

# Financial Bailouts and the Philosophy of Frédéric Bastiat

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## Abstract

Frédéric Bastiat (1801-1850) was a French thinker who did most of his writing in the last six years of his life. One of his major contributions to economic thought was his application of opportunity cost to a wide range of economic policies. The present paper uses the Bastiat approach to analyze the economics of bailouts and concludes that bailouts always and everywhere result in negative-sum games and necessarily violate the property rights of some individuals.

## Keywords:

Bastiat, Keynes, Multiplier, Bailouts.

## JEL classification:

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## ■ 1. Introduction

Frédéric Bastiat (1801-1850) was a French farmer, journalist and political economist. He has been compared to Franklin and Voltaire for his integrity and purity and the elegance of his writing style. Hébert considered him to be unrivaled in the way he exposes fallacies (see Skousen, 2001, p. 59).

His place in the history of ideas is secure. Three of his contributions that have stood the test of time are his essay, *Ce Qu'on Voit et Ce Qu'on ne Voit Pas* [What Is Seen and What Is Not Seen] (see Bastiat, 1862, 1964a), the *Petition of the Candlemakers* (see Bastiat, 1873, 1964b) and *La Loi* [The Law] (see Bastiat, 1850, 1998). His parable of the broken window (Bastiat, 1964a, pp. 2-4), which has become known as the Broken Window Fallacy in the economics literature, is said (Rothbard, 1995, p. 445) to have refuted the Keynesian multiplier theory (Keynes, 1936) nearly a century before Keynes (1883-1946) advanced it.

Bastiat's greatest contribution to subjective value theory was how he rigorously applied the theory in his essay, "What Is Seen and What Is Not Seen." In that essay, Bastiat, by relentlessly focusing on the hidden opportunity costs of governmental resource allocation, destroyed the proto-Keynesian notion that government spending can create jobs and wealth. (DiLorenzo, 1999, pp. 62-63)

## ■ 2. What is seen and what is not seen

In the opening salvo of *Ce Qu'on Voit et Ce Qu'on ne Voit Pas* (see Bastiat, 1862, 1964a), Bastiat tells the story of a boy who breaks a window. A crowd gathers to discuss what they have seen and the discussion soon turns philosophical. Someone suggests that breaking an occasional window might actually be a good thing. After all, what would happen to glaziers if no windows were ever broken?

What is seen is that the destruction of the window increases employment for glaziers, leading some to conclude that destruction of property can have a beneficial economic effect. To put it in Bastiat's language, what is seen is increased business for glaziers and the loss of a window by some second party, let's call him Jacques, who must now pay six francs to replace it. The gain of the glazier is exactly offset by the loss to Jacques. What is not seen is the loss by a cobbler, since Jacques could otherwise have used his six francs to buy a pair of shoes. What is seen is one winner and one loser. What is not seen is the second loser. It is this failure to see the second loser that makes the analysis incomplete.

The lesson to be learned is that we must not confine our analysis to that which can be seen. We must expand our thinking to include what is not so easily seen. As Bastiat has said:

There is only one difference between a bad economist and a good one: the bad economist confines himself to the *visible* effect; the good economist takes into account both the effect that can be seen and those effects that must be *foreseen* (Bastiat, 1964a, p. 1)

The rest of his essay is devoted to giving examples of this principle. During Bastiat's day, like today, the idea that government spending is good for the economy is prevalent. If the government spends money on projects, the people who receive the money turn around and spend it, and the people who receive it from them also turn around and spend it. Every franc the government spends increases economic activity by more than one franc. It is the principle upon which the Keynesian multiplier theory is based.

What is seen is economic expansion in the areas where the government spends money. What is not seen is what would have happened to that money if the taxpayers had been allowed to spend it themselves instead of having the government spend it. The increased government spending is exactly offset by the reduced spending of the taxpayers.

### ■ 3. Opportunity cost, the multiplier & bailouts

Public spending is always a substitute for private spending ... it may well support one worker in place of another but adds nothing to the lot of the working class taken as a whole (Bastiat, 1964a, p. 16)

In mid nineteenth century France it was popular to say that the money injected into the economy for these public works projects is like a stone that is cast into the lake that "will cause an infinite number of concentric circles to radiate great distances in every direction." (Bastiat, 1964a, p. 27) It is the same argument that Keynes used in 1936 to advocate increased government spending to create jobs.

Bastiat's response is that "The stone is thrown in at one point in the lake only because it has been prohibited by law from being thrown in at another." (Bastiat, 1964a, p. 28) In other words, the same amount of spending would have taken place in the private sector if the government had not spent the money in the government sector.

It must not be forgotten that governments have no resources of their own. Whatever resources they have they must first take from someone. If government spends more, taxpayers must spend less. The fact that increasing government spending by one franc increases economic activity by some multiple of one franc is not the whole story. The other side of the coin shows that extracting an extra franc from the taxpayers leads to reduced private sector spending by some multiple of that franc.

The Keynesian multiplier theory is based on the belief that an injection of government funds into the economy can increase economic activity by some multiple of the injected amount. It is the premise upon which economic stimulus packages are based. But, as Bastiat pointed out in the mid nineteenth century, such government spending cannot increase total economic activity. It is an example of what Bastiat would call bad economics because it limits its analysis to the visible effects of the policy. It ignores or overlooks the effects that cannot easily be seen but must be foreseen.

If funds are injected into Madrid to boost the economy of that city, they must first be taken from some other part of Spain. The people of Valencia, Segovia, Costa del Sol and other regions of Spain have the funds extracted from them so that the economy of Madrid can prosper. As the funds are extracted from those cities, their economies must shrink, since those funds can no longer be spent in those local communities. The people in those communities who must pay to support the economy of Madrid are losers, while those who live in Madrid are winners. However, this process is not a zero-sum game because the cobblers of Costa del Sol, the restaurateurs of Valencia, and the hoteliers of Segovia are also losers because the people of those cities no longer have the funds to support those local businesses. Thus, it is what economists would call a zero-sum game because there are more losers than winners.

That is as far as the Bastiat analysis would go. However, we can push the analysis a step further using a more complete version of the Keynesian multiplier. The version of the multiplier that Keynes advanced in 1936 focused only on the sector of the economy where the funds were injected. He totally ignored where the funds came from, and the shrinking effect they would have on wherever they were extracted. He also overlooked the differential impact the funds would have by being extracted from one sector of the economy and injected into another sector. We can improve on the Keynesian example by taking these factors into account.

If the government bails out a failing company or a failing industry by injecting it with funds, it is fair to say that the industry being bailed out is less healthy, less productive, than the industries that are called upon to surrender their resources to be

used in the bailout. If that were not the case, there would be no need for a bailout. In equation format, we could express this concept as follows:

$$cmr_1 - cmr_2 < 0, \tag{1}$$

where  $c$  is the cash injection into the economy,  $m$  is the multiplier,  $r_1$  represents the rate of return of the bailed out company,  $r_2$  indicates the average rate of return for the companies that provide the funds for the bailout, and  $r_1 < r_2$ .

It is reasonable to expect that the rate of return for the bailed out company or industry would be lower than the rate of return for the average industry that is providing the bailed out funds. Otherwise there would be no need for a bailout. In fact, it would be reasonable to assign a value of less than zero to the bailed out company or industry, since the reason it is being bailed out is probably due to the fact that it is losing a lot of money, perhaps to the point of bankruptcy. In other words, any funds used in bailouts must necessarily be transferred from more productive uses to less productive uses, causing a net loss in efficiency. There is really no need to express this relationship in equation format. This conclusion can be reached a priori. However, to humor the econometricians among us, let's assign values to the variables in the above formula. Let's say that:

$$c = \text{€}1,000,000,000, m = 5, r_1 = 1\%, r_2 = 5\%$$

Plugging these values into the equation (1) we get

$$cmr_1 - cmr_2 = \text{€}1,000,000,000(5)(1\%) - \text{€}1,000,000,000(5)(5\%) = (\text{€}-40,000,000)$$

In other words, the total economy has shrunk by €40,000,000. Bailouts are always and everywhere a losing proposition. That being the case, there is never a legitimate argument for using government funds to bail out any industry. Any jobs saved in the bailed out industry are more than offset by jobs lost in the other sectors of the economy. Governments are incapable of creating jobs. At best, they can only shift jobs from one sector of the economy to another.

Bastiat referred to this redistribution, this taking of property from those to whom it belongs and giving it to those to whom it does not belong, as legalized plunder (Bastiat, 1850, 1998). He pointed out that the forced taking and redistribution of property when done by individuals would be classified as a crime. The fact that such redistribution is sanctioned by law merely makes it legal. It is legalized plunder (Bastiat, 1850, 1998). In substance it is the same as private theft except for the fact that the government is doing the stealing.

Rather than individuals using force to take other people’s property, they use the institution of government to do the stealing for them. Auto industry executives or executives in the banking, insurance or other industries can avoid being arrested for robbery by asking government to perform the task of confiscating other people’s assets for them.

Once government is permitted to bail out one company or one industry a precedent has been set. A slippery slope is established whereby excuses may be made to bailout any other company or industry that is in distress or that may suffer losses.

Bastiat saw this possibility. In fact, the same arguments that are being made today for and against bailouts were made in mid-nineteenth century France. Bastiat’s view was as follows:

But how is this legal plunder to be identified? Quite simply. See if the law takes from some persons what belongs to them, and gives it to other persons to whom it does not belong. See if the law benefits one citizen at the expense of another by doing what the citizen himself cannot do without committing a crime.

Then abolish this law without delay, for it is not only an evil itself, but also it is a fertile source for further evils because it invites reprisals. If such a law – which may be an isolated case – is not abolished immediately, it will spread, multiply, and develop into a system (Bastiat, 1998, p. 17).

The system Bastiat warned us about is now upon us. Governments everywhere think they have the moral authority to take the property of those who have earned it and distribute it to those who have not earned it in the name of the public good. In fact, they are dissipating the wealth of the country and of the people. They are rewarding incompetence, inefficiency and failure and punishing competence, efficiency and success.

#### ■ 4. Concluding comments

Although Frédéric Bastiat was primarily known as a pamphleteer and advocate of free trade rather than an economic theorist (Blaug, 1986, pp. 14-15; Haney, 1949, p. 238; Schumpeter, 1954, p. 500), he was brilliant in his ability to reduce complex economic theory into words that could be understood by nonspecialists (Roche, 1971). His application of opportunity cost to a wide range of issues constitutes one of his lasting contributions to economics, which is made more remarkable by the fact that the theory

of opportunity cost was not fully developed until a generation after his death – by William Stanley Jevons in England (1871), by Carl Menger in Austria (1871) and by Léon Walras in the French speaking part of Switzerland (1874).

Although Bastiat's essay, *Ce Qu'on Voit et Ce Qu'on ne Voit Pas* [What Is Seen and What Is Not Seen] (Bastiat, 1862, 1964a), has not received the attention it deserves in the history of economic thought, applications that can be derived from this essay have been almost totally absent in the applied economics and political science literature. The present paper uses Bastiat's approach to the application of opportunity cost to bailouts, a topic that has become increasingly talked about in recent years, both pro and con (Copelovitch, 2010; Muolo, 2008; O'Hara and Malkin, 2010; Ritholtz, Fleckenstein and Task, 2010; Stern, Feldman and Volcker, 2009; Woods and Paul, 2009).

Future studies could apply his approach to any number of public policy issues where the concept of opportunity costs is relevant. Expenditures involving the military, any future bailouts, economic protectionism, including tariffs, quotas and antidumping laws, national content requirements and other trade restrictions are ripe for the Bastiat approach. Taxes and government expenditures, subsidies, all kinds of regulation and most of the topics in books on welfare economics could also benefit by using Bastiat's approach.

A word of warning is needed, however. Although applying an opportunity cost approach to a wide range of public policy issues would be a major improvement over the present situation, it is not sufficient. The underlying theory behind opportunity cost analysis is utilitarian ethics (Goodin, 1995; Mill, 1993; Shaw, 1999). The underlying premise is that a policy is good if the result is a positive-sum game and bad if the result is a negative-sum game. The dimension totally missing from such analyses is property rights. A utilitarian would not hesitate to disparage property rights if the result is a positive-sum game (Bentham, 1988; Brandt, 1992; Frey, 1984; Waldron, 1987).

For a rights theorist, outcomes are irrelevant. All that matters is whether someone's property (or contract or association) rights have been violated. If even a single violation occurs, the policy is a bad one. Thus, it might be said that utilitarian approaches are fatally flawed (McGee, 1994) because they ignore this basic yet very important moral issue.

In *The Law* (1850, 1998) Bastiat addresses this issue. He provides guidelines to determine whether a policy should be adopted or repealed. As quoted above, one must look at whether the law takes property from one individual and gives it to another – forcible redistribution. If the law benefits one person or group at the expense of another person or group by doing what people themselves cannot do without

committing a crime (forcible taking of property), the law must be abolished, the policy must be repealed, lest the approach develop into a system where plunder becomes legalized and protected by law (Bastiat, 1998, p. 17), which is exactly what bailouts and all other forms of subsidy and protectionism are – legalized plunder.

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