncertainty" which led to a loss of business confidence that in turn resulted in a reduction of business investment. These factors combined to turn what would otherwise have been the "depression of 1929-1930" into the "Great Depression of 1929-1947."

Save for the secondary deflation, these factors may be thought of as non-monetary-induced distortions of the structure of the economy; i.e., non-monetary-induced misallocations of resources. Perhaps a better name for them, given Tullock's misunderstanding of the issue, would be *non-cyclical* governmental interventions.

According to Tullock (1987, p. 75) although "the interest rate" is of importance for decisions concerning expenditures on capital goods, it is "but of very little significance in deciding how much to produce in an existing factory." Certainly, however, interest rates are significant for operating decisions for those businesses that use credit to finance part of their operating expenses, e.g., payrolls, accounts receivable, and inventories. And, surely, rises in interest rates that increase such expenses tend to lead to higher prices and decreased quantities sold. The diminished volume of sales, in turn, lead to smaller orders placed by such businesses with their suppliers, including those with existing factories.

But even putting matters in this format is somewhat to do violence to economic reality. For, there is no hard and fast distinction to be made between expenditures on capital goods and on all other factors of production. The key element in determining how powerful an effect any given change in the interest rate will have on economic decision-making is length of run. Other things equal, the longer the amount of time involved, the more elastic the response will be with regard to interest rate changes. To be sure, it takes far more time to build *most* factories than to produce goods in an existing factory. But *some* factories are quickly built, and *some* products take a long time to manufacture. That is, the key is the extent and duration of the misallocation of resources of all types – human capital, capital goods, natural resources, and often overlooked, scarce entrepreneurial talent – regardless of the details.

Tullock (1987, p. 74) then states that, as regards capital goods already existing at the time when the expansionary monetary policy is initiated, there is no reason to think either that such goods "should be particularly damaged by what has happened" or "that there is too much of [them] under the current circumstances." But does not the creation of new capital goods "damage" the value of existing capital goods? And is not the problem precisely that the new capital goods are of the wrong type, and that, although there may not be "too much" capital goods in general, there is too much of the particular types created because of the monetary expansion?

What Tullock fails to reckon with is the primordial economic fact that goods and services have substitutes and complements. Even if no extant capital good is *directly* "damaged" by misallocative investments consequent on artificially lowered interest rates, this does not mean that every extant capital good will fit in as well with other aspects of the economy compared to the situation where the government had not meddled with the economy's price signals.<sup>9</sup> Capital goods, contrary to Tullock's vision, are not homogeneous. They are not putty-like substances, able to be fit into, without any

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additional cost, any given existing capital structure. Rather, if they are to be efficiently employed, they must be created in such a manner as to fit in with the remainder of the economy. Thus, new investments must be coordinated with whatever already exists, and also with the decisions of others. And this can best be done, Tullock notwithstanding, only if market signals are not perverted by unwise governmental monetary policy.<sup>10</sup> The capital structure of the efficient economy is, as it were, a delicate latticework, and the Fed is like the bull in this particular china shop.

Tullock (1987, p. 75) next deals with that class of capital goods that were produced for those industries which, themselves, produce consumer goods, and the production of which were undertaken and completed during the period of "the artificially depressed interest rate." He thinks that, although the investors therein will lose money, the capital goods, having been already completed and therefore, being a "sunk cost," there is no reason why they "... stop being used." That is true, provided the revenues generated therefrom cover the operating expenses with something left over to put against the overhead expenses, the capital goods will be used. However, depending on the specificity of the capital goods, there may be a struggle over the control and reallocation thereof. It is impossible that during such struggles, the optimal use is made of these resources.

Again, Tullock fails to take into account the interconnectedness of all capital. Yes, it cannot be denied, the *physical* manifestation of the already existing capital goods may remain largely undisturbed despite the advent of the new, misallocated, capital to come on stream. (However, the *uses* made of some of it will change.) Sunken costs are indeed sunk, as he so correctly informs us. However, the *value* of old capital goods will be attenuated by not being able optimally to work in tandem with other investments, and this is something not in Tullock's ken.

Tullock (1987, p. 75) also states that, as there is more of it, "... the demand for labor to work with it will be higher." But, of course, the demand for labor is derived from the demand for the goods the labor is to be used to produce, not from the supply of capital goods. He goes on to say that because there would then be increased production of the consumer goods, with sales at lower than anticipated prices, "... there should be higher living standards." To the extent that this occurs, there are indeed higher living standards, at least for many of those remaining employed. A measured rate of unemployment of say 15% would be considered by many economists evidence that the economy was bordering on, if not in, a depression; and yet, as measured, 85% of the workforce would still be employed, many of whom would benefit from the reduced prices and other conditions of the downturn.

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Tullock's analysis continues along this line. His key point seems to be that malinvestments induced by monetary policy may lead to bankruptcies, but they do not cause significant unemployment. Thus, although Tullock never spells out his assumptions either as to how rapidly and accurately information is transmitted in the market process or as to how rapidly people react to the new knowledge, he seems to have made a typical neoclassical assumption that markets for goods and for labor and other resources adjust very, very rapidly, if not instantaneously.

Another problem with Tullock's analysis is his (implicit) objective value theory. Thus, he critiques Rothbard's statement that in response to artificially lowered interest rates, "... businessmen react as they would react if savings had genuinely increased" by stating that if, in response to lower interest rates, more factories are being built, "... then, in fact, savings that are available for building factories must have increased" (Tullock, 1987, p. 74). This ignores the centrality of the concept of subjective value to sound economic analysis.

Of course, if additional factories are built, resources must be diverted to such activity from some other use, including, possibly, leisure. But this does not necessarily mean that savings, as a category of purposeful human action, have increased. It is the subjective value attached to something by the valuing mind that is important for human action and a fortiori, economic analysis. Thus, the existence of the additional factories does not, ipso facto, mean that savings must have increased. Rather, it constitutes evidence of an *attempt* to increase savings. Consider the following example.

Today A has control of a volume of goods of a certain value to him. Suppose him to consume some of the goods, and not consume the rest, in an attempt to conserve and, perhaps, even increase, the value thereof for future consumption. There are various ways A could attempt to accomplish this, e.g., lending his command of resources to B. However, regardless of the method that A uses, what he is attempting to do is to shift his ability to satisfy his wants from the present into the future, by attempting to have more control of goods in the future, albeit at the cost of control at present. Should, for whatever reason, A's attempt prove unsuccessful, i.e., should he be unsuccessful in his attempt to conserve value for future consumption by preserving control of goods into the future, then his attempt to save would have *failed*.

Even without government intervention into the economy, many attempts to save would fail because of our inability to accurately foresee the future. Such failures, for the most part, are random in nature. Governmental monetary policy, however, induces, through false price signals, including false interest

rates, an element of systemization in the attempts to save, and, consequently, an element of systemization in the failures of such attempts. The losses of value associated with these governmentally induced failures are referred to, at least by Austrian theorists, as "forced saving." This is an undesirable, because misleading, phrase; a more accurate but, unfortunately, more cumbersome phrase is, "forced destruction of some or all of the value of resources and/or goods because they were diverted from their most valuable use." In other words, malinvestments *is* forced saving. One manifestation of the fact that value has been destroyed in such situations is the attempt to minimize, and allocate among the different parties involved, the losses through the bankruptcy process, which Tullock mentions several times.

#### 4. TULLOCK'S (1989) REPLY TO SALERNO

Let us consider two other criticisms of ABCT presented to us by Tullock. He (1989, p. 149) speaks of a "gold inflation" during the reign of Alexander the Great, explaining "Alexander spent the Persian emperor's gold reserve." But this is not at all "inflationary," except in the most superficial of understandings of that concept. True, if this reserve constituted a significant proportion of the gold in the hands of both the banking and non-banking public, then, when it is suddenly released, prices of goods in terms of gold would rise. But no less would apply to *any* sudden dishoarding. It is no more "inflationary" than were a bunch of misers to reach into their cookie jars and under their mattresses to abruptly spend money never before utilized in this manner. Nor, even, would the phrase "gold inflation" apply to a case where a new and significant seam of this metal found. The reason for this is that both the dishoarding and the discovery would be considered part and parcel of the market process. It would be no more "inflationary" than would be the case if one said that "burger inflation" took place after the advent of Ray Kroc.

Second, states Tullock (1989, p. 149), "It is possible to get out of an inflation without a depression." This can be understood in one of two ways,

1. "It is possible to get out of an inflation without creating unemployment." This, as we have seen, is only possible if we assume rational expectations, perfect information, instantaneous adjustment, etc. But without these heroic assumptions, it is *impossible* to get out of inflation without unemployment.
  2. The statement might be interpreted to mean: "It is possible to get out of an inflation without suffering economic losses due to previous resource misallocation."
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This is because the prior bout of inflation necessarily misallocates resources. It is not true, as Tullock (1989, p. 149) avers, that the costs of inflation are limited to "the reduction in efficiency of the economy while the inflation is going on." To be sure, these must indeed be counted in the total tally of the costs of inflation. But the costs *also* result from the misallocations of resources in the form of durable capital and consumers' goods, and of human capital that have been made and that do not cease to exist when the inflation ends. Because these misallocations do not take the form of homogeneous blobs, they cannot be costlessly integrated into a different sector, the structure of production, and thus constitute a very significant cost of inflation completely apart from the inefficiency correctly identified by Tullock. This economist (Tullock, 1989, p. 149) goes on to say that "the more severe the inflation, the easier" it is to end it without a depression. But this is surely wrong. For the greater the inflation, *ceteris paribus*, the more serious the misallocation it engenders. And the more serious the misallocation engendered by the inflation, the more damage it does to the economy.

## 5. CONCLUSION

In conclusion, neither has Tullock proven, nor can he prove, that Austrian business cycle theory is incorrect in this regard.

## NOTES

1. For another critic of ABCT, who neglects this vitally important point, see Wagner (1999); for a rejoinder, see Block (2001).

2. See, e.g., Brietzke (2001) and Mar'ie Muhammad (1999).

3. Labor markets do not adjust rapidly to changes in market conditions: partly because layed-off employees frequently are uncertain as to the duration of the layoff, and thus often prefer to await anticipated recall over searching for new, possibly less desirable, employment; partly because they are not well organized; partly because of low opportunity costs (because, e.g., relocation of a family in order to become reemployed rapidly after a layoff may not seem to be a very valuable alternative); and, partly because the existence of various governmental income maintenance programs has increased the viability of unemployment.

4. We assume he means *real* GDP, for certainly, the process Rothbard describes is an inflationary one, which fact alone could easily account for an increase in measured nominal GNP.

5. This is not to suggest that the Smoot-Hawley tariff and faulty Fed policy that failed to prevent a massive secondary (monetary) deflation did not also play important roles in turning what should have been, if prior history were a reliable guide, a short, sharp downturn to correct the misallocations of the 1920s, themselves

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the result of faulty Fed expansionary policies, into the massive, widespread prolonged depression of the 1930s. They, of course, did. See on this Rothbard (1975).

6. Admittedly, shared by neo classical economist such as Tullock.

7. Higgs (1992) makes the case that the economy did not recover until early 1947, some 18 months after the end of WWII and many years after the conventional dates (anywhere from 1939 to 1942, depending upon the commentator) for the end.

8. We full well recognize that the term "The Great Depression" is now so enconced in the language that any attempt to change it would be either a hubristic venture or a Quixotic quest.

9. See in this regard Salerno's (1989, p. 142) very valuable explanation of "intertemporal complementarity."

10. See on this Lachmann (1956), Hayek (1941), Mises (1966), Rothbard (1983, 1993), Garrison (2001).

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