Government Bailouts

From the perspective of the Austrian School

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Abstract

The subject of this essay is the effects of government bailouts on economic prosperity from the perspective of the heterodox Austrian School of economics. Proponents of the school see economics as the science of the logical implications which can be inferred from the ultimate given of human action. They also object to use of broad economic aggregates such as GDP to reach conclusions about the health of an economy. The essay's conclusions are that government bailouts act to preserve valueless production as well as to prevent valuable production from ensuing. Furthermore, they act to decrease the overall production of an economy since they extract resources from the private sector which is more capable than the public sector to allocate resources in a productive manner. Government bailouts also create a problem of moral hazard in the form of an incentive to take on excessive risk. Therefore, they act to increase the danger of bankruptcies, impoverishing society as a whole.

Key words

government bailout, Austrian School, government intervention, business failure, resource allocation, capitalism, economic prosperity, moral hazard, expropriation, perverse incentives.

Prologue

This essay is a final assignment for a bachelor degree in business by the faculty of business at Bifröst University. The assessment of this essay is 14 ECTS credits. The work was performed from May 2010 till August 2010.

The subject of this essay is government bailouts from the perspective of the Austrian School of economics. Issues of resource allocation relating to the issue of bailouts as well as the moral hazard problem of bailouts are covered in-depth.

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I, undersigned, have done this essay on my own and in full accordance to the regulations and demands of Bifröst University regarding work of final assignments in undergraduate studies.

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i. Introduction

The recent US government bailouts and the following public outrage were what sparked my interest in the subject of bailouts in general. The bailing out of American institutions and private companies in 2008 and 2009 were costly[1]. These bailout decisions seem to have been taken quite haphazardly as they have no discernable pattern. While Bear Sterns, Fannie Mae, Freddie Mac, AIG, Citigroup, Bank of America and the Detroit Three[2] got bailed out, other supposedly too big to fail institutions like Lehman Brothers were allowed to fail.

The US government has said that by bailing out these entities, it was rescuing the financial system and the economy in general from a financial meltdown and preventing a precipitous rise in unemployment. These institutions and companies were supposedly 'too big to fail', that is, they were too big for the public to let fail since their failure could mean the fall of the entire financial system or trigger a domino effect of failing entities which would lead the economy further into a state of recession or even depression. According to this rationale, nonintervention into the economy would have been more costly than to intervene. (Raum & Aversa, 2008)

Economists are by and large divided on the issue of bailouts. Some say that government bailouts are a necessary departure from free market forces in times of crisis while others criticize some bailouts but not others, choosing to judge each rescue on its own merits, while still other economists reject all bailouts on principle. The root cause of these differences of opinion can in many ways be traced back to differences in economic thought.

Following the current global recession, it is a popular opinion that the free market is to blame. The recent deregulations in America have allowed market participants to exercise bad business practices on a large scale, eventually dragging the economy down with them. Now, the government has to intervene with the economy even more, as it clearly has not been able to adequately manage the destructive forces of the market. (Ritholtz, 2009) Others claim exactly the opposite. They claim that the market has not been able to function properly since it is not free enough. The market is heavily burdened with government interventions and the current global recession is a consequence of that fact. Hence, in order for prosperity to ensue, the government needs to lessen its role in the economy, starting by putting a halt on all further government interventions, like bailouts for instance, intended to rectify the unintended bad consequences of former interventions. The government should allow the free market forces to use its corrective powers to properly reallocate

[1] As of August 4th 2010, $538 billion has been spent, invested or loaned by the US government in relation to bailouts. (ProPublica, 2010)
[2] General Motors, Ford and Chrysler

society's scarce resources, since their misallocation caused the recession in the first place. The biggest proponents of this viewpoint today are the members of the Austrian school of economics. (Woods, 2009)

The Austrian School is a heterodox school of economic thought which rejects all government bailouts on principle since it is a school which promotes the free market and a laissez faire approach to the economy. Following the current global recession, the school has experienced a resurgence of interest, most likely because of a large absence of a prediction of the crisis within the scene of orthodox economics. In this essay I will explore the theories of the Austrian School of economic thought and apply them to the issue of government bailouts.

ii. Scope and research question

In this essay I will explore the effects of a government bailout of a private company on economic prosperity, mainly long term, from the perspective of the Austrian approach and theory of economics.

In particular I will explore if the preservation of national employment and in turn national production via a government bailout will serve to forward economic prosperity in the long run.

The role of moral hazard, especially from an Austrian perspective, in relation to government bailouts will be also explored. Lastly, policy recommendations will be offered based on the conclusions.

Government bailouts of financial institutions and companies involved in national defense or mobility in its widest sense will not be explored. That is because their failure poses a risk of financial system failure, economic infrastructure failure or puts the security of a nation at risk. While the arguments in this essay can also apply to these institutions and companies to some extent, the complications posed by the nature of these entities would serve to undermine the focus of this essay on bailouts of private companies. The more fundamental issue for those entities is whether they should in the first place be able to enter a situation where a bailout may be necessary, as opposed to whether they should be bailed out or not. For those entities, the discussion of whether their purpose should be conducted within the economy in a different manner, for example whether they should be nationalized or privatized or if the fractional reserve banking system should be abolished, is more relevant. Hence, the bailouts of these entities will not be of focus in this essay.

The research question is:

'What are the effects of government bailouts of private companies on long term economic prosperity from the perspective of the Austrian theories of economics?'

1. Bailouts

1.1. Definition

The term 'bailout', means, simply put, 'a rescue from financial distress' (Webster, n.d.). A more detailed definition follows as:

> *A situation in which a business, individual or government offers money to a failing business in order to prevent the consequences that arise from a business's downfall. Bailouts can take the form of loans, bonds, stocks or cash. They may or may not require reimbursement.* (Investopedia, n.d.)

The term can be extended to mean the act of an investor buying a floundering company in order to prop it up or when a philanthropist buys an unprofitable business in order to convert it to a charity. However, the bailouts we are concerned with in this essay are only those done by governments. To understand the term of bailout more deeply let us briefly consider its origin. The originator of the term is not known but it is clearly a metaphor referring to the act of removing water from a leaky boat, or a good boat in a bad storm, and the act of paying money to a court so that someone can be released from prison until their trial. The leaky boat and the prisoner can be thought of as the financially distressed company and the water remover and the bail money provider are the ones providing a bailout. In the same manner, the bad storm can be thought of as the times of economic turmoil.

While the scenarios are different they are both about saving someone who is in trouble and has usually gotten there by himself, either by sailing in unsafe waters or by breaking laws which they should be aware of, referring to the rationale of government bailouts critics; companies should bear their own losses. Also, the bailout is not necessarily out of kindness; a person removes the water from a leaky boat which he occupies as much to save his own skin than the one of others. This scenario is comparable to the supposedly increased systemic risk which governments have to deal with in times of economic turmoil; they will intervene in the economy in their effort to mitigate the recession. The scenario is also comparable to the nature of the government to enact on popular policies in order to stay in office, but in that context they do not remove the water from the boat in order to save their own skin, they do it in order to prevent being kicked off the boat.

With the somewhat negative synonyms of the term of bailout, the popularization of the term in matters concerning government rescues from financial distresses has been a blessing for critics of government bailouts. While governments and proponents of bailouts have sometimes opted to call the act a rescue or an investment, the term 'bailout' will be used throughout this essay as its definition provides the most accurate description of the phenomenon in question.

1.2. History of government bailouts in the US

The United States will be the point of attention since being by far the biggest national economy in the world (World Bank, 2010) it provides the most projective examples of company bailouts. The goal is not to get lost in the technicalities of the bailouts but merely to quantify them and look at the official rationale for them. All amounts are presented in 2008 U.S. dollars. Bailouts of companies and institutions which can be considered a part of the financial system or are strictly speaking paramount for national mobility or security will not be mentioned, apart from the Lockheed bailout since it marks the first bailing out of a private company within the US.

The US government made its first bailing out of any single company in 1971. The company was Lockheed Aircraft Corporation and was in the form of loan guarantees worth $1.4 billion. In relation to the bailout senator William Proxmire coined the term 'corporate welfare' to describe the government's special treatment of the company. The rationale for this bailout was national defense as well as potential loss of employment and national production. (Ritholtz, 2009)

In 1980, The US government bailed out automobile manufacturer Chrysler. That bailout came in the form of a $4 billion loan, and its stated motive was to save 200,000 jobs. The American automobile industry as a whole, mainly the Detroit automakers General Motors, Ford and Chrysler, which was being bailed out the 2nd time over, were bailed out in late 2008. The bailout package was in the form of low-interest loans amounting to $25 billion and was enacted in order to avoid a rise in unemployment and a loss in production. (Nankin, Umansky, Kjellman, & Klein, 2009)

As we can see, the official rationale is most often the preservation of employment. The goal of these bailouts was mainly, except for the national defense consideration of the Lockheed bailout, to prevent unemployment figures from rising, and in turn, to prevent national production numbers from dropping. As the measure of unemployment and national production are two of the main economic indicators in which people gauge in order to assess a nation's economic performance, any government has a built-in incentive to keep those indicators in good shape, especially for the duration of their stay in office, that is, in the short term.

2. The Austrian School

The Austrian School is a heterodox school of economics which has its roots in the philosophical foundations of libertarianism and classical 19th century liberalism. Its proponents advocate a free market, laissez faire approach to the economy and are more or less entirely against government intervention in the economy. Members of the school advocate a strict adherence to the analysis of human action exclusively from the perspective of the individual agent as the driving force behind economic activity and change, as opposed to the analysis of institutions, classes, or broad economic aggregates such as GDP or general price levels. (Boettke, n.d.) In this essay I will refer to proponents of the Austrian School as 'Austrians'.

Contributions of the Austrian School to the profession of economics are numerous. They include the justification of a free market economy over a centrally planned one via an explanation of the economic calculation problem that a socialist planned economy faces. Austrians contributed to the development of the subjective theory of value and consequently were involved in the development of the neoclassical theory of value. Proponents of the school also developed a theory on the business cycle called the Austrian theory of the business cycle. Notable diversions from the orthodox schools of economics are the Austrian's distinct view on government interventions, inflation, business cycles and the method of economic inquiry. (Boettke, n.d.)

Seeing private property rights as the most rational mechanism for allocating scarce resources in accordance with the wishes of consumers (everyone in an economy), Austrians highlight the *de facto* coercive nature of government interventions into the market and the distorting effect they have on incentives. While few Austrians go as far as to recommend total abolishment of the government, most of them want the government to be of minimal magnitude and all Austrians are wary of government expansion. (Callahan, 2004)

Austrians also object to the use of fiat money and promote the use of commodity money like gold. Another key issue for Austrians is their view that by imposing a single national legal tender which can be produced out of thin air, acts to create errors on a massive scale via inflation. (Hülsmann, 2006) On the topic of inflation, Austrian economists argue against the neoclassical focus on general price levels and fluctuations, contending that such changes are not inflation but the *symptoms* of inflation. Austrians still adhere to a definition of inflation that once was a part of the general economic vernacular, but dropped out of fashion after the post-WWII

Keynesian[3] revolution; that any expansion of the money supply is by definition inflation, rather than just potentially ‚inflationary'. (Schiff, 2010)

Some Austrians oppose the idea of fractional reserve banking. They contend that the system will inevitably lead to banking crises as banks are not obliged to back up each claim to money with actual money, resulting in an unsustainable excess of credit creation. (Woods, 2009). Austrians have always opposed the establishment of central banking within economies, claiming that they cause unsustainable economic booms, namely credit bubbles, by artificially setting interest rates in the economy through the fixing of the price of loanable funds. This contention is based on the Austrians unique view on capital; unlike neoclassical economists, Austrians view capital as heterogeneous, as opposed to homogenous. While goods that are directly consumable are goods of the first order or consumer goods, goods whose value comes from their aid in producing consumer goods, are called goods of a higher order, or capital goods. Capital can be arranged into goods of the second order, which are used to produce consumer goods, and goods of the third order, which are used to produce goods of the second order, and so on. As the order of capital goods gets higher, more savings are required for them to be profitably produced. This means that as the interest, which is the price of savings, gets lower, projects requiring a higher order of capital goods are deemed to be more profitable. But as the interest rate which a central bank sets is not a reflection of the preferences of consumers, this will inevitably result in the eventual realization of the unprofitability of ensued investment project which have already gone underway. This is when the alleged credit bubble bursts. (Callahan, 2004)

We will continue our examination of the Austrian School itself by looking at its history. Then we will examine its method for economic inquiry which is different from the neoclassical method. We will then end our examination of the school by studying its criticisms.

2.1. History

The Austrian School of economics draws its name from the fact that most of its early members were from Austria. The founder of the Austrian School of economics is considered to be Carl Menger (1840-1921) who was a classical liberal and methodological individualist in part influenced by French liberal theorist Frédéric Bastiat (1801-1850). Menger saw economics as the science of individual choice. His work, *Principles of Economics* (1871), is considered to be a starting point for the Austrian

[3] Keynesian economics is a macroeconomic theory based on the ideas of the 20th century British economist John Maynard Keynes. Keynesian economics argues that the private sector decisions sometimes lead to inefficient macroeconomic outcomes and therefore, advocates active policy responses by the public sector, including monetary policy actions by the central bank and fiscal policy actions by the government to stabilize output over the business cycle. (Sullivan & Scheffrin, 2003)

tradition of economic thought. At some level, every Austrian since has seen himself as a student of Menger. Menger is famous for his contribution to the development of the theory of marginal utility, explaining how the greater the number of units of a good that one possesses, the less he will value an additional unit. The theory, which is considered to be a revolution within the profession, provided a solution to the famous diamond-water paradox within economics. (Callahan, 2004)

Eugen von Böhm-Bawerk (1851-1914) later expanded the theories of Menger and applied them further to problems like the ones of value, price, capital and interest. In his work *Positive Theory of Capital* (1889), Böhm-Bawerk explained the workings of capital and in turn how the exploitation theory of the Marxists was wrong long before the communists came to power in Russia. His contributions acted to solidify the ground of the Austrian School as a unified way of looking at economic problems. One of Böhm-Bawerk's students of note was Joseph Schumpeter which popularized the term 'creative destruction' in economics, which will be discussed in this essay. (Callahan, 2004)

In 1912, Ludwig von Mises, the most prominent figure of the Austrian School, published the book *The Theory of Money and Credit*, where he showed how the theory of marginal utility applies to money and offered a theorem showing that money must always originate in the market. He also presented the outline of the Austrian theory on business cycles, which is one of the school's most prominent theory to date. Mises predicted, in his book *Socialism* (1921), that the execution of the social order of socialism would result in chaos. Mises and his student, Friedrich Hayek (1899-1992), authored many books on the business cycle during the 1920s and 30s and this work was rewarded with the shared grant of the Nobel Prize in economics to Hayek in 1974. Hayek's popular book, *The Road to Serfdom* (1944), helped revive the classical liberal movement in America after the New Deal (a series of economic programs enacted by US president Franklin Delano Roosevelt from 1933-1938) and World War II. (Callahan, 2004)

The economic treatise by Mises which is thought to define the Austrian School, *Human Action*, was published in 1949 but got poor reception since much of mainstream economics had taken a decisive turn towards Keynesism. Henry Hazlitt (1894-1993), an American journalist and libertarian economist, became one of Mises's most prominent admirer and popularized his ideas in books such as the highly accessible *Economic in One Lesson (1946)*. Hazlitt is credited for bringing some of the works of Mises and Hayek to public attention with his reviews of their works in *The New York Times*. He also made his own contributions to the Austrian School, with, for example, his published critiques on Keynes's magnum opus *General Theory of Employment, Interest and Money* (1936). (Callahan, 2004)

During Mises's stay in America, his most prominent student was Murray Rothbard (1926-1995). Rothbard's book *Man, Economy, and State: A Treatise on Economic Principles* (1962) is considered to be one of the most important books of the Austrian School and served to strengthen Mises's own views. The works of Rothbard have served as a link between the Mises-Hayek generation and the Austrians working today. The Ludwig von Mises institute, founded in 1982, is presently the biggest promoter of the ideas of the Austrian School. Prominent figures of the school today are the republican U.S. congressman and author Ron Paul and his former economic advisor, author and 2010 United States Senate candidate Peter Schiff, as well as authors Israel M. Kirzner and George Reisman (Callahan, 2004)

2.2. Method for economic inquiry

This chapter is mostly based on the worsk of Immanuel Kant and Ludwig von Mises on epistemology in general and the epistemological foundation of economics in particular. Since an extensive examination of these philosophical considerations is beyond the scope of this essay, its subject will be covered in broad strokes.

Since the second half of the 20th century, empiricism has become the dominant approach to economic inquiry within neoclassical economics. The empirical approach is to create a hypothesis by making observations using the physical senses, and to verify them by examining cause and effect. The Austrian school rejects this approach and advocates the use of logic to acquire economic understanding (Hoppe, 1995). Now we will go on to see why.

The concern of scientific methodology raises the very first question an economist must raise: 'What is the subject matter of economics, and what kind of propositions are economic theorems?' Mises's answer to that question is that economics is the science of human action. (Hoppe, 1995) Furthermore, Mises states the following about the science of economics:

> *Its statements and propositions are not derived from experience. They are, like those of logic and mathematics, a priori. They are not subject to verification and falsification on the ground of experience and facts. They are both logically and temporally antecedent to any comprehension of historical facts. They are a necessary requirement of any intellectual grasp of historical events.* (Mises, 1966)

Mises uses terminology and insights from the philosophy of Kant to arrive at his conclusions about the epistemological foundations of the science of economics. Kant argued that all propositions can be classified in a two-fold way. On one hand, arguments are either a priori or a posteriori, on the other hand, they are either analytical or synthetic. A priori (prior to) statements are ones which can be justified before experiencing them, and a posteriori (posterior to) statements are ones who need to be experienced (are dependent on empirical evidence) in order to be justifiable. Propositions which are analytical are so because the means of formal logic is sufficient in order to verify their truthfulness; if it is not, they are synthetic. As analytical statements do not need to be verified by observation, they are not considered by empiricists to be knowledge of anything real. (Hoppe, 1995)

Austrians base their economic justifications on the deductive logic which is derived from a priori truths. It is this view of economics as an a priori science, whose propositions can be inferred through logical justifications, which distinguishes the Austrian School of economics from orthodox schools of economics. (Hoppe, 1995)

Neoclassical economists, who can all be regarded as empiricists, claim that a statement which is at the same time synthetic and a priori does not exist, or put another way, they deny the existence of statements of whose validity can be established, even though in order to do so the means of formal logic are not sufficient, but necessary, and observations are unnecessary. However, Kant and Mises, claim that these kinds of propositions do exist because their truth follows from self-evident material axioms, which are statements that are self-evidently true in the sense that an attempt to deny them would implicitly admit their truth. Because of human action, the gulf between the mind and material reality is bridged; hence the presence of observable evidence is attained. Therefore Mises called economics the science of action or 'praxeology', the logic of action, in order to emphasize its commonality with applied logic. (Hoppe, 1995) Because the term has not gained widespread use I will continue to refer to the profession, even when discussing Austrian views explicitly, as economics.

However, in order for human action to systematically bridge the gulf between the mind and material, it has to be a constantly given state. Let us now see why it is precisely that. The ultimate given in the social world is that humans always desire something; hence, while seeking relief of this dissatisfaction of their current state, they act. This is a necessary truth, since if humans were always completely satisfied; it would make no sense for them to act, jeopardizing the state of satisfaction. Even abstaining from action is a human act, since, for example, humans may decide to rest in order to alleviate their dissatisfaction with fatigue. Humans act from the subjective value they put on ends and means; they will pursue the action which they perceive as to provide them the highest marginal utility. People, somehow, do choose ends and do act to pursue them. The goal of economics is to explore the implications of these facts. (Callahan, 2004) Put more precisely, human action is:

> *... purposeful behavior. Or we may say: Action is will put into operation and transformed into an agency, is aiming at ends and goals, is the ego's meaningful*

response to stimuli and to the conditions of its environment, is a person's conscious adjustment to the state of the universe that determines his life. (Mises, 1966)

Austrians object to the use of empiricism in social sciences, which economics are a part of, and claim that when researching the actions of humans one must not use the same tools as are used in natural sciences, like physics and chemistry, which are devoid of the human factor. Because humans are both the subjects and the conductors of economic research, objectivity is farfetched and the Hawthorne effect, which is the prospect that humans will alter their behavior when they know that they are being observed (Encyclopedia, 2008), will always be a problem. Furthermore, as humans are capable of learning from experience and knowledge, hence modifying their decision making criteria over time, there can be no constants in human behavior. Consequently all empirical knowledge of human action will forever be historically contingent. This problem cannot be solved by forecasting future behavior for it is impossible to obtain information about future knowledge, since if this was possible, it would already be known and therefore could not be considered as future knowledge. (Callahan, 2004)

The Austrian School of economics does not apply mathematics or statistical methods in their economic research. They claim that the social world is too complex to be aggregated into mathematically tractable equations and that the application of them will always provide inaccurate insights based on faulty inputs. Indeed, Bryan Caplan, critic of the Austrian School, remarks that the empirical evidence on the contribution of mathematics within the profession is decidedly negative. (Callahan, 2004)

The use of mathematics within economics is based on the claim that humans are rational economic agents; that their behavior results in the same outcomes as 'a computer calculating how to employ certain 'parameters' to achieve an 'optimum' result'. (Callahan, 2004) Austrians deny this notion of a perfectly rational 'economic man' and claim instead that humans are creative and intelligent beings, and that they are intelligent precisely because their actions are not the outcome of a mechanical process like the one of a mathematical equation. Since there are no constants in human behavior over time, mathematical equations can only work to project the correlations between past actions and therefore are only a part of historical economics and cannot be fundamental laws of economics.

The subject of economics therefore is, in the Austrian view, not about the *correlation* between economic events but about the *logic* of them (Callahan, 2004) or in the words of Mises yet again:

The mathematical economists disregard the whole theoretical elucidation of the market process and evasively amuse themselves with an auxiliary notion [i.e., equilibrium] employed in its context and devoid of any sense when used outside of this context. (Mises, 1966)

In the past, the Austrian's position on economics was in line with the then-orthodox view of the subject. *The Nature and Significance of Economic Science*, written by Lionel Robbins in 1932, which came to very similar conclusions as Mises about the epistemological characterization of economics, was respected in the profession of economics as the main methodological guide for almost twenty years. Hence, Austrians consider the diversion of economic inquiry into empiricism to be the deviant approach, not theirs. (Hoppe, 1995)

2.3. Criticism

The strongest criticism of the Austrian School has been based towards the epistemological foundations of the school. Many mainstream economists contend that a priori knowledge cannot be knowledge of anything real (Friedman, 1953)and that the Austrian school is unscientific because of its rejection of the heavy integration of mathematics and econometrics within the profession. Because of the schools' rejection of empirical evidence in economics it has been largely dismissed within the mainstream. The Austrians answer this criticism by pointing out that because humans act; the gulf between the mind and material reality is bridged, making Austrian economics as much a part of reality as neoclassical economics (Caplan, n.d.), as action has no meaning outside of the world of actions – which is inevitably the real world. (Hoppe, 1995)

The Austrian business cycle theory, which views the origins of economic bubbles as the result of excessive credit creation, is regarded to be incorrect by economists Milton Friedman and Paul Krugman. Friedman examined the history of business cycles in 1969 and concluded that the theory is contradicted by historical evidence. (Friedman, 1969) Paul Krugman criticizes the theory in his article *The Hangover Theory* where he claims that the theory is intellectually incoherent. (Krugman, 1998) Austrians have replied to Krugman's criticism by contending that his analysis is based on a deficient model of the economy's capital structure (i.e. it assumes that capital is homogenous, not heterogeneous). (Murphy, 2009)

The Austrian theory of the business cycle has also been criticized on the terms that it cannot explain why recessions occurred before the creation of the Federal Reserve in 1913, which has the power to excessively expand credit via the fiat money system. Also, critics claim that the theory implicitly implies that bankers and investor are overly irrational and seemingly unable to learn from past experiences of credit bubbles and consequently being wary of the Fed's artificially set interest rates. Historian and Austrian scholar Thomas Woods offers solutions to these issues in his book on the current global recession, *Meltdown*. He claims that recessions occurring before the inception of The Fed can be explained by the fractional reserve banking system. Because American banks were not obliged to keep gold reserves (as of 1900 the US economy was adhering to a gold standard) in line with their amount of issued paper money, they created an unsustainable excess of credit and consequently created credit bubbles. (Woods, 2009)

As for the irrationality of economic actors regarding the interest rate set by the Fed, the answer lies within game theory. For example let us imagine company A and company B in an economy in which a central bank has just recently lowered the interest rates to a particularly lower figure than usual, and let us further assume that this interest rate is below the rate the market would have set. Company A is newly established, whereas company B is long since and well established. Company A utilizes the opportunity of cheap credit to its fullest extent and fiercely bids for labor in the marketplace, as it does not have much to lose but a lot to gain. Even though company B believes that the credit expansion will result in a bust, it has no choice but to participate in the boom by exploiting the cheap credit as well, since if it does not, it may well lose employees to temporarily highly competitive companies like company A. Company B can only hope that when the bust hits, its soundness will make the downturn less severe than for companies such as company A. (Woods, 2009)

3. On economic prosperity

Within the profession of economics, there are different views on the source and nature of economic prosperity. The definition of economic growth is the expansion of production. As more gets produced within an economy, the more amounts of resources are available to go around. This is true since the supply of an economy equals its demand; as the supply expands, consumers will be able to demand more. Hence, increased production acts to increase living standards. (Mankiw & Taylor, 2006)

The main *measure* of economic growth today is the *gross domestic production* (GDP), an indicator which measures the total spending and revenue (which are two sides of the same coin, one man's spending is another man's revenue) within an economy. As such, it measures the market value of all final goods and services officially produced within the borders of a country in a year. (Mankiw & Taylor, 2006)

Austrians and Keynesians, which can be considered as neoclassical economics, have a fundamental disagreement about the source of increased production. While Austrians contend that savings are the source of increased production, Keynesians claim that spending is the source. (Schiff, 2010) To see how this fundamental disagreement arises, let us look at how these two different economic camps look at the problem.

Let us consider a short story to illuminate the Austrian view on savings in the role to increase production. Imagine Robinson Crusoe stranded alone on a desert island. He has the capacity to catch two fish a day with his bare hands and does so each day. In order to stay alive, he only needs to consume one fish a day, but in order to stay properly fed, he eats two a day. One day he decides to create a fish net in order to further his capacity to procure fish. To produce the fish net, Crusoe has to concentrate his labor exclusively to the task for one day. So in order to create the fish net and live to tell about it, he has to under-consume one fish the day before. He has, in essence, exercised savings, since to save is to defer consumption. Because the fish net has capacity to catch more than two fish a day, Crusoe's act of saving has allowed him to increase his productive capacity. He has expanded economically. (Schiff, 2010). The story holds true whether we are talking about an economy consisting of a single individual, like in our story, or economies filled with millions of individuals. This is because of the fact that decisions within an economy are taken on the individual level. The demand for sugar within an economy is not derived from the economy itself but from the individual preferences of many people. Although people can act in combination with each other, any particular action is performed by only one person. (Callahan, 2004)

In contrast to the Austrian view, Keynesians claim that spending acts to increase production since increased demand sets pressure on producers to produce more. When aggregate demand falls, as in recessions, producers are forced to contract their production. Hence, Keynesians contend that during recessions; demand needs to be boosted in order to cover the newly arisen deficiency of demand. The new lack of the 'propensity to consume' by the public has to me made up for by demand from some other source. For the same reasons, most Keynesians claim that since savings are deferred demand, they lower aggregate demand and consequently act as to decrease production. Keynesians call this phenomenon the paradox of thrift. Austrians answer this claim by contending that while it is true that savings in the form of money slipped under ones pillow does not act to increase production, most savings will go to investments. That is because they will go to financial intermediaries like banks and investment funds, which will invest the savings. Now, it is also true that a bank might loan out this money to individuals who take the loan for the sole purpose of increasing their current consumption at the expense of their future consumption; as in which the loan makes society no better off. But savings are also channeled to businesses, where the loans act as an investment which will expand the economy's productive capacity when the businesses prove to be successful. Hence, savings in a modern economy essentially equals investment, and as such it acts to increase production in the future. (Hazlitt, 1959)

As we can see, Austrians and Keynesians have perfectly dissident views on the effect of savings within the economy. While Keynesians look at increased production as the consequence of increased consumption, Austrians look at it as the consequence of increased savings. But, as savings act to create capital, and capital is the source of productive capacity there would, in the Austrian view, not be any economic expansion without savings. Consequently, any government measure taken to decrease savings in favor of consumption will in the long run serve to impoverish, not enrich the economy. (Callahan, 2004)

To Austrians, the GDP measure is misleading when attempting gauge the future of economic prosperity of an economy. Consumer spending, investment and government spending and net exports make up the GDP. Facing the impression that GDP equals economic prosperity, as well as the fact that consumer spending and investment contracts during a recession, one could conclude that a recession should not necessarily entail lessened prosperity since the government can simply make up for the contraction in GDP by increasing government spending by the same amount. During a recession, Keynesians recommend doing just this in order to boost aggregate demand and consequently prevent a contraction in production. (Mankiw & Taylor, 2006) Austrians, on the other hand, do not recommend an increase in government spending since it takes resources from the private sector, where they are more efficiently allocated. Gauging GDP, they claim, is simply a way to observe the amount of spending within an economy, not whether an economy's resources are efficiently allocated or not, or to put it another way – a quickly rising GDP can just as easily be a sign of future poverty as future wealth. As the amount of production within an economy is contingent to the efficiency of the allocation of society's scarce resources, it does not act in favor of the economy to further spending *per se*. Hence, the goal of an economy should not be to increase its GDP, but rather to increase its production. (Hazlitt, 1959)

This illuminates another fundamental disagreement between Keynesians and Austrians; the view on the free market's ability to steer society's scarce resources to productive channels. Keynesians reach the conclusion that the workings of the free market often need to be overruled by government interventions, especially during a recession where market participants are in a state characterized by an excessive irrationality. Conversely, Austrians contend that the free market is always better suited to economize society's scarce resources. Furthermore, they claim that a recession is in itself simply a product of the realization of market participants that certain resources have been misallocated. As such, the reallocation of resources within the economy should be allowed to run its course without interruption, for market participants, through their collective wisdom, are much more competent for the job than a select few bureaucrats who cannot, however brilliant they may be, know the preferences of everyone within an economy. (Hazlitt, 1959)

To conclude, Austrians are spokesmen of the free market and savings as opposed to government interventions and spending in the role to increase production. They claim that as private enterprise is less burdened with government interventions like taxation, regulations and prohibitions, it is more capable to further economic growth. Austrians reach this conclusion because they see government interventions as an act which creates perverse incentives which distort the efficient allocation of scarce resources and therefore cause needless poverty.

4. Economics of government bailouts

This chapter will go on to explain the economic effects of government bailouts in their widest sense from the perspective of the Austrian School. Firstly, the function of the market in relation to production will be explained, and how the market deals with business failure as well as how government intervention hinders the process. Secondly, the lessons from Frédéric Bastiat's broken window essay and Joseph Schumpeter's concept of creative destruction will be applied to the case of company bailouts. Lastly, moral hazard considerations will be discussed in relation to bailouts.

4.1. Fundamentals of economics

To begin with, let us briefly discuss some of the basic fundamentals of economics in order to reach a more clear state of thought about the efficiency and welfare losses which stem from a government intervention like the bailing out of a private company.

The profession of economics deals with the management of society's scarce resources. (Mankiw & Taylor, 2006) Because society's resources are scarce but the needs and wants of people are endless, this limited supply of resources need to be allocated in some rational manner. Put simply, society's finite resources need to be economized. To achieve this end, a system is needed. The system which we will explore is the one of capitalism, which in its most basic sense is simply a system of survival of the fittest. Most individuals constantly strive to better their situation by achieving more wealth, and since in a capitalistic system most of society's resources go to those who work hard, capitalism encourages production, making society as whole wealthy. (Reisman, 1990) Contributions to society are most typically in the form of employment or the running of a company. Let us explore the nature of the latter kind of contribution.

In order for a private company to stay in business it must, generally speaking, offer some products and services which have an adequate amount of demand for them in order to provide enough revenues which will cover the company's costs. What this means is that consumers effectively decide which companies will stay in business and which will not. Of course, companies which keep their costs low are more likely to stay in business than companies which do not, but all companies must have an adequate stream of revenues in order to be able to avoid failure. Hence, only companies which contribute something of value to society will stay in business, or put another way: Society will not transact anything of value to companies who do not contribute something of value to them. (Hazlitt, 1946) As a side note, value is purely subjective and is created in the minds of consumers, but that does not make it any less important as the products and services being offered are only being offered to those who decide upon its value. (Callahan, 2004)

If a system is to work properly, it has to have strict rules and boundaries. One of the rules of capitalism is that when you fail to make a long-term profit, your business will fail without exceptions. This may seem harsh but without this rule there would be no measure of how good businesses are, since without bad businesses there would be no good businesses. You lose when you show more losses than profits, just like when you acquire a failing grade on a test, you have flunked it. Therefore it is essential to have a measure like this where everyone has to adhere to the rules if the system is to work as an incentive for people to contribute something of value to society. The prospect of profits is supposed to provide people with an incentive to take risks and the fear of losses is supposed to incentivize showing caution, creating a balance of risk taking and risk aversion. Making exceptions and stretching the boundaries of the system only serves to undermine its ability to fulfill its purpose; it makes people slack. (Reisman, 1990)

4.2. Business failure and unemployment

Companies need to have various resources tied to them in order to be able to produce their offerings. These resources can, for example, be in the form of human, physical and financial capital. When companies fail, these resources get freed up and therefore get the opportunity to flow into potentially more valuable projects. Business failure can therefore be looked at as a cure for the temporary unwise allocation of society's resources into this company. The marketplace, through the collective wisdom of every consumer in the economy, communicates its preference through its demand and sends the message that society's resources are not being put to a valuable enough of a use in this company. Subsequently the resources that get released from a failing company, stream into growing industries where healthy expansion is possible. (Hazlitt, 1946)

When companies fail, the workers at those companies lose their job. While losing one's job may be financially, and psychologically, distressing for an individual, it is not in the best interest of the economy to adopt the minimization of unemployment as a guiding principle. Employing people is only a means to the end of production. Production creates wealth and the rate of production is based on productivity or the measure of the efficiency of the production. Companies which have low relative productivity, that is, have higher rates of input per unit of output compared to other competing companies, are not likely to stay in business for long. That is because their costs are likely to be higher than their competitors' costs. While the failure of such a company may create short-term unemployment, the long-term effect is that the productivity of the economy as a whole will become greater because the resources of the unproductive company will enter a potentially more productive channel. This is true since labor and financial capital tends to seek profitable industries as they provide higher wages and higher investment yields. Essentially, the marketplace provides efficient employment of labor and capital through its desire for the most quality products and services for the least amount of money. (Callahan, 2004)

Therefore, even though most people would probably rather be employed than unemployed, maximum employment should not be the goal of policy makers but rather the one of maximum production. The end goal is production; employment is only the means to that end. Making employment the end will lead to the deprivation of productivity since more jobs can be attained by doing things less efficiently. For example, a government with totalitarian powers could easily achieve more employment by decreeing that the town hall exterior needs to be tidied by increased frequency for each month. Furthermore this government could achieve maximum employment by ordering every citizen to run in circles and paying them for it, but this is not likely to be very productive for society. Therefore, making employment the end, as opposed to production, is counter to the rational goal of getting the greatest results with the least effort and does not make economic sense. (Hazlitt, 1946)

When industries as a whole fall on the wrong side of the law of the survival of the fittest, chances are that the skills and expertise of the workers previously employed in this industry become obsolete. This can be very inconvenient for those workers, but the task of the economist is not to further fairness, which, on the level of the economy as whole, frequently collides with the goal of economic prosperity. In a capitalist economic system only survival of the fittest applies. However, for society as a whole the failure of industries can be very fruitful since this generally means that it is being replaced by more efficient (productive) means which are more capable of expanding an economy's production. An example of this is the horse and buggy industry; when the automobile was invented, this industry became redundant as a much more efficient and convenient alternative had become available. (Hayek, 2008)

This process is often called 'creative destruction' which is a term introduced by German sociologist Werner Robart and popularized by Austrian economist Joseph Schumpeter. The term emphasizes that, paradoxically, destruction in the context of lost jobs and redundant skills can bring about a stronger economy in the long run. While it can bring about temporary hardship for a worker to be rendered obsolete, the economy as a whole will benefit in the long run since innovations improve productivity and, in turn, improve living standards. (Reinert & Reinert, 2006) Indeed, 90% of the labor force in America was working in farming in 1790 but in 1990 this number was down to 2.6% because of agricultural technology innovations. (About.com, n.d.) What this means is that labor in the agricultural industry has been largely rendered useless over the years and a whole lot of people have lost their jobs in the process. However, the process has dramatically improved living standards in America since all the labor which was allocated in the agricultural industry went to work in other industries while the economy was still getting the same output from the agricultural industry. Because of the 'failure', or major shrinkage in terms of employment, of one industry, other industries blossomed and. As a result, Americans saw their economy as a whole grow enormously.

Therefore government bailouts of companies act to preserve jobs which produce products and services which consumers have declared 'not good enough' relative to other products and services within the economy. Furthermore the government has by its intervention hindered the transfer of the resources within the failed company to other potentially more value making ventures. In short, these types of bailouts prolong value-destroying activities and hinder value-making activities. They stop the forces of supply and demand from allocating society's scarce resources in a rational and efficient manner. The result is a loss of economic welfare.

As we can see, the failure of businesses and industries can be very for the economy as a whole in the long run. This is precisely because business failures are a sign of the fact resources are not being allocated in a rational and efficient manner. Therefore, in order for economic prosperity to be furthered unhindered, government bailouts should not be enacted upon.

4.3. The public and private sector

Up until now, any discussion of the government and its effect on the economy has been left out. This was done intentionally to show how the free market functions when its inherent mechanism is unhindered by the presence of a government. Now the discussion turns to the nature of the private and public sector.

The private firm is born out of capital that has been put into the business by the company owners. The money which is gotten either by borrowing or saving is at a risk of being lost, referring to the risk that entrepreneurs take by guessing the future needs of the market (it is impossible document the collective preferences of all market participants because of the immense complexity of human needs, and especially since most people do not know what they want). Indeed, most new companies fail in the first few years. (Shane, 2008) Because of the risk of loss, the entrepreneur has a powerful incentive to make his business profitable, which can only happen by offering products and services which consumers value, leaving out deceitful methods of profitmaking like fraud, false advertising and such, which are for the most part illegal.

The incentive to seek out profits and avoid losses makes the private firm strive to provide the best products and services at the lowest price possible in order to attract buyers, that is, they aspire to create the most value from the least amount of input or essentially try to find ways to create the most wealth by using the least amount of resources. Furthermore, the dynamics of competition acts as an encouragement for entrepreneurs to improve upon their offerings. When entrepreneurs rightly guess about preferences of consumers, they will turn a profit. But these profits are likely to be temporary since other entrepreneurs will want a slice of that pie and will either attempt to offer the same goods at a lower price or improve upon the goods' quality. Therefore, consumers enjoy a constant lowering of prices and increased quality of products that they value. In other words, the competitive forces within an economy act to increase the economization of economic goods.

The public entity, on the other hand, is born out of capital from taxpayers. In order to stay in business the public entity does not have to offer anything of value since it gets its stream of revenue through the government either way. That is because the money is extracted from the taxpayer. Moreover, the public entity does not have to fear about the competition taking away its profits which means that the incentive to improve upon its output is hardly existent. The fear of loss and the desire to profit, which acts as an incentive to create value, is not present within the public entity as it cannot truly fail in the economic sense of the word. This important distinction between private and public entities indicate that private entities provide more direct economic value for society than public entities and are therefore better at creating wealth and in turn raising living standards. (Hazlitt, 1946)

Therefore in order to maximize economic prosperity the magnitude of the public sector should be minimized to the extent that is possible without abolishing essential services like law, public order and economic infrastructure, while the magnitude of the private sector should be maximized. Put another way, jobs created via extracted tax revenue should be minimized and the number of jobs which have the opportunity to be created in private enterprises should be maximized since those jobs offer greater value than public ones. (Hazlitt, 1946) Government bailouts act to lessen the magnitude of the private sector because in order to finance the bailout, it has to extract money from the private sector, and as such, a government bailout acts to lessen the economic value which resources are able to provide.

4.4. The broken window fallacy

Every dollar that goes to the public sector through taxation, which is the government's only revenue, loses the opportunity of being invested in the private sector where it is more efficiently allocated. (Hazlitt, 1946) In order to see more clearly why this is true let us examine a short story on a common misconception by the French classical liberal theorist Frédéric Bastiat which illuminates the errors of not taking note of what is not seen and not considering the long-term effect of actions.

The fallacy goes like this: Someone has broken a window at a baker's shop. Consequently a glazier gets the job of making a replacement window for the baker. Let us suppose that the market value of this particular task is five dollars. This means that a job has been created of five dollars' worth and hence society is better off since more is getting produced by that much. Also, the transaction between the glazier and the baker creates a new wave of money circulation, making businesses for others by the same amount for an infinite number of people since the glazier may spend it on other merchants who will spend it on still other merchants and so on. (Bastiat, 1850)

While this is true, it is not the whole story. Let us examine what does not happen because of the broken window and therefore is not readily seen by observers. The money that the baker has to use to pay the glazier never gets to other businesses, which the baker may have intended to use it for. If we assume that the baker was planning on buying a new suit for the five dollars that took to replace the window, then it can be said that he is one suit poorer; instead of owning both a window and a suit he only has a window. The end result is merely that the glazier gains business while the tailor loses business to the very same degree and therefore no new employment has been attained and, more importantly, society's production has *not* expanded. (Bastiat, 1850)

What is seen is the new window being made and the baker paying for it, but what is the not seen is the lost business of the tailor and the creation of the money circulation which would have merely been initiated by the purchase of the suit instead of the window. (Bastiat, 1850) Furthermore, in regards to the argument of a money circulation initiation, there is no reason to believe that this transaction in particular is some kind of a starting point for the journey of these five dollars through the economy. Unless the baker had picked up those five dollars warm from a money printing press or counterfeited it, the money had already been in circulation. Moreover, there is no reason to believe that the glazier, or other users of money, has any more of a propensity to spend than the baker, increasing the velocity of these particular five dollars throughout the economy. As the money has to spent eventually it will inevitably continue in its circulation. Even though it might be spent earlier because of this 'need creating' window breaking incident that does not mean that wealth is created since wealth comes from saving, not spending. (Hazlitt, 1946)

This is the minuscule version of this fallacy and it comes in many shapes and sizes, but the fundamental misconception is always the same; people fail to consider what is not readily visible to them – the effect on a third party or the long term effects on society as a whole. The broken window fallacy can be extended to any amount of destruction and can still be spotted within the mainstream today. For example, this is what American economist Paul Krugman had to say about the 9/11 attacks: '... the terror attack ... could even do some economic good ... Now, all of a sudden, we need some new office buildings ... rebuilding will generate at least some increase in business spending'. (Krugman, 2001) American journalist, Timothy Noah, said this about the 9/11 attacks: '*economically* the net result of the terrorists' actions is likely to be beneficial to the United States.' (Noah, 2001) And lastly, in his article about the Great Hanshin earthquake in Japan in 1995, American journalist Nicholas D. Kristof mentions that: 'Despite the devastation, experts said today that in some ways the earthquake could give a boost to an economy struggling to recover from a long recession.' (Kristof, 1995)

These comments on the merits of destruction are based on the misconception already discussed – to ignore the effect of any action on a third party. While the reconstruction projects which will have to be initiated within the economy do act to initiate production, they merely do so because 1) the production which was already in place needs to be replaced and 2) the direction of production is being shifted from other projects. The projects that *will not* be executed, because of this shift, will not be seen, but they are no less real. When one is not aware of this fallacy, it is easy to reach the conclusion that public works and bailouts are beneficial. What is seen are the public works being carried out and the failed companies continuing its business, but what is not seen are the jobs which would have been created via the money which goes from the private sector into the public sector.

Through this observation, we can see that the common rationale for government bailouts, to prevent a precipitous rise and fall in unemployment and national production, respectively, is based on a fallacy. The rise in employment stemming from a government bailout is countered by a fall in employment to the same degree because of the lost opportunity of taxpayer's money to create employment via the private sector. Just the same, the rise in national production stemming from a government bailout is countered by a fall in national production by the same degree because of the lost opportunity of taxpayers' money to create it via the private sector.

While the destruction of New York City's Twin Towers and Japan's Great Hanshin earthquake is a considerably larger amount of destruction than a single broken window, the same principles apply. To make the point clear enough let us consider the extreme example of warfare and its effect on economic welfare. By the same arguments as in the broken window fallacy, it is argued that the surge in production projects which follows a great destruction of a nation's commodities acts to create prosperity in spades. But if we examine this statement closer with Bastiat's story in mind it becomes clear that only the *direction* of production has been shifted. All the work which goes into replacing the houses and streets means that there is not any work being done on other things by just that much. All the purchasing power which is used to buy these houses and other replacements which were lost in the war is not available to buy other things.

Sure, the economy may see increased productivity for some time, given that not too many people died in the war, because of the urgency of those new projects, but claiming that destruction creates wealth because it makes people work to replace the commodities which were already in place, is purely false. (Hazlitt, 1946) Also, society would be better off without the war because of the fact that resources would be allocated to projects which would satisfy the more sophisticated wants of people rather than their primitive needs like the one of a shelter.

The lessons to be learned from these erroneous claims are that in order to wisely distinguish a bad economic event or action from a good one, one must not only look at the immediate effect on one group but rather examine the long term effect of every group, palpable or potential, involved in the situation. In the case of government bailouts of companies we must not only consider the immediate direct effect, which is that certain employers keep their jobs and the production in a certain company continues, we must also consider the effect on everyone else within the economy.

While workers in the bailed out company are better off, taxpayers in the economy are worse off by the same amount since the bailout money has to come from them. The short-term effect is that the bailed out company can continue to provide its employment and that national production will not contract to the extent of this company's output. However, the long-term effect is that national production will suffer a net loss because of the lost opportunity of this company's resources to be reallocated in a more efficient manner. As we can see, the effect of government bailouts can be misinterpreted when one overlooks the woods to scrutinize particular trees. (Hazlitt, 1946)

4.5. Efficiency and welfare loss

As we know, when businesses fail the government sometimes bails them out in order to protect the jobs that a particular business offers, as well as to retain the company's contribution to national production. There are a lot of economic problems and unintended consequences which this action creates and we shall explore them one by one.

When a company fails it is because its products and services are not valued enough relative to the offerings of other companies. Consumers have effectively decided that the offerings of this business are not valuable enough for the company's existence to be sought after within the economy. Furthermore, since the company was not able to continue its life spans by taking loans, creditors from the private sector have clearly reached the conclusion that the failed business is not viable. (Woods, 2009)

When the government bails out a company, it does so inevitably with the money of the taxpayers, since that is the only stream of revenue that the government has. Even though the government uses borrowed money for the bailout, the end result is the same since the money has to be paid back eventually with the government's only pool of resources; the taxpayers money. Furthermore, by borrowing money the government increases the demand for loanable funds which drives up interest rates, crowding out potential investments in the private sector. Printing the bailout money also serves as taxation because the taxpayers will pay for it by being forced to accept higher prices which will eventually appear (all else being equal) because of the increased supply of money. Taxpayers are therefore coerced to temporarily help this business survive. The government overrules the consumer's choices. This provides the private company a deal much like the public entity; the losses do not lead to business failure. (Reisman, 1990)

The failure of this business means that the resources like labor and capital are not being efficiently employed in this company. The resources which have gone into this business have been misdirected since the value of the resources which go into making the company's offerings are more than the value of the offerings themselves. When the government saves the company its resources do not get redirected from this misallocation. Instead of getting to create value somewhere else these resources will destroy value by being kept in the failed company, where they continue to be employed in the production of goods which are, at least for now, not competitive within the marketplace. (Schiff, 2010)

Resources in a free market flow where profit opportunities lie and because profits indicate value creation this free flow allows resources to be allocated where they create the value. If the resources are to be tied up in a failed business by the decision of the government, they fail to go to more productive means which consumers, with their collective wisdom, will lead them to via the direction of their demand. (Hazlitt, 1946)

The short-term effect is the sustained employment of the people in the failed company but the long-term effect is that production will not be as much as it could be without the redistribution of the resources stuck within the company. With the taxpayer money coerced to sustain this company, the taxpayers are poorer by that much purchasing power which could have been used to consume products and services which they really want and in turn create valuable employment. The jobs created by the government act to make the economy lose its opportunity to create other more valuable jobs to by the same amount. (Mises, 1966)

We do not know whether a bailed out company will be able to fend for itself again in the marketplace right away or not (it probably won't because there is a reason for its failure in the first place), but it is certain that until the bailed out company starts to show sustainable profits again, the released resources would have acted to create more wealth than the resources stuck in the uncompetitive company. (Hazlitt, 1946)

It can be argued that while the economy is in a slump and aggregate demand is down, then it makes economic sense to bail out companies so they should not fall victim to temporarily adverse external conditions. But when economic conditions become less than optimal, it is bad for every firm in the economy and it is the businesses with the least amount of profits and the worst financial management (for example the ones which does provide the least amount of financial slack for unexpected occurrences) which are the first to go down. (Hazlitt, 1946). Furthermore, the Austrian view of recessions is that they are merely the cure for a resource misallocation, or more to the point over-allocation, on a large scale just like a business failure is the cure for the misallocation of resources within an individual firm. Hence, recessions should be allowed to run their course without government interventions so the corrective measures of the free market will able to effectively correct an overheated economy which is trying to produce beyond its productive capacity. (Callahan, 2004)

The first rule of economics is that there is no such thing as a free lunch which means that you cannot have something for nothing (Mankiw & Taylor, 2006), so it should be clear that government spending on bailouts comes out the taxpayers' pocket. Furthermore, government spending is not as likely to create value since it is a spending decision made by a select few who are no match to the collective buying decision rationale of the vast number of consumers in the economy. The consumers are much better suited to choose commodities of value since, in their aspiration to further their own interests they choose products which provide them with the most pleasure for the least amount of money. Public spending is of a very different nature in which the spender, the government, is not concerned about making a profitable investment decision since his risk of financial loss is nonexistent. (Hayek, 2008)

In conclusion, the government intervention of private company bailouts acts to relieve the private sector of resources to the same degree that it acts to provide failed companies with them. We have seen that resources are more effectively economized within the private sector than in the public sector, and as such, the transfer of resources from the private to the public sector acts to degenerate the economization of society's scarce resources. Government bailouts act to further the short-term interests of an isolated group within the economy, while at the same it drives back the interests of everyone else within the economy by just as much, as well as to contract the production of the economy as a whole.

4.6. Moral hazard

In this chapter we will explore how government bailouts are a result and cause of the problem of moral hazard.

4.6.1. Fundamentals of moral hazard

The problem of *moral hazard* arises when a person, called the *agent*, administers an economic good owned by another person, called the *principal,* on his behalf. If the principal is unable to perfectly monitor the agent's behavior, the agent tends to engage in behavior which is undesirable from the principal's point of view, that is, exert less effort than what the principal would consider ideal. The term moral hazard refers to the 'hazard' or risk that the agent may behave in an 'immoral' or undesirable way because of the nature of the situation. (Mankiw & Taylor, 2006) Implicit in the definition of moral hazard is 1) the different access the agent and the principal have to relevant information about the situation at hand, a situation which is referred to as information asymmetries, and 2) the separation of ownership and control; in order for a moral hazard to arise, the agent has to acquire control over an economic good which is in a principal's ownership.

To take an example, let us look at a moral hazard arising in a situation of voluntary separation of ownership and control and information asymmetries. Imagine a clerk (agent) operating a grocery store while his employer (principal) is not in the store with him. In this situation, the agent may be tempted to shirk from his responsibilities of handling products carefully or dealing with customers in a polite manner. He is only able do so because the principal has given him control over the goods in the store, that is, a voluntary separation of ownership and control has been commenced. Furthermore, he will most likely only do so when the store owner is not supervising his behavior, that is, when information between the agent and the principal is asymmetric. (Hülsmann, 2006)

As we can see, a moral hazard is the incentive for an agent to administer a property owned by a principal in a way that does not act in the interest of the principal or more to the point; in a way that is unproductive. Hence, economists refer to moral hazard as a perverse incentive which, opposed to 'good' incentives, acts to decrease production, or put another way; acts to decrease the economization of economic goods. But before we conclude that in the aim for maximum economic prosperity, a government should try to minimize moral hazard, we should ask if the principal is able to sanction the possible expropriation[4] or not, or in essence; do agents, acting on a perverse incentive, effectively impoverish the principal? As we shall see, an expropriation is not a necessary

[4] To expropriate is short synonym for a 'person's use of another person's property against his will and without impunity' (the acting on an incentive provided by a moral hazard). I use it as a technical term following Murray Rothbard in (Rothbard, 1998)

byproduct of moral hazard. However, the emergence of the moral hazard itself within a modern economy is inevitable because it is a perverse incentive which inevitably arises from indispensable arrangements in modern societies like employment. Because of that, and the fact that moral hazard does not entail expropriation *per se*, moral hazard in and of itself should not be minimized by governments, but rather the kind of moral hazard which systematically entails expropriation. (Rothbard, 1998) That is the kind of moral hazard which we will mainly concentrate on in our discussion of the phenomenon.

The conventional approach to moral hazard is to describe it as a problem mainly related to the asymmetries of information, making it a part of the economics of information. Conventional theory discusses the various contractual devices a principal can use to limit his exposure to the perverse incentives of a moral hazard as well as his liberty to sever any contract in order to stop the moral hazard, once there, from affecting him negatively. However, conventional theory does not recognize the ability of the free market to limit an expropriation stemming from a moral hazard, namely via good judgment or the anticipation of an expropriation. (Hülsmann, 2006)

Austrians claim that the role of expectations in the free market act to provide a powerful antidote to the expropriation which can arise from information asymmetries in the case of voluntary separation of ownership and control. Austrians claim that information asymmetries are merely a sideshow in the creation of moral hazard and consequently disagree with the conventional categorization of moral hazard as a part of the economics of information. They contend that information asymmetries only entail expropriation *accidentally* and *ephemerally*, and only do so in a case of voluntary separation of ownership and control, that is, in a free contractual relationship. Moreover, they claim that when separation of ownership and control is forced, that is, without the principal's consent, the moral hazard which arises *systematically* entails expropriation, even in the absence of information asymmetries. Austrians therefore claim that the phenomenon of moral hazard is not a part of the economics of information, but is instead a part of the economics of property – the discipline that analyses the implications of property ownership on human behavior. (Hülsmann, 2006)

Before we will explore the rationality behind the Austrian contentions on moral hazard, let us clarify their claim. The nature of the situation between an agent and a principal can on one hand be subjected to information asymmetries or symmetries and on the other hand be subjected to voluntary or forced (involuntary) separation of ownership and control. In practice, the principal is very rarely able to consistently and flawlessly monitor his agent; hence the situation where an agent has an incentive to shirk on his responsibilities will almost definitely arise sometime in any agent-principal relationship. Therefore, information asymmetries are practically a given element in the relationship. Information asymmetries create moral hazard ephemerally and accidentally when separation of ownership and control is voluntary, but when separation of ownership and control is involuntary, moral hazard will arise whether information is asymmetric or not. Hence, information asymmetries are merely a sideshow in the creation of moral hazard. The prime element in the exploration of moral hazard is the separation of ownership and control, since the nature of it determines whether a moral hazard will systematically entail expropriation or only accidentally and ephemerally. It is also the vital element of moral hazard creation since without it a moral hazard could not arise. In contrast, moral hazard can arise when information is asymmetric and when it is not. (Hülsmann, 2006)

It is useful to consider the fact that there are countless examples of the problem of moral hazard as it can arise in almost any human endeavor constituting the situation of separate ownership and control. A car owner may be subject to moral hazard to the extent that he will drive less carefully when he knows that his car is insured by an insurance company. Taxpayers are subject to moral hazard if they can migrate to areas with lower taxes. The International Monetary Fund may create a moral hazard among debtor governments to the extent that they believe that the IMF will provide them with loans if the going gets tough. Notice that the problem of moral hazard can arise even when information is symmetric; though citizens are aware of the government's taxation they still have an incentive to evade it, and though the government is aware that its citizen are trying to evade its taxation, it still has an incentive to tax. (Rothbard, 1998)

Now we shall explore how, in the situation of information asymmetries and voluntary separation of ownership and control, the market provides a powerful antidote to expropriation like Austrians claim it does, and further, we will see how the expropriation can only be accidental and ephemeral. Next, we will examine how the case of forced separation of ownership and control entails a systematic expropriation, with or without information asymmetries, namely in the context of government intervention. Lastly, we will apply this to the case of the government intervention of bailouts.

Now let us look at how the free market mechanism provides a solution to the problem of moral hazard, at least to an extent, in the context of information asymmetries and voluntary separation of ownership and control.

In the free market, an individual has the freedom to use his property as he sees fit. He can lend it to other individuals, assign a co-owner or allow other people to use it under conditions that he is free to set. In essence, the free market system only includes voluntary separations of ownership and control. Let us again turn the attention to the example of the employer-employee relationship in the context of a grocery store. When an employer hires an employee, he voluntarily grants this employee control over his property, namely the store and everything in it. When the store owner is not monitoring his actions, the clerk may increase his own psychic income at the store owner's expense, that is, exercise laziness and sloppiness in the tasks which he is given. (Hülsmann, 2006)

One might be tempted to reach the conclusion that in this situation the agent successfully expropriates the principal. However, as the separation of ownership and control is voluntary, the forces of the free market provide a powerful antidote to this expropriation in various ways. First of all, the role of expectations mitigates the problem. When the store owner hires a clerk, he weighs in the possibility of his employee shirking on his responsibilities when he decides how much wages to pay him. To the extent that he can anticipate it, he will decide upon a salary which will reflect this deficiency. Secondly, the principal can limit the danger of a moral hazard arising in the first place by utilizing various contractual devices which he is free to set; for example delayed payments such as a year-end bonus so the employee suffers a larger penalty if he is caught shirking. Lastly, because of the principal's liberty to sever the employment contract, he is able to minimize the moral hazard, once there, affecting him negatively. Also, the fear of getting fired and subsequently suffering a loss to one's reputation remains a primal incentive for agents not to succumb to moral hazard. As we can see the moral hazard arising in this context can only be accidental, as to the extent that the principal makes a bad judgment about the agent's willingness to shirk, and it can only be ephemeral, because of principal's ability to sever an employment. (Hülsmann, 2006)

Since the free market mechanism provides such a powerful antidote to moral hazard, it is a reasonable conclusion that the problem of moral hazard within this context is more or less completely neutralized. Information asymmetries are always a given in our world. A world where information is perfect does not exist so there is no superior efficiency to compare to. Therefore our world cannot be considered inefficient to any meaningful comparison. Because the market is much more capable to alleviate the shortcomings of a moral hazard than the government, which has an even more limited access to information, because of its lesser magnitude in comparison to the private sector, it is not the second-best solution to let the market handle the problem, it is best solution. As such, resources *are* being allocated in an efficient manner to the extent that humans are capable of, and as such, the moral hazard arising in this context is not a market failure. (Hülsmann, 2006)

The moral hazard or more to the point, the expropriation entailed by the involuntary separation of ownership and control can be reduced by limiting government intervention. Thus, paradoxically, government interventions intended to limit moral hazard in the free market, while trying to solve a problem which is virtually nonexistent, creates a systematic moral hazard entailing unsanctionable expropriation.

4.6.2. Government interventions as a moral hazard

Our discussion of the moral hazard problem in the free market provides us with a clearer thought on how a moral hazard occurring from government interventions differs from ones which occur in the free market of voluntary exchange. Let us now turn our discussion to government interventions into the free market which creates an unintended consequence in the form of moral hazard.

Interventions, by their very nature, involve an involuntary separation of ownership and control over the economic goods of society. While a forced kind of the aforementioned separation can also occur in the private market through crime, the government one is far more important in practice, not only because of the greater quantitative impact, but also because it can be anticipated, for it is enshrined in the law. (Hülsmann, 2006) The interventions of our interest are the ones of taxation, monetary intervention and bailouts. They are, as we shall see, both the cause and effect a moral hazard, creating a vicious cycle.

When the government taxes it proclaims itself the owner of some share of its subject's resources. The subject is forced to hand over these resources involuntarily, since if the transfer were voluntary we would be speaking of donations to the government. (Hülsmann, 2006) Monetary intervention is another example of a government intervention which all modern economics are subjected to. That is where the government imposes a legal tender which all market participants are obliged to accept and is therefore called *fiat* paper money. Because the central bank has monopoly control over the money supply in the economy, it can print whatever amounts it sees fit and consequently buy any amount of goods and services. (Rothbard, 1998)

Let us recall that the government has no source of revenue but from taxes. The government taxes either through direct tax, deferred tax via borrowing or indirect tax by creating inflation. All these taxes act to increase the tax burdens on citizens in a way. In the case of government borrowing, the tax is merely deferred since taxes since the government has to eventually pay the loan from its only stream of revenue; taxation. Hence, taxes will eventually have to be set higher in order to pay back the loan. In the case of inflation tax, the expansion of the money supply debases the currency and the tax emerges in the inevitably higher prices for the people who acquire the new money later than others.

The case of taxation and fiat money creates moral hazard on the side of companies. That is because they realize, either by deductive reasoning or by observation, that the government has the power to bail out virtually any company, either by taxation or by the creation of money. They also know that it is in the government's political interest not to let big entities fail on their watch, potentially spreading damaging economic contagion and raising unemployment temporarily. Hence, big companies which perceive themselves as 'too big to fail', which failure would mean a precipitous rise and fall in unemployment and national production, respectively, will more or less engage in reckless financial planning, since they know, or at least believe they do, that the government will bail them out if they fail. Empirical evidence supports this perception as public debts and private debts are at record heights all over the world. As a consequence, smaller entities will notice how the big entities play the moral hazard card and will to some extent venture to set out on the same path. (Hülsmann, 2006)

Let's consider a simple example to see how this reckless financial planning happens in practice. Imagine a company which considers itself too big to fail. The company has the opportunity to enter an investment which will cost \$65 million up front. If all goes well the project will yield a return of \$100 million. But there is only a one-third chance of this happening and a two-thirds chance that the investment will yield only \$40 million. The expected payoff, then, is only (1/3 * \$100 million) + (2/3 * \$40 million) = \$60 million. If the company loses \$25 million on the investment, which has a two-thirds chance of happening, it will result in its bankruptcy as the company, in its current state, can only afford to lose \$5 million. Ordinarily, this investment would never be made simply because \$60 < \$65. However, the prospect of a government bailout changes the result. Because the loss of \$25 million is \$20 million above the company's tolerance for loss, the government bailout would provide the company with \$20 million if the investment will go bad, making the scenario in which the investment will go bad synonymous with \$60 million (\$40 million + \$20 million). Hence the expected investment payoff will look like this: (1/3 * \$100 million) + (2/3 * \$60 million) ≈ \$73.33 million, making it an investment which should be enacted upon as \$73.33 > \$65. In reality most big companies probably will not take the prospect of a government bailout as an absolute given, but they will most likely, as it is simply rational to do, weigh in the possibility of it, to the extent that they can predict it, in their financial planning.

We can see that in a system where government bailouts can be expected that, to some extent, profits get privatized but the losses get socialized and the risk is somewhat extended from the private company to the public. (Ritholtz, 2009)

It is noteworthy that the very phenomenon that the government is trying to prevent is unintentionally incentivized in an indirect way; companies which expect to be bailed out in case of business failure take on more risk than they otherwise would since they don't expect to have to bear their losses. Hence governments inadvertently promote business failures by shielding companies from them. (Ritholtz, 2009)

The perception that the government has the power to bail out virtually any entity may not create a big moral hazard. But as governments have indeed done this (as with the Chrysler bailout in 1980 and the Detroit 3 bailout in 2008), the moral hazard has likely grown exceptionally. As the moral hazard induces reckless financial planning, the likeliness of business failures is furthered, creating more situations of urgency like the initial government bailouts. If a government continues to rescue companies from financial distress this vicious cycle will be perpetuated, impoverishing society as a whole. In order to stop the vicious cycle and reduce the moral hazard, a government has to cut the cord by announcing that they will not enact bailouts in the future and stick to that remark.

As the government has acquired control of economic goods not owned by them by a decree of law, its expropriation can be anticipated (but not prevented, highlighting the irrelevance of information asymmetries in this situation). Hence, this system creates a moral hazard on the side of the citizens. This is because they know that in order to promote and voter satisfaction, the government will engage in bailouts in their effort to reallocate capital where it is more urgently, by their measure, needed. Free-riding, or, as we will see, merely rational individuals, will attempt to exploit this arrangement by seeking to appeal to the government's criteria of entities that urgently need help, or will need help later on if push comes to shove.

Taxation and monetary intervention also creates a moral hazard on the side of the government. Remember that moral hazard is simply the incentive of an entity to use more resources than it otherwise would have used, because it knows, or believes it knows, that another entity will provide some or all of these resources. This description fits perfectly with the government's financial relationship with its citizens. Not only do citizens provide those resources, but they have a very limited ability to stop providing them as the government forces the relationship by a decree of law. Since these resources will continue to be procured whether they are spent in a prudent manner or not, the incentive to allocate them wisely cannot be considered to be very powerful.

This observation is especially relevant to the case of government bailouts. Imagine a very simple economy, inhabiting 100.000 people, each with a wage of 1.000 dollars a month. One day a business, employing 10 people, goes bankrupt. In order for the government to save this business from bankruptcy, it has to come up with 100.000 dollars. For the 10 individuals who were already employed in this particular firm, the bailout is of great interest to them. If the bailout will not be enacted upon, these individuals will not get their monthly wage of 1.000 dollar until they get a new job, increasing the uncertainty, along with its implicit risk, of the future for those individuals. Consequently, these individuals will have a great incentive to put pressure on the government to go along with the bailout. Meanwhile, the 99.990 other inhabitants of this economy will not have such a powerful incentive to go through the trouble of protesting the bailout, since for them it merely means that they will be taxed additionally by the amount approximate to one dollar, or 1/1000 of their income. Hence the pressure on the government to enact a bailout is much greater than the pressure to let the firm fail. Consequently, because it is in the government's interest to keep its voters happy, the bailout is likely to happen. It is precisely because the government has no skin in the game in the allocation of its resources, that it is likely to enact on such popular actions, as opposed to rational actions. Hence, we have an argument for the minimization of the government, as when the government is of a smaller magnitude, it is less able to squander society's scarce resources.

In conclusion, moral hazard entails systematic expropriation when separation of ownership and control is involuntary, whether information is asymmetric or not. An example of such a moral hazard is the one of government bailouts which creates a moral hazard on a massive scale because of its high profile within a society. As the taxpayers are largely unable to reject to provide resources to government bailouts, the expropriation is unsanctionable. Hence, citizens will attempt to get a slice of the pie by seeking to appeal to government's criteria for bailouts, which is business failure on a large scale. Therefore, these situations will inevitably come up, since market participants don't expect to have to face its bad consequences.

4.6.3. Perverse incentives stemming from a moral hazard

Government bailouts and too-big-to-fail policies work to distort incentives in various ways. For example, let us imagine two identically big companies in a time of economic boom. The companies are so big that their failure would mean a noticeable surge in short-term unemployment as well as a noticeable decrease in national production. Company A is prudent and does not take risky investment decisions. Company B, however, engages in risky investments. During the boom period, companies like company B have a potential to grow bigger than companies like company A because of their risky investments which have more potential payoffs.

Now let us imagine that an unexpected recession hits the economy. Because company B has been engaging in risky business practices, it is a good possibility that this company will fail. Because company A has been prudent in its business practices, it is not likely to fail. Now, company B is likely to receive a government bailout for it is so big that government officials perceive it as being too big to fail. In an economy where the government shows signs that it will not let big companies of this kind fail, risk-taking is unintentionally incentivized. Company B figures that because of government's too-big-to-fail policy, it would be better off taking big risks as they will either pay off handsomely or result in losses which will be borne by the taxpayer.

Furthermore, creditors also know about this and consequently these big companies can borrow money more cheaply than their smaller counterparts, meaning that the too-big-to-fail policy does not only incentivize excessive risk-taking, but it facilitates it also. This also means that smaller companies are at a disadvantage because they have greater financing costs, having an adverse effect on competition. And since competition serves to create wealth, this leads to a lessened degree of wealth creation. Because recklessness is rewarded and prudence is punished, the prudent company is basically forced to engage in excessively risky business practices in order to keep up with the competition.

This government bailout policy entails unintended consequences and perverse incentives which are counteractive to the goal that they are trying to reach; when they indicate that they will not allow big companies to go bankrupt, they indirectly bring about bankruptcies of big companies. They remove the essential loss factor of capitalism which the system cannot be without if it is to encourage wealth creation.

Now, it would be best if big companies would just ignore the too-big-to-fail policy and continue operating in a prudent manner, but game theory states that this will never happen. Let us imagine a pool of companies which can be considered too big to fail. If none of the companies would exercise imprudence that would be the best net result for the economy. If one company decides to be prudent while all the others decide not to, that is the worst result for that particular company since the others will grow bigger. If one company decides to be imprudent while all the others decide not to, that is the best result for that particular company since it gets ahead of the competition. Since no company can rely on the others to abstain from the supposed 'free lunch' provided by the government, the end result will be that every company will exercise imprudence since that is every company's best move in the particular situation. It is important to stress that the government bailout does not have to be expected by perfect certainty; it only needs to be expected to a limited extent for companies to conclude that it is a better move to engage in riskier business practices than to count on the competition to pass on the opportunity for exploitation.

In conclusion the moral hazard stemming from government bailouts of private companies inevitably create incentives for some companies to exercise imprudence. The moral hazard also acts to facilitate bad business practices as well as having an adverse effect on competitive forces within the economy. Hence, moral hazard creation results in a welfare loss since it increases the likelihood of bankruptcies and derogates the wealth inducing competitive dynamics among companies.

5. Conclusions

Capitalism is a system which incentivizes wealth creation through the greed for profits and disincentives wealth destruction through the fear of loss. Because a government bailout provides a company with a deal in which losses does not materialize in a business failure, it removes, to some extent, the disincentive to destroy wealth.

Consumers, by their collective preferences transformed into buying decisions, provide companies with a feedback of whether they are creating wealth or not. When businesses fail, it means that consumers have decided that it has failed to create wealth. As society's resources are scarce, a decision has to be made on what society will produce and what it will not. It follows, that if A is being produced, the resources which go to produce A cannot be used to produce B. Because of this tradeoff, the resources within a failed company should be reallocated to a company which does create wealth, as if they are not reallocated, they cannot be considered to be efficiently allocated. Government bailouts, to the extent that the failed company will continue to suffer losses, act to perpetuate the misallocation of society's scarce resources, and as such, they act to prevent the effective allocation of them and consequently, the economy's production will contract.

Government bailouts can only be enacted upon by taking resources from the private sector, for taxes are a government's only source of resources. Consequently, these resources won't be available in the private sector, where they would have acted to create wealth through the motivation to show a profit, which is absent in the public sector. As a result, government bailouts act to reduce wealth creation.

The goal to prevent a precipitous rise and fall in unemployment and national production, respectively, which result from a company failure, will not achieved by government bailouts. That is because the fall in unemployment stemming from a government bailout is countered by a rise in unemployment to the same degree as the resources which are channeled to the failed business won't be available to create employment in the private sector. Just the same, the rise in national production stemming from a government bailout is countered by an identical fall in it because of the lost opportunity of the resources, which went to finance the bailout, to create production in the private sector.

Hence, governments cannot prevent a rise in unemployment and, in turn, a fall in national production by bailing out companies. Conversely, government bailouts will result in the contraction of national production since they act to preserve the production of goods deemed worthless by consumers and to prevent the flow of resources tied in a failed company to more valuable ventures.

Consequently, government bailouts are beneficial to an individuals related to the bailed out company, but they are harmful to the rest of the participants in the economy by the same amount and detrimental to the economy as a whole.

Moral hazard is the incentive of A to use more resources than he otherwise would have used, because he knows, or believes he knows, that someone else B will provide some or all of these resources. A fundamental moral hazard lies within a government's method to procure resources which is to create a forced separation of ownership and control over the resources of taxpayers. The government does this in order to provide certain entities with resources which have an urgent need for them. The government does this because of the failure of the free market to do so. The consequent problem of moral hazard which this system creates is created at the side of the government and its citizens. As for the government, it will use its resources in an imprudent manner since they will be provided for whether they are spent in a rational manner or not. As for the citizens, they will seek to appeal to the government's criteria of entities that urgently need resources, and when they succeed to do so, they will have an incentive to use more of these resources than they otherwise would, since they are provided by taxpayers.

This moral hazard problem is considerably furthered when a government indicates that it will bail out private companies or actually does so. The message which a government sends when it indicates that it might bail a company out in certain situation, or the act of actually doing it, serves to strengthen the perceived correlation of market participants between a company failure and a government bailout. The result is that some market participants will engage in a more or less reckless financial planning, since they expect taxpayers to provide the resources necessary to further a company's life when losses will exceed profits to a degree which would result in a business failure.

Hence, because of the increased risk taking in an economy, the risk of business failure is increased, resulting in more situations where government bailouts have been enacted upon in the first place. If government bailouts continue to be enacted upon, a vicious cycle will ensue as the perceived correlation between business failure and government bailouts is strengthened. Furthermore, the moral hazard acts to facilitate the excessive risk taking since it provides companies which play the moral hazard card an excessively low price of loanable funds

In the Austrian view, it is the fundamentals of an economy which determines how much wealth it will create. As an economy is less subjected to government interventions, the more powerful the incentives in place are for wealth creation.

Therefore, it is to be concluded that government bailouts act to impoverish society in general.

5.1.Implications for policy recommendations

Governments should object to company bailouts on principle because they derogate the workings of the capitalist free-market system. Business failure is merely the cure for a misallocation of resources and the market should not be restricted in its effort to rectify the situation. Governments should therefore not act to prolong the life of failed companies. The government should also not proceed with company bailouts when the economy is in a state of recession or depression. That is because economic downturns are merely business failures on a large scale and therefore the mass reallocation of resources should go on uninterrupted, as the market participants are much better suited than governments to allocate them.

In order to minimize the emergence of moral hazard within economies, governments should declare that they will not under any circumstances bail company's out, should they fail. That way, companies will be more prudent and a fewer of them will fail, making society better off. A government, however, should not make such a claim if it is not absolutely sure to stick to the remark, because a failure to do so will most likely undermine the government's ability to influence the behavior of market participant through its released statements, since they will be more likely to judge further remarks of the government as false.

6. Final Words

The English philosopher Herbert Spencer once said that 'the ultimate result of shielding men from the effects of folly is to fill the world with fools'. I think that this quote catches the long term effect of bailouts on market participants, who make financial decisions based on the possible outcomes of those decisions. Shielding market participants from the suffering of monetary losses, acts to undermine their careful stewardship of society's finite resources.

All actions have consequences, bad or good, and in a system that is designed in a way that bad consequences are nonexistent or improbable, the actions taken are likely to be incautious and overly risky. A system like that inevitably creates a vicious cycle where entities continuously behave in a more and more reckless manner since they do not have to face any bad consequences of their irresponsible behavior, where in a healthy system there would be consequences which would lead to improved conduct. What this system effectively entails is that if the bailout-expecting company gains profits from this excessive risk-taking, it wins, but if it suffers losses, the taxpayer loses.

When a decision is to be made whether to bail out a company or not, government's should consider the points on economic implications discussed in this essay and weigh them against other noneconomic factors which decide whether a bailout should be necessary or not. But as we have seen, the unintended consequences of bailouts can be much more severe than the original problem, which makes it probable to outweigh any noneconomic considerations.

It could be said that taxpayers tend to look at government bailouts as the unnecessary bailing out of convicted criminals who themselves got into trouble and should pay their dues. Meanwhile, the government explains bailouts as a rescue from the temporary economic turmoil they find themselves in, or as put earlier, as the removal of water from a sinking boat which finds itself in dangerous waters by mere accident. That is at least what governments tend to want their citizens to think in their attempt to provide a rationale for their bailouts.

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