

Jack High

The Case for Austrian Economics

The 1930s revolution in economics started so grandly. Keynes was trodding new paths and finding a *general* theory that subsumed classical theory as a special case. Sir John Hicks, a follower of Keynes, hit upon a new, mathematical method applicable to a wide variety of economic problems. A Great Depression may have engulfed the Western economies in the thirties, but no depression intruded upon the economics profession. These were the glory days, the days of high theory. It was the Glorious Economic Revolution come to save not only the dismal science, but the depressed masses and politicians as well.

The Revolution gave us a new policy and a new method. The New Policy said that the market, left to itself, would stagnate, leaving millions unemployed and starving. Only an enlightened State, by shoring up aggregate demand, could prevent disaster. The New Method said that economics is as mathematical and as predictive as physics. No more need economists haplessly toy with mere words; now, they could harness the mighty mathematical function to extend and test their knowledge.

Armed with their new tools, the economic revolutionaries went to work. They developed a sophisticated array of monetary and fiscal prescriptions, and administered them at the highest levels of government. They wrought an elegant mathematical edifice that described the properties of a hypothetical economic system in equilibrium. Yet, despite their efforts and considerable talent, the New Economists could not keep the revolution on track.

The New Policy was supposed to stabilize an inherently unstable market. It was not supposed to heat inflation up to twenty per-

cent. It was not supposed to give us rising prices *and* rising unemployment. Yet this is what happened in the 1970s.

The New Method was supposed to give us solid understanding of the market economy. It was supposed to help us predict the course of economic events. But when beleaguered policy makers turned to the New Theory for support, they found none. The elegant mathematical structure, unattached to any significant reality, floated serenely above the hustle and bustle of daily economic life.

Confronting the Crisis

Today, crisis and economics appear together frequently, and in the best places, too. A couple years ago, for example, Basic Books published a special volume entitled *The Crisis in Economic Theory*. Some of the profession's most respected practitioners offer their opinions on what is wrong with their science. On this much economists agree: *Something* is wrong. But beyond this, no consensus exists, nor does one appear likely in the near future. Economists are not striking out in a new direction. Rather, they are groping, disputing, and hoping.

Although economists have not yet abandoned the direction set by the revolution of the thirties, they are at least questioning it. Of course, the line and severity of the questioning vary from economist to economist. One of the most interesting aspects of *The Crisis in Economic Theory* is the perspective it gives us on attitudes towards the revolution. We can discern four different attitudes.

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(1) The conservative attitude, which endorses both the government stabilizing the market and the mathematical theory.

(2) The centrist attitude that rejects government stabilizing but endorses the mathematical method.

(3) The centrist attitude that endorses government stabilizing but rejects the mathematical method.

(4) The radical attitude, which rejects government stabilizing and mathematical economics.

To Frank Hahn, one of the great architects of mathematical economics, the discipline is healthier than many people think. True, equilibrium theory has been less enlightening than expected (123); true, that theory ignores monetary problems, expectations, and unemployment (130-135); however, economists will soon enough address these subjects with their sophisticated mathematical techniques, and when they do, the policies of Keynes will most likely be vindicated (136-137). Hahn represents the conservative view of the Revolution. Both the policy and the method are inherently sound, but need more development.

Two camps hold middle ground on the acceptance of the Revolution. The first camp comprises the Rational Expectations and the Monetarist schools. Both of these groups roundly criticize Keynesian policy. They feel Keynesian policy is flimsy and ignorant of long-term consequences (36,39), and they feel that Keynesian policy assumes that people are irrational and contradictory in their behavior (86, 88).

In place of Keynesian policy, these economists want policy based on "rational expectations," or on a "monetary rule." Both of these policies are justified by using mathematical equations that are supposed to predict how the economy reacts to government intervention. This is how Monetarists and the Rational Expectations school retain the mathematical method.

The second camp holding the middle ground on the Revolution is the Post-Keynesian school. These economists see mathematical economics as "analyzing a

problem that has no real-world equivalent or solution" (157). In place of irrelevant and sterile mathematics they would substitute a theory that is both humanist and historical.

As the Post-Keynesians see it, Keynes introduced a new *logical* method of looking at the market. Keynes's contribution lay in discovering that the use of money destabilized the market. If large numbers of people decide to hold more money, unemployment will follow, because no workers are required to produce more money. Only government spending can prevent this unemployment (167-170). Thus the Post-Keynesians reject the method of the Revolution, but retain its policy.

Holding a more critical attitude towards the Revolution are the Austrian economists. They reject both the mathematical method and the Keynesian policy. The Austrians believe that "the attention paid to the formal apparatus has been responsible for failure to appreciate a number of insights crucially important for economic understanding" (115).

Austrians look on the market as a *co-ordinating process*. The trouble with focusing upon a few statistical aggregates, as the Keynesians do, is that it ignores the complex process of market adjustment. Keynesian policy, by ignoring market complexity, not only fails to stabilize the market, it also *induces* large-scale discoordination (120-121). The Austrians believe that the only way to reconstruct economics is to overturn both parts of the revolution. Both the mathematical method and government intrusion into the market should be rejected as unproductive and harmful.

There are several reasons why the Austrian alternative to the legacy of the thirties should be considered at some length. First, Austrian economics was *the* primary contender to Keynesian and mathematical doctrine in the 1930s, though it lost out in the competitive struggle of ideas. Second, Austrian economists predicted that Keynesian policy would fail, and that mathematical economics would result in sterile theory. Now that these predictions have been borne out, the ideas on which they were based

should arouse curiosity. Third, Austrian economics offers a comprehensive and integrated view of economic theory and policy.

Austrian Reconstruction of Theory

Several contributors to *The Crisis in Economic Theory* set guidelines which they felt economic theory should follow. Economics should be more dynamic and risk-centered. Economics should stop assuming that man does nothing more than flawlessly calculate gain or loss. Economics should pay more attention to human institutions. Finally, economics should be unified; micro-theory and macro-theory should be united by common principles. These are guidelines with which Austrian economists would generally agree, and which they have urged on the economics profession for many years.

Austrian economics accords the entrepreneur a central place in economic theory. The entrepreneur is alert to opportunities for profit; he introduces new goods and new production techniques into the market, and he bears the risk of carrying on business enterprise. In large part, the market is a process set in motion by entrepreneurs eager to capture profits. Thus Austrian economics focuses on change, uncertainty, and risk.

We usually think of the entrepreneur as limited to a specialized business function, but entrepreneurship is a set of mental processes exercised by everyone in the market. Entrepreneurship means alertness to new opportunities, judgment in the face of uncertain situations, and the creation of new ways of doing things. Each of us in our own small ways performs these tasks daily.

Like all economists, Austrians assume that people act to substitute a more satisfactory for a less satisfactory condition. But to say that people will try to bring about a preferred state is not to say that people always act in their objective self-interest. Ignorance, misperception, poor judgment, and just plain stupidity are all part of human life. The

market does not eliminate frailty, but it does encourage us to keep it to a minimum. In a market, people bear responsibility for their errors. This responsibility induces us to use our intelligence.

Austrian economics also lays considerable emphasis on economic institutions. In fact, the market itself is seen as a vast set of institutions, much of which has been developed to help us coordinate our activities. Money, for example, not only facilitates exchange, but also makes possible double-entry bookkeeping. The calculation of profit and loss on the books permits specialized producers the world over to know whether they are using resources economically. If revenues cover resource expenses, good; if they do not, producers know that the resources they are using have more highly valued uses elsewhere. Many economic activities, from the establishment of large, organized exchanges, through the publishing of trade journals, to the advertising and marketing of goods, cannot be appreciated unless we understand the market as a process of change and coordination.

Finally, Austrian economics unifies micro- and macro-theory, or, to be exact, it never split economic theory to begin with. The explanation of the trade cycle developed by Ludwig von Mises and Friedrich von Hayek related directly to their view of the market as a coordinating process. The trade cycle is a large-scale breakdown of the coordinating process, and its cause must lie in the failure of one or more of those institutions that usually serve to coordinate economic activity.

The particular institutions singled out by Mises and Hayek are the central bank and the credit market. The central bank increases the money supply by lowering the interest rate and loaning businesses more money than savers have saved. The interest rate is a sensitive signal in a market economy; it tells businessmen how much savers are willing to set aside for investment projects. A high interest rate indicates that people prefer present consumption, and that a relatively small volume of loanable funds is available.

The distortion of the interest rate by the central bank can lead to widespread miscalculation. Businessmen will undertake many investment projects that they should not undertake, because the artificially lowered rate of interest makes it appear that the amount of saving is larger than it really is. Only after they have partially completed their uneconomical projects do businessmen perceive that the volume of saving is not as large as they had thought. They then realize that their undertakings are not profitable, and many of them fail. Thus, the boom-bust cycle so familiar to capitalist economies emanates from the inflationary activities of the central bank.

Austrian Reconstruction of Policy

Economic policy always embodies something more than economic theory. An economist's policy recommendations reflect his political and ethical views as well as his economic ones. Strictly speaking, there is no such thing as Austrian economic policy. Nevertheless, Austrian economics lends credence to liberal (in the Classical sense) politics and the free market. Classical liberalism teaches that a social system based on force is evil; Austrian theory teaches that it is unnecessary. Classical liberalism teaches that a social system based on a respect for rights is ethical; Austrianism teaches that it is also practical.

On the macro-economic level, Austrian economics rejects the "economist-king," that enlightened despot who monitors and stabilizes the erratic activity of his economic subjects. According to the Austrians, fiscalist and monetarist planners who pretend to control business fluctuations and unemployment in fact create them both.

In place of these monetary planners, we need only establish a free market in money. A voluntary monetary system responds to the demands of consumers more sensibly and more sensitively than does a government controlled system. A voluntary system would supply the kinds and quantity of money that people require to carry out their

daily exchanges. It would take away the perverse, state-granted power to inflate, and thus would eliminate the boom-bust cycles that monopolistic central banks have inflicted on the general populace for two centuries.

On the micro-level, Austrian economics rejects the army of bureaucrats who regulate and prosecute voluntary production and exchange. Regulation and anti-trust laws have usually been motivated by economic gain. Through them, businessmen have been able to restrict competition, raise prices, and increase profits. Lawyers and economists have been able to build up a huge business in the courts, and draw handsome legal and consulting fees.

Unfortunately, economic theory has supported much of this activity. For nearly sixty years, economists have taught that competition is a passive market state in which an infinity of sellers produce an identical product and sell it at the same price. Competition thus conceived excludes advertising, lowering price, introducing new products and new production techniques, and organizing a business more efficiently. In other words, the orthodox view of competition excludes all those activities that constitute real competition in the business world.

Because the orthodox view of competition excludes advertising, marketing, pricing, etc. as anti-competitive, these practices, especially if they are successful, incite regulatory and anti-trust action. Again, the Austrian prescription is to establish a free market in the production and sale of goods. If a company prospers by serving its customers, let it thrive. As long as its methods do not coerce, then the company's profits indicate that it is using resources more efficiently than its competitors. And using resources can include using them to advertise, to innovate, and to differentiate a product. These activities are not inherently coercive.

On the other hand, if a company cannot cover its expenses by serving its customer, then it should go out of business. Chrysler has proved that a very large company can be

inefficient, and when it is, that the market will discipline it. Size and large advertising budgets do not guarantee that a company is using resources efficiently, or that it will survive in the market.

Politics and Economics

Murray Rothbard, a student of Ludwig von Mises, introduced into Austrian economics the distinction between the "economic" and the "political" means of acquiring wealth, which is ultimately a moral distinction. The economic means of acquiring wealth comprise all those acts of production and exchange that respect the right of property. The right of property does not mean merely that a person has a legal title to something, but that a person has a moral claim to something. The political means of acquiring wealth comprise all those acts of plunder that violate right of property. Government may very well transfer legal title to wealth through tax laws, but this does not make taxation any less coercive, and less a violation of rights.

Using the distinction between the economic and political means of acquiring wealth, we can divide social activity into two broad categories—the market process and the political process.

The market process consists of all those activities in which people pursue their goals through voluntary interaction, i.e., interaction that respects the right of property. These goals need not benefit only, or even primarily, the person who pursues them. Religious activity and charity are no less a part of the market process than profit-seeking enterprise.

The political process consists of all those activities in which people pursue their goals through coercive interaction. Robbery, taxation, and exploitation of foreign resources using governmental power are obvious examples, but there are many subtler ones. Inflation is a method by which government officials and their allies in the business

community gain wealth at the expense of most of the rest of us.

We know that men will devise the most ingenious economic and political means to acquire wealth, and that these means set in motion radically different social processes. If men accept the moral doctrine of rights, the resulting social process encourages the division of labor, increases our standard of living, stimulates cultural diversity, and promotes peace. If men accept the moral doctrine of plunder, the resulting social process breaks down the division of labor, impoverishes the many for the enrichment of a few, stifles cultural diversity, and continually stirs up armed conflict.

Austrian economic policy favors the market process and opposes the political process. It opposes the fiscal and monetary policies so fondly promoted by Keynesians and Monetarists. It opposes anti-trust and regulatory activity. It opposes foreign military adventures, which benefit the military-industrial complex and encourage an ugly form of temporary slavery—the draft. It opposes the public "education" system, which instills obedience to State authority in young children. It opposes the vast welfare system, which saps the productive, manipulates the poor, and feeds an already bloated bureaucracy.

The Austrians wish to reshape both the method and the policy that have dominated economics for the past fifty years. Austrian theory is realistic: its main task is to explain the vast, complex, changing pattern of human interaction that we call market economy. It is dynamic. It is risk-centered. It gives human institutions their just due.

Moreover, Austrian economics is compatible with the tradition of natural rights that has undergirded Western Civilization for over 300 years. Austrian economics does not insist that anyone adopt this particular moral view (in fact many Austrian economists do not), but it does enable us to see that a social system built on natural rights is eminently workable.

It is too early to tell how influential Austrian ideas will be when (and if) the cur-

rights is eminently workable.

It is too early to tell how influential Austrian ideas will be when (and if) the current confusion about economic theory and policy subsides. But it is not too early to

know that Austrian economics holds interest, insight, and promise for anyone concerned with furthering a humane social order.

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