THE POLITICAL PHILOSOPHY AND THE POLITICAL ECONOMY OF PUBLIC REGULATION. AN APROPOS ON THE ULTIMATE CAUSE OF THE CURRENT CRISIS

Octavian-Dragomir Jora, Alexandru Butiseacă*

Abstract:

In this paper we will briefly comment on the political philosophy (that is, considering the relationship among various types of normative judgments – as those of moral, ethic, legal nature) and on the political economy (that is a critique of interventionist policies, in a means-ends dialectics) of the regulatory setup orchestrated by public authorities. We will analyze them given their particular nature (State-made endeavors, where the State is the social apparatus of legal, but not necessarily rightful, coercion and compulsion), and emphasizing the necessary qualitative outcomes derived from their very nature; and, finally, providing a possible way of rethinking the regulation-driven or deregulation-driven crisis dilemma.

Keywords: ethics, economics, regulation, deregulation

The stake of the "de/re/regulation debate"

The economists' guild is divided, among other issues regarding the current crisis, also on the theme of the nature and impact of the regulatory mainframe, preceding the current downturn, on the emergence of the whole turmoil. What for some was the "fire-starter", for others was the only "extinction/prevention" imaginable (insufficient as it was, since the crisis finally started). If for some the deregulation preceding the current crisis (like abolition, at the beginning of the 80's, of Regulation Q from Glass-Steagall Act (1933), which aimed at controlling interest rates; the accomplishment of cancelling Glass-Steagall Act in 1999 by removing the interdiction to combine commercial banking and investment banking activities etc.) unleashed the so-called "irrational forces of the market", launching them in a unsustainable speculations in the real estate and financial territory, for others it was quite the regulatory residuals (the statist management in the sphere of money and banking or pieces of legislation, such as Community Reinvestment Act from 1977, giving disadvantaged categories of people access to owning houses, despite prudent credit principles) that created the premises for the 2008 wreck. In this paper, we will briefly comment on the political philosophy (that is, considering the relationship among various types of normative judgments – as those of moral, ethic, legal nature) and on the political economy (that is a critique of interventionist policies, in a means-ends dialectics) of the regulatory

* Octavian-Dragomir Jora is Assistant Professor, PhD Candidate, Bucharest University of Economics
Alexandru Butiseacă is Assistant Professor, PhD Candidate, The Romanian-American University

setup orchestrated by public authorities, given their particular nature (State-made endeavors, where the State is the social apparatus of legal, but not necessarily rightful, coercion and compulsion), and emphasizing the necessary qualitative outcomes derived from their very nature, and, finally providing a possible way of thinking the regulation-driven or deregulation-driven crisis dilemma.

An indisputable fact is that the economic reality standing before us is, as Ludwig von Mises would say, complex – the result of some various factors with antagonistic influences. This thing also has consequences in the debate area (even in genuine, honest debates; all the more when demagogy intervenes), because the actors - as far as historical facts are taken as referential – can virtually endlessly immunize their arguments and positions. In such wise, regulation supporters can state, regardless of how much regulation there already is, that there isn't enough, or that there isn't quite the best formula (and regardless of the little deregulation produces, it is enough to be blamed for all the problems); and vice versa for deregulation supporters. There is a way out of this (merely political) deadlock, and that is the return to a theoretical debate. In social sciences we are condemned to not even understand the daily phenomena if we don't already operate (whether we realize it or not) with a theory, be it derived from political philosophy or political economy. In this manner, the dialogue can continue if the debating parts raise their eyes from the facts and resume to theoretical debate, explaining how, in principle and in general, the crisis results from deregulation (statists) or, on the contrary, from Government intervention (liberals). To the extent that those two theories claim contradictory things, they cannot be both right at the same time, at least for those still operating with the classic and, by the way, "natural" Aristotelian logic.

A political philosophy view on regulations

This paper starts from the faith and conviction that *the intellectual adventured in the social sciences* who is not supported by a logically consistent and naturally realistic (political) "philosophy", a logically consistent and naturally realistic "ethics", will enter "unarmed" the arena of scientific knowledge, while he will enter, if interested, the political arena with an entire "rack" of *vicious* judgments. The regulation/deregulation discussion is a hypostasis of a broader debate on the need *to maintain under strict control the human behavior*, eventually by *legally keeping it away from immoral territory*. The current crisis was explained also as a slippage toward immoral habits – greed, carelessness, moral hazard opportunism, besides… rough stupidity, incompetence and ignorance. Consequently, the advocates of regulations state that these propensities have to be tamed by… law.

The main theoretical problem is raised: deregulation/under regulation in relation to what? To talk about "deregulation" or "under regulation" implies to subsidiary accept a main standard regarding regulation, a problem that takes us at the heart of law theory. This isn't the place to expand the main debate with respect to this problem (natural law versus positive law), but Hayek's (1973) or Leoni's

(1991[1961]) observation suggests itself, observation according to which, when developed without founding criteria/principles, "the law" perverts itself, becoming arbitrary and discretionary "legislation". From tool of general interests it becomes one of special interests and rent-seeking pursued with public policy tools (which could turn out to be extremely efficient in this view). So, from the perspective of political philosophy looking for a "standard" in order to judge regulations becomes crucial.

First of all, we will distinguish between *ethics* and *morality*, in other words, between *justice* and *virtue*. We will name *ethical* behaviour "the limited meaning of justice" – "don't take the other's right" –, meaning non-aggression and the "sacred" respect of private property, and *moral* or *virtuous* behaviour "the comprehensive meaning of justice", respectively – "work all virtue". When saying *virtue* we will choose the meaning attached to it in the Christian tradition, pointing that, without any other further inquiry in "comparative moral religious systems", there is an evident *common denominator* in moral traditions across cultures, isolating a common core of virtues. We will summarize the announced two investigative levels connected by a… logical relations: the ethical level and the moral level.

Just/ethical level: The ethics of liberty and private property succeeds to give a rational answer to the question "when is physical violence *allowed* from a social point of view? (*Not advisable! Forgiveness still exists*.)". The answer is: only for legitimate defence of the person or the property against physical aggression, or for the purpose of obtaining due remedies further to such aggression, and only from the aggressor, and only for the victim or their agents. The ethics of non-aggression, freedom and property is *the only ethical position which may be universalized and which is non-contradictory when applied.* The importance of this level is that it is/should be *the critical etalon in laws/legislation making*.

Moral level: The actions are here divided into *moral (virtuous)* and *immoral (vicious; non-virtuous)*. The essential dissimilarity with ethical conduct occurs due to the fact that the moral level supposes some virtually *unlimited* means to work virtue (defined from the religion or philosophy point of view, in accordance with a personal *Weltanschauung* as assumed or accepted by the community), possibilities that go from the minimum threshold assigned by the ethical level (do not transgress your fellow's freedom and legal area – in other words, the legitimate private property) up to the maximum limit of self-sacrifice for the other's sake. Immorality includes in-ethics, but is more comprehensive. The differential between non-virtue and aggression may be strictly sanctioned by non-aggressive opprobrium (e.g., the greed, the carelessness, the selfishness manifested within the strict limits of the *property* of the immoral person deserves no more than "blame & shame".)

So, given the *unlimited* nature of virtue, of the moral facts in the most comprehensive meaning, to include some moral elements at the ethical level would be equivalent to giving a blank check to those invoking the said principle

on all those they had in view as not enough virtuous and "therefore" legally punishable. If the entire *virtue* becomes *duty* (to be extracted even by force if necessary) towards third parties, it may reasonably bring the question of claiming the supreme sacrifice of someone for our sake. To generalize this possibility results in unimaginable consequences for the right order (which would be anything but order). As – like a world in which the presumption of guilt would be valid instead of the presumption of innocence – everybody would be permanently guilty. Because who would pass and elude brilliantly the test of having done "everything" under a given circumstance?

Therefore, does it make any sense to pretend to regulate greed in order to avoid crisis, or, rather, the only thing that should be tackled by a sound law is the aggression against someone's person or property. And, if the State is naturally associate with this kind of invasive behavior, wouldn't be the case to simply outlaw this behavior, and reframe its actions solely to securing lives and properties of individuals without harming anyone, that is by deregulating – otherwise put, from abolishing aggressive institutions and policies?

A political economy review on regulations

Moreover, when the law tends to go beyond what is strictly necessary to ensure the integrity of the non-aggressors' property, it places itself in a truly calculation chaos. Because, for instance, what is the main limit of the interest or exchange rate, or of the proper balance between equity and debt in banking? Etc. Any regulation with respect to features that have entrepreneurial character (that refer to particular future circumstances of place, time, and persons) is clueless, committing legislation to coordinates which at a particular time seem adequate, only to later become stale (moment at which the Government clearly produces "public bads", let alone public goods). And particularly because of that, in its classical meaning, the law was considered to address general aspects of human interaction and not factual, particular (and absurd) ones (i.e.: houses have to be red; carrots have to cost 2 euro/kilo, etc.).

Another problem that corrupts the correct reference to deregulation stems from the classical problem of interventionism instability. Briefly, this theory asserts that state intervention in the economy – considering economy to be in itself a system and an interconnected structure – can never be just punctual, targeted and strictly limited, but will inevitably put the authority in front of the unavoidable effects on adjacent sectors to those where intervention took place, effects that have to be "solved" by new interventions (gradually accumulating interventions) or by removing the previous interventions that generated them. If the first approach is pursued, the interventionist economy in question is gradually heading toward socialism (the system of "comprehensive intervention"); if the second approached is embraced, then it is heading towards a more purely free market system (Mises 1998a, Chapter 3).

This being said, if at a certain time a bundle of interventions are designed to consolidate each other in a certain state of stability (apparently, at least) and

one of them, by “deregulation”, is dropped out, it is very likely that the situation will become, at least at the superficial level of perception, if not also substantially, even more unstable. But it is here that the problem arises: if interventions make a system, and a few of them are eliminated and instability is obtained, it may seem from this that re-regulation is in order (or re-intervention when this was eliminated). But also this situation may suggest – or necessarily does – that deregulation hasn’t gone far enough to eliminate the whole bundle of interventionist instruments.

At the end of these observations, we want to make a reminder that the free market is fully equipped to handle “the production of regulation”, a production incomparably more dynamic, more flexible and well adapted to entrepreneurial (and not only) needs than the statist/governmental one. Private commercial law, together with commercial and business practices, has its origins somewhere in the international trading activity of medieval merchants. Furthermore, private arbitration is currently considered the most effective method (without anyone doubting its correctness) to solve disputes, the public judicial courts way being recognized as a quasi-dead end. It’s worth concluding for now, we think, with this: from a liberal perspective, perhaps the best thing the state could do would be to make way for private supervisory and regulatory institutions. As for morality, the economics of voluntary social / communitarian inclusion or exclusion provides the best law.

The (de)regulation and the subprime crisis

A proven fact though is that an economic crisis is also an intellectual crisis in the economists tribe. Three characteristics interest us such phenomena: they come from somewhere (are recurrent), appear in the industry of financial assets (for example real estate) and sit on clusters of errors (not just a bank or developer that fails, but clusters of them). A non-mystical explanation though exists. Ludwig von Mises and Friedrich Hayek found it a long time ago: this is the… regulated expansion of credit.

The reasoning is simple enough: this expansion is made possible precisely by the organization/operation of the regulated modern banking system (fractional reserves, central banking, and *fiat* money). It has a complex source: first, the production (and hence the expansion) of fiat money is made by the central bank (the State monopoly of monetary production), which creates the framework by setting the volume of “reserves” in the system; then, through the fractional reserves system, banks take part in the expansion, becoming – within the limits prescribed by the rules of minimum reserve requirements (RRs) – co-creators of money along with central bank (the so-called mechanism of the multiplication of credit). (The basic feature in modern banking is no longer the non-coverage of demand deposits with reserves, but the elimination of any distinction between demand and term deposits, which makes virtually all bank deposits de facto demand deposits.)

It was Mises (1953) who realized that the production of additional money through the modern banking system does not stay at the level of simple inflation (generating only uneven price increases and redistribution), but also affects credit and the interest rate, and altogether produces changes in the inter-temporal structure of production. And that because the new money first enters in the form of credit in the banking system, influencing (lowering) interest rates, without this being "taken into consideration" in the rest of the production structure. Therefore there is a mismatch/incompatibility between the interest rate (which decreases) and the rest of prices structure (which for the moment remain unchanged). Of course this incompatibility occurs only if the credit expansion is not anticipated; if it is, then the interest rate does not decrease, being adjusted with the anticipated inflation.

So, if there is unanticipated expansion of credit in the system (the cumulative result of pumping reserves into the system by the central bank and of multiplying credit through the fractional reserve mechanism), the interest rate will tend to fall below what it would have otherwise been, which is misleading for entrepreneurs. They, perceiving a relief regarding the access to capital, will launch themselves into more ambitious investment projects ("longer", more capital "intensive"), relying on the illusory existence of higher real savings, consistent with the new vision (more optimistic) on the inter-temporal structure of production. Things go apparently great until the entrepreneurs and employees from the area of these new initiated investment projects "meet" at the market with the people wishing to exercise their present consumption at levels consistent with prior interest rate, because the structure of preferences has not changed. This was only falsely suggested by the artificial expansion of credit. This "clash" begins to occur immediately, but becomes obvious only gradually, its main symptom being prices' increase. This immediately raises problems for entrepreneurs who have initiated "longer" projects which, in light of the new prices, no longer seem so profitable. (In the light of the new prices, interest rates also tend to be corrected back upward).

Thus a turning point is reached: either credit expansion ceases and unsustainable projects are liquidated – liquidation matching the expansion in importance; or, still confident in its own money management capabilities, the central bank facilitates again, implicitly even more, the lending conditions through a new round of credit expansion. The cycle repeats: back into the seemingly profitable projects and perhaps even new ones will be initiated. Once again the investment atmosphere is an optimistic one, and the interest rate is lower than it would have been otherwise. To the extent that not even now people's preferences for consumption versus saving/investing have not changed, the meeting between the recipients of new money resources and the rest of the population puts again upward pressure on prices (and interest). (The subprime crisis of 2007 is the daughter of the one exploding in 2000 that marked the ending of the dot.com bubble economy on US stock exchanges. And that one is related to a previous boom in mid-90s and, recurrently, so on and so forth…).

In order to avoid the deflationary consequences of the 2000 bust plus the "9.11", the Fed decided to sponsor a suite of interest rate reductions, to less than 1% (in the summer of 2003). M.O. – classic, by crediting the mandatory reserve accounts kept by commercials banks in the Federal Reserve System. On these new reserves, banks created new deposits, on which more borrowing could be made to the mathematical limit of the credit multiplier. The increase in credit availability reduced both the interest rate and banks' prudence. And the banks, naturally looking to maximize profits by using all available resources, opened their gates to clients with a credit history and rating ridiculously low. In 2004, the Fed started to fear the inflationary effects of its cheap money policy and slowly raised the interest rate, in order to reduce the propensity for credit expansion. The volume of credit entering real estate was drastically reduced, house prices fell, and multiple underperforming mortgages started to pressure on banks' liquidity. Banks, in turn, not only stopped lending but went looking on the inter-bank market for money to plug their balance sheets. But the subprime crisis did not appear because the reference interest rate rose with almost 4 pps in from 2003 to 2007. That's why it happened earlier. (Memento: on the free market, the deposit interest rate is determined only by the time preferences – saving vs. consumption – of all market actors. If it decreases by fiat rather than because an increase in saving, the investors, who cannot see the trick behind the number, enter large investment projects, time-consuming as well, that beforehand were downright unprofitable. Investors should now some economics too, and figure out what the central bank is doing to sift good from bad in the interest rate. Banks should also not speculate on a large scale this lack of precaution – and form the above mentioned clusters of failure. (The central bank should also not let commercial banks err in their ways, though without sapping the purpose of the banking system with excess regulation, on top of the existing one.)

The increase in the reference rate only hurries the inevitable disclosure of errors. The guilty party is thus Greenspan the Expansionist of 2001 rather than Greenspan the Anti-Inflationist of 2004. And, by any standard, a monetary policy prompted over a fractional reserve banking system is not an offshoot of free market, but one of pure regulations. And, moreover, it was something that channelled the fake monetary affluence to the most unfortunate debouche: the Community Reinvestment Act, fighting discrimination and supporting social inclusion by means of easier credit to members of poorer suburban communities. (As a funny coincidence, a CRA rating is required for the approval of mergers and acquisitions in the banking system.) The perverted behaviour could be logically linked with unwise regulations, not with the lack of regulations, having in mind that the free market, based on the sacred respect for person and property, is by its very nature, inclined to born the just amount of business regulations, without confusing puritan morality or hard-core democracy with natural and rational legitimacy, as a both non-conflictual and efficient premises for social order.

Conclusions (and a common-sense advice)

The crisis tend to be rather associated with certain behaviours nourished by certain regulations (in central and commercial banking or in welfare entitlements territory), than with pure (free) market excesses. They have in common the departure from the standard of natural rights that should be protected in society (even by the State). When public authorities tend to exceed the limit of regulating, they invariably do it for the benefit of some and at the expense of others. This creates incentives for opportunistic behaviours, be they unethical or immoral. Their consequences, given their unsound and unsustainable premises (which conflict with the very *law of scarcity*, the censor for any societal project aiming at non-conflict and efficiency) are dramatic, and the corrections necessary are as painful as necessary. In the above logic, the only thing a government should aim for is not to refuel the vicious circle of unwise regulations and privileges.

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