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Understanding "Austrian" Economics, Part 2

by Henry Hazlitt

After the passing of its three founders—Carl Menger, Friedrich von Wieser, and Eugen von Böhm-Bawerk—Austrian economics fell for a long time into eclipse. It was not so much refuted as neglected. English-speaking economists began devoting themselves to such matters as mathematical treatment of problems of "general equilibrium." The Austrian view was revived mainly by one man, an Austrian by birth as well as an "Austrian" by conviction—Ludwig von Mises (1881–1973). He made his influence felt both by his written works and by his oral teachings. Among his early distinguished students and followers were Gottfried Haberler, Fritz Machlup, Oskar Morgenstern, Lionel (subsequently Lord) Robbins, and, most influential of all, F. A. Hayek.

Ludwig von Mises was prolific, but his principal contributions were made in three masterpieces. These were *The Theory of Money and Credit*, first published in German in 1912, *Socialism: An Economic and Sociological Analysis*, also first published in German in 1922, and *Human Action*, which grew out of a first German version appearing in 1940, but was not published in Mises's own rewritten English version until 1949.

Mises on Human Action

Though there is now a gratifying number of able young American economists writing in the Austrian tradition, *Human Action* still stands as the most complete, powerful, and unified presentation of Austrian economics in any single volume. Mises always generously acknowledged his indebtedness to his predecessors. He recalled in a short autobiography (*Notes and Recollections*, 1978) that around Christmas 1903 he read Menger's *Principles of Economics* for the first time. "It was the reading of this book," he wrote, "that made an 'economist' of me."

It would carry me to too great length to itemize and explain all the contributions to economics that Mises made, and I will content myself with mentioning only two. He was the first to prove that it was impossible for socialism to undertake "economic calculation"; and he made one of the most important contributions of any economist toward solving the problem of "the trade cycle."

Because Mises so uncompromisingly rejected government interventionism in all its forms, he acquired the reputation of a "laissez-faire extremist" during most of his lifetime, and was scandalously neglected by the majority of academic economists. But because Hayek elaborated his own ideas in a more conciliatory form, his writings

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attracted more attention from the academic world, and he leapt into prominence in 1931 with his own contribution to the theory of the trade cycle, *Prices and Production,* along lines similar to Mises's. The result is entitled to be called the "Mises-Hayek" theory.

Hayek is also a prolific writer, but though he has written volumes on money, on the trade cycle, on inflation, and on *The Pure Theory of Capital* (1941), he has never attempted a comprehensive book on economic principles. Of late years he has turned his attention mainly to the realms of politics, ethics, and law, and has written profound and widely discussed treatises on *The Constitution of Liberty* (1960) and a three-volume work on *Law, Legislation and Liberty,* completed in 1979. He has been more widely influential in his own lifetime than was Mises, and was awarded the Nobel Prize in Economics in 1974.

Today's zealous group of younger "Austrian" economists, though all acknowledging their great debt to Mises, do not treat his *Human Action* as the final word on the subject, but are exploring a whole range of economic problems with a new vigor. Murray Rothbard [1926–1995], a student of Mises, produced a two-volume treatise, *Man, Economy, and State* (1962), along Misesian lines, with notable clarity of exposition, and making important contributions of his own, pointing out the fallacies, for example, in the prevailing theories of "monopoly price."

Israel M. Kirzner (b. 1930), professor of economics at New York University, another former Mises student, although he has not undertaken a comprehensive book of "principles," has explored individual problems in five separate volumes: *The Economic Point of View* (1960), *Market Theory and the Price System* (1963), *An Essay on Capital* (1966), *Competition and Entrepreneurship* (1973), and *Perception, Opportunity, and Profit* (1979). His work is distinguished by great scholarship, systematic thoroughness, and precision of statement. He has brought further illumination to every problem he has dealt with.

Finally, no reference to individual writers would be adequate that did not include Professor Ludwig M. Lachmann [1906–1990]. Though he is one of the most original and profound among living Austrian economists, his work has not yet nearly achieved the recognition it merits. Among his principal books are *Capital and Its Structure* (1956; republished in 1978), *The Legacy of Max Weber* (1971) and *Capital, Expectations, and the Market Process* (1977). His writings are notable for their emphasis on the role of expectations and for their thoroughgoing application of a "radical subjectivism."

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Ludwig Lachmann (1906–1990)

Restrictions of space permit me merely to list the names of half a dozen of the now-increasing group of important "Austrian" economists: S. C. Littlechild, Gerald P. O'Driscoll, Jr., Mario J. Rizzo, Hans Sennholz, Sudha R. Shenoy, and Lawrence H. White. But so arbitrarily short a list must omit a number of names unjustly.

The "Austrian" economists, more consistently than those of any other school, have criticized nearly all forms of government intervention in the market—especially inflation, price controls, and schemes for redistribution of wealth or incomes—because they recognize that these always lead to erosions of incentives, to distortions of production, to shortages, to demoralization, and to similar consequences deplored even by the originators of the schemes. But personal value judgments of government policy are of course not an essential part of Austrian theory.

The present vigorous Austrian School is not content merely to keep re-expounding the principles developed by Menger and Mises, but is addressing itself constantly to new problems, or a more thorough probing of old ones. This is dramatically evident in a recent volume, *New Directions in Austrian Economics* (1978), edited by Louis M.

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Spadaro, with contributions from eleven writers. Professor Spadaro himself, in his concluding essay, outlines some of the still unresolved problems that Austrians ought to explore. In some sense, however, practically all eleven contributions do the same thing.

I have heard it said (by an economist of another school) that there is no such thing as Austrian economics; there is only good economics or bad. But in the same way we could say that there is no such thing as Ricardian economics, Marxist economics, Keynesian economics, and so on. This sort of statement, though true in one sense, is false in another. It is fallacious in implying that if anything is classified in accordance with one characteristic, it cannot be classified in accordance with any other. It is like saying that there are no such persons as Americans or Japanese; there are only men and women. Those who call themselves "Austrian" economists give themselves this label because of its historic origins; but they happen also to believe that its fundamental theses are true, and offer more promise than any other for further progress in economic science.

Perhaps something should be said about the chief differences today between Austrian economics and what we may call "orthodox" or "mainstream" economics. The difficulty here is that "mainstream" economics itself would be hard to define. Economists are still divided into a number of recognizable "schools"—neoclassicists, Keynesians, the Chicago school, the Lausanne school, and so on. The limits of space forbid me to go into the distinguishing doctrines of each of these schools. But one outstanding difference of the Austrians from all of these lies in their method of reasoning. The Austrians emphasize methodological *individualism*. That is, they not only begin by emphasizing human actions, preferences, and decisions, but *individual* actions, preferences, and initiatives. Mainstream economists are concerned with "macroeconomics," with averages and aggregates; and those of the Lausanne school, trying to reduce economics to an "exact" science, and therefore seeking to quantify everything, are obsessed with complicated mathematical equations that try to stipulate the conditions of "general equilibrium."

Equilibrium a Useful Concept, Though Never a Reality

Now "general equilibrium" is defined by these economists (when it ever is) in highly abstract and obscure phrases; but for laymen it might be defined as a condition in which all the tens of thousands or millions of commodities and services are being turned out in the exact quantities and proportions in which they are relatively wanted by producers or consumers, so that there are no "shortages" or "surpluses." All prices reflect costs, and there is no more profit in making one commodity than any other. (In fact, there is no "pure" profit at all.) These economists admit that at any moment this condition does not exist, but they contend that there is a constant long-run *tendency* toward equilibrium, because when there is an unusual profit in turning out some one product, producers will turn out more of it, and when there is a loss in turning out some other product, producers will make less of it, or transfer to making something else.

Now the concept of equilibrium (or much better, the Mises concept of an "evenly rotating economy") can have great usefulness as a tool of thought. We are often better able to analyze the problems of change if we begin with the fictitious assumption of a state of affairs in which certain changes are hypothetically eliminated. But this is a purely imaginary construction, a useful fiction. It should never be confused with reality.

While a true "equilibrium" between the marginal cost of production and the market price of any one commodity is a condition that is seldom reached, even momentarily, a "*general* equilibrium" in the relative production, supply price, and demand price of *all* commodities and services is a condition that is *never* reached, even for an instant of time.

The concept itself is extremely nebulous. Neoclassical economists seem obsessed today with setting up complicated algebraic

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equations stipulating the conditions of equilibrium or functional relations under "perfect competition" and the like, but it is difficult to specify precisely what their x's and y's stand for. They cannot refer to physical quantities, because you cannot add apples to horses, or a ton of gold watches to a ton of sand. One might add or compare quantities times prices, but what would be the meaning of the total, or any of the parts that make it up? The price, even of one commodity, differs from hour to hour, place to place, and transaction to transaction. The value of the currency itself fluctuates and constantly changes its exchange ratio with commodities. If we simply add or compare "values," then we must recognize that values are purely subjective. They are impossible to measure or to total because they differ with each individual.

If we pass over these fundamental difficulties, where do we arrive? Even if we assume that there may be a persistent long-run *tendency* toward general equilibrium, we must admit that there is also a persistent short-run and long-run tendency toward the persistence of *disequilibrium.*

This is not only because there is a tendency of entrepreneurs, in increasing or reducing production in response to market and profit signals, to overshoot the mark, but because individual entrepreneurs, so far from making merely automatic responses, are constantly gaining new knowledge, alert to new opportunities, changing methods and reducing production costs, improving products, innovating—turning out entirely new products or inventions. And consumers too are constantly learning, changing tastes, and demanding new products to meet new wants. So Austrian economists seldom speak of market equilibrium, but of the market *process.*

My own suspicion is that the enormous attention now being devoted to stipulating the mathematical conditions of "general equilibrium" is a pursuit of a will-o'-the-wisp, of questionable help in solving any real economic problem.

But space forbids me to go into too many detailed contrasts. Let me sum up briefly the main Austrian theses once again, this time not in my own words or in Menger's, but in those of two prominent living [1981] "Austrians."

Israel Kirzner

"Beginning in the 1870's in Vienna, Austria," writes Professor Kirzner, "the school was distinguished by its emphasis on the *subjective* elements in economic analysis, on the significance of *time* in production processes, and on the role of *error and uncertainty* in economic phenomena" (his italics).

The summarization by Professor Lachmann is remarkably similar: "The first, and most prominent, feature in Austrian economics is a radical subjectivism, today no longer confined to human preferences but extended to expectations. . . . Secondly, Austrian economics displays an acute awareness of the many facets of time that are involved in the complex network of interindividual relations. . . . In the subjective revolution of the 1870's the first step in the direction of subjectivism was taken when it was realized that value, so far from being inherent in goods, constitutes a relationship between an appraising mind and the object of its appraisal" (*New Directions in Austrian Economics*, pp. 1–3).

All the rest of Austrian economics follows from these basic insights. Let me conclude with my own opinion that any economic analysis that fails to embody such insights cannot be entirely sound.

Recommended Reading

Those who have no previous acquaintance with Austrian economics, and would like a short and simple text written along Austrian lines, might begin with *Essentials of Economics* by Faustino Ballvé (126 pages;

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Irvington-on-Hudson, N.Y.: Foundation for Economic Education). A more advanced . . . introduction (1979), specifically explaining the Austrian point of view, is *The Fallacy of the Mixed Economy,* by Stephen C. Littlechild [out of print].

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Murray Rothbard (1926–1995)

Surprisingly, the original *Principles of Economics,* first published in 1871 by Carl Menger, the founder of Austrian economics (328 pages), still makes an excellent, very readable, and not too technical introduction to the school's basic principles.

Of course, *the* authoritative and most complete work on modern Austrian theory is *Human Action*, by Ludwig von Mises (907 pages, first published in 1949 [fourth edition, FEE, 1996]). Some may find this difficult reading. A very clear two-volume work written thirteen years after *Human Action* by a student of Mises is Murray N. Rothbard's *Man, Economy, and State* [Ludwig von Mises Institute, 987 pages].

For the reader interested in the latest developments in Austrian economics I can highly recommend two books: One is *The Foundations of Modern Austrian Economics,* edited by Edwin G. Dolan, which contains contributions by half a dozen writers [1976, 238 pages, out of print]. The other is *New Directions in Austrian Economics,* edited by Louis M. Spadaro (1978), 239 pages, with contributions by eleven writers [out of print].

Most of these foregoing books have already been mentioned in the text. The reader may also profitably consult others mentioned there, especially the volumes by Kirzner and Lachmann. □

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Rent-Seeking: A Primer

by Sanford Ikeda

Readers of *Ideas on Liberty* often come across references to the term "rent-seeking." Usually from the context it's plain that it refers to something undesirable, but what exactly is it?

The idea of *rent* is an old one in economics. In mainstream economics it refers to a payment to the owner of a fixed factor of production over and above its "opportunity cost," that is, what it could fetch in its next most profitable use. In the case of land, for example, any payment to the owner of a particular parcel beyond the cost of, say, clearing and leveling it or for its "permanent and indestructible qualities" was traditionally considered rent.[1]

There are those, including nineteenth-century social critic Henry George, who believe that such payments are wasteful because (1) they could have been spent to bring other goods into existence, such as houses or food, instead of being used merely to transfer ownership of an already existing commodity from one person to another, and (2) they do nothing to increase the supply of the fixed factor. Does this mean that the pursuit of rent is a bad thing because it's wasteful? No, not in this case.

Let's examine the first argument. A pure rental payment for a fixed factor such as land, whether it's paid in increments over time or all at once in a lump sum, doesn't merely move a product around from one person to another. (In fact, land doesn't even do that because it isn't movable, except near places like the San Andreas fault, where occasionally it is.) But what rent does help to do is encourage the transfer of land ownership from a less-profitable use to a more-profitable use—from, say, a housing development to agriculture, if growing crops will fetch a higher profit than building houses on the land. In this way, the transfer, and thus the rental payment, is part of a process that increases *wealth*.

Here it's important to realize that *production* in economics has nothing necessarily to do with the physical transformation or movement of things, but rather with the *creation of value*, which is subjective in nature. For instance, if John and Mary, without either one using force or fraud, trade ownership of an apple and an orange, both necessarily expect to feel subjectively better off as a result (or else at least one of them wouldn't agree to the trade) because each will be giving up something he or she values less for something he or she values more. The net gain in subjective value that each one feels constitutes newly created wealth. In developed societies this is how most wealth is produced, by free trade.

Likewise, the consumers of food generate for the landowner a greater excess of revenue over cost than do potential consumers of the houses that could have been built on

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