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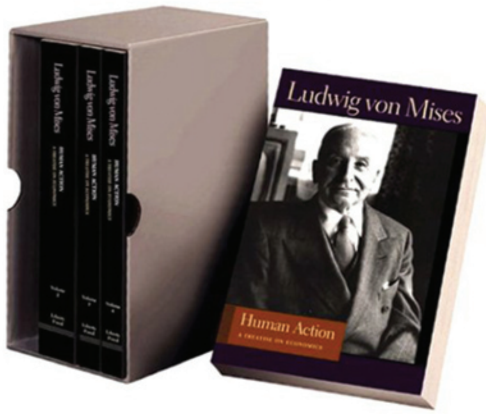

Everything you always wanted to know about Austrian Economics*

*But were afraid to ask

Economics can be confusing enough on its own without the added complexity of dozens of competing 'schools of thought' with different approaches, assumptions and conclusions. Institutional economics, new institutional economics, public choice, monetarists, Keynesians, classical economics, neo-classical, new classical, new Keynesian, Austrian, evolutionary, supply-side, Marxist, Chicago school and others.

The story is further complicated by the fact that the different schools often overlap. Sometimes these economic sub-groups conceal more than they reveal. However, for those interested in free market economics and the argument for small government, there is one school of thought that is worth specific consideration—the Austrian school.

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Austrian economics in context

Austrian economics came about as a split in mainstream economics at the end of the nineteenth century. Before 1871, mainstream economics followed the 'classical' teachings of people such as Adam Smith and David Ricardo.

Classical economics taught that the value of anything was determined according to the labour that was spent on producing it. This 'labour theory of value' was rebutted at the end of the nineteenth century by three economists who all came to the same conclusion independently. The Englishman William Jevons, the Frenchman Leon Walras and the Austrian Carl Menger realised that production and consumption needed to be studied in marginal increments. One important conclusion of the 'marginal revolution' was the recognition that value came from the marginal utility that a person has from consuming a good.

At the turn of the twentieth century, a new mainstream emerged that united the ideas from the marginal revolution with classical economics. This 'neo-classical economics' was most closely associated with Alfred Marshall (who popularised the famous supply and demand graph) and is still taught to every undergraduate economics student.

But Carl Menger and a small group of his students (specifically Eugen von Bohm-Bawerk and Friedrich von Wieser) continued to develop an alternative successor school to the classical economists with important differences from the neo-classical school.

This new group of thinkers was referred to as 'Austrian economists' as a put-down by members of the dominant German Historical School to indicate that Menger and his associates were not part of mainstream German economics.

How is Austrian economics different?

Both Austrian and neo-classical economics admit an intellectual debt to classical economics and both accept the lessons of the marginal revolution. The primary differences lie in methodology and the treatment of time.

The Austrian school, like the preceding classical school, has a strong preference for deductive reasoning and preferred to build theories of the economy based on logic and reason instead of observation. Austrian economists question the value of empirical economic data and are generally sceptical of economic models. This stands in direct contrast to the neo-classical school, which eagerly pursued general equilibrium modelling where the economy is represented by a complex set of thousands of simultaneous equations and a range of estimated variables.

Perhaps more importantly, Austrian economists concentrate on market dynamics, with uncertainty and the consequences arising from changes in knowledge, institutions and preferences over time. Neo-classical economics is primarily concerned with static equilibrium analysis of how an economy will look if knowledge, institutions and preferences are held constant.

In recent decades, mainstream economics has expanded to give greater consideration to economic dynamics. Economic texts still concentrate on static equilibrium analysis, but they also include chapters (hidden in the back) on time and uncertainty. And new areas of economics are concentrating on dynamic issues. New Institutional Economics, for example, is primarily concerned with how institutional arrangements (for example, property rights, laws, social capital) work, how they change and how they affect economic outcomes. Another relatively new area of research is Evolutionary Economics, which uses a 'biological' approach that emphasises complex interdependencies, dynamic competition, innovation and growth.

Another point of differentiation is that Austrian thinkers often extend their analysis past the realm of traditional economics and into areas of sociology and all human action. Traditional economics (called *catallaxy*) is simply one part of the larger study of all human action (called *praxeology*).

This is another area to which mainstream economists are starting to pay more attention. Gary Becker pioneered neo-classical economic analysis of marriage, suicide and car crashes. More recently, economists have given greater attention to the role of social capital, civil society and other areas of non-traditional economics.

As mainstream economists increasingly consider issues of praxeology and

Carl Menger
(1840-1921)

Eugen von Böhm-Bawerk
(1851-1914)

Ludwig von Mises
(1881-1973)

Friedrich Hayek
(1899-1992)

I am certain nothing has done so much to destroy the juridical safeguards of individual freedom as the striving after the mirage of social justice.
- F.A. Hayek

Freedom is indivisible. As soon as one starts to restrict it, one enters upon a decline on which it is difficult to stop.
- Ludwig von Mises

economic dynamics, it is becoming more difficult to maintain the appearance that Austrian ideas are clearly separate from mainstream ideas. Good mainstream economists are increasingly incorporating the lessons of Austrian economics in their own approaches.

Economic calculation debate

With the deaths of the Austrian first generation in the early twentieth century, the lack of English translations of Austrian economists, and the ascendancy of the neo-classical school, the Austrian approach was marginalised and unpopular. It was at this time that the second (and most famous) generation of Austrian economists were developing their ideas.

Ludwig von Mises and Friedrich von Hayek are the most well-known, influential and arguably the best of the Austrian economists. These two lonely figures led the argument against the neo-classical economists who claimed that it was possible for socialism to work efficiently.

Some neo-classical economists, following the lead of Vilfredo Pareto, argued that it was possible to use models and survey data to centrally plan the appropriate economic decisions in a socialist country. They claimed that this approach could achieve a higher level of economic efficiency because it could imitate a perfectly competitive equilibrium, while the free market was often in disequilibrium.

Mises (who was 18 years the senior of Hayek) was the first to respond with *Economic Calculation in the Socialist Commonwealth* in 1920. He argued that, without a market, a socialist economy would not have prices and could therefore not allocate capital goods efficiently. Neo-classical proponents of general equilibrium modelling responded that, with enough information, it would be theoretically possible to model the 'shadow prices' of a perfectly efficient market, which could then be used to inform planning decisions.

The debate between the planners and the Austrians highlights the difference in approach of the two schools. The neo-classical planners emphasised the need for efficiency as achieved through a perfectly competitive equilibrium, while the Austrians recognised the importance of the dynamic competitive process instead of simply the static competitive outcome.

It was perhaps Hayek's discussion of knowledge that finally showed the inadequacy of the socialist system in efficiently allocating resources in a complex and dynamic economy. However, it wasn't until the collapse of the Soviet Union and the fall of the Berlin Wall that Mises and Hayek were finally vindicated.

Hayek, knowledge and a dynamic economy

In 1944, Hayek published his most famous book, *The Road to Serfdom*, which discussed how a planned economy would tend towards greater political authoritarianism because of the government's need for certainty and control over information.

One year later, he published 'The Use of Knowledge in Society'. In this article Hayek explains that individuals hold a significant amount of unique knowledge of time, place and preferences which can never be adequately collected in one place. The existence of this diffuse, unique and changing individual knowledge raises the prospect of a constantly changing equilibrium.

Hayek then re-states the economic problem as 'mainly one of rapid adaptation to changes in the particular circumstances of time and place' and goes on to explain 'We cannot expect that this problem will be solved by first communicating all this knowledge to a central board which, after integrating all knowledge, issues its orders. We must solve it by some form of decentralization'.

Hayek goes on to explain how the price mechanism succeeds in providing all the information necessary for individuals to make decisions. The 'information-sharing' role of the price mechanism shows why it is not sufficient to have artificial model-derived shadow prices, and that it is necessary actually to go through the market process to determine the price because it is the process that helps to coordinate the widely dispersed information.

Austrians are happy to admit that the market process would probably not provide a perfect static equilibrium as understood by neo-classical economists, but it would make the best use of all knowledge and therefore would get closer to the ever-changing equilibrium than any other approach.

Austrian economics resurgent

In 1974 Hayek received the Nobel Prize in Economics and the Austrian school started to receive more respect and attention. It was at this time that the third generation of Austrian economists started

Murray N. Rothbard
(1926-1995)

rising to prominence.

Murray Rothbard, in particular, was a student of Mises and helped to define the modern libertarian and anarcho-capitalist movement.

The Austrian school, and Hayek in particular, has been associated with political movements in English-speaking countries during the 1980s, especially the reforms of Margaret Thatcher in the United Kingdom. Consequently, Hayek has sometimes been referred to as a 'conservative', but this is a tag he explicitly rejected in his essay 'Why I Am not a Conservative', where he explained that he was politically a classical liberal or libertarian and complained that while conservatives have opposed socialism, they offer no coherent political philosophy or direction for reform.

Rudd on Hayek

Late last year, Austrian economics was made topical in Australia by an attack on Hayek made by Kevin Rudd. This was notable for Rudd's almost perfectly inverted understanding of Austrian economics and Hayek. Indeed, Rudd seems unaware that Hayek is an Austrian economist and instead refers to him as a 'neo-liberal' economist (whatever that means).

The many mistakes that Rudd made cannot be fully addressed here, but it does provide a chance to correct a few general misunderstandings about Hayek (and, by implication, about Austrian economics).

Perhaps the most absurd mistake made by Rudd was to imply that Hayek's views have become mainstream in Australia, that John Howard is dancing to the tune of the Austrian economists and that his 'neo-liberal experiment has now reached the extreme'. It is impossible to reconcile this empty political rhetoric with reality. The Howard Government is following a high taxing, high spending, big government conservative agenda that is a major disappointment to classical liberals and Austrian economists.

One of the more important pieces of Rudd-fiction came from a discussion of the role of selfish market behaviour vis-à-vis compassionate interaction with civil society. Rudd interprets Hayek as promoting the market as a replacement for civil society (the 'commodification' of life) and he complained that this will lead to a selfish order and a loss of social capital. A similar accusation has occasionally been levelled against many in the classical or neo-classical school who advocate free markets—although, strangely, Rudd wants to exclude Adam Smith from those who might be accused of advocating selfishness. Given the overwhelming similarities between the philosophies of Hayek and Smith, this distinction is not sustainable.

Rudd was able to build a false dichotomy between markets and civil society by not mentioning the third possible way to coordinate human activity—government coercion. In reality, Hayek (like most people) is a supporter of a strong civil society based on compassion. However, civil society and brotherly love are not sufficient to coordinate a complex world economy of six billion people and 150 countries.

The real dichotomy is about which mechanism is used to supplement compassion—should it be voluntary trade in a free market or government control, regulation and planning? Austrian economists have generally concluded that free markets are superior to government in coordinating economic decisions. Rudd complained that allowing a voluntary free market will undermine civil society, but there is no theoretical or practical reason to believe that this is true. Indeed, history suggests that it is more often government that undermines civil society and destroys social capital.

It is good to see Hayek and the ideas of Austrian economics receiving greater attention in Australia. Unfortunately, Rudd's contribution was nothing more than a politically-motivated and entirely misleading misinformation campaign.

Austrians and the mainstream

Austrian economics is the unpopular cousin to neo-classical economics. They both share an appreciation of marginal analysis and they both grew out of classical economics. The remaining differences between the two approaches have been decreasing in recent decades as mainstream economists are increasingly paying attention to Austrian ideas such as uncertainty, knowledge, dynamic change and innovation.

Many Austrian economists are proud to distinguish themselves from the mainstream. But, equally, there is a large body of economists who are happy to take the lessons of Austrian economics without choosing to sail under the Austrian banner. For this reason it can be problematic to draw too fine a distinction between the neo-classical and Austrian traditions.

However economists chooses to self-identify, if they consider only the static equilibrium analysis of narrow neo-classical economics at the expense of considering knowledge, dynamics and economic change, then they have an imperfect understanding of economics and would benefit from reading some of the Austrian masters.

The Ludwig Von Mises Institute website (www.mises.org) is an invaluable resource for students of Austrian economics and Libertarianism. It offers the full-text of many classic texts as free pdf files, as well as lectures from Mises, Rothbard and other modern libertarian scholars in MP3 and video formats. It is also republishing libertarian classics that have been long out of print, both freely available on the web, and printed using print-on-demand technology.

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