Primer on Austrian Economics
By Jeffrey Herbener

The Austrian School of economics began in 1871 when Carl Menger, a professor at the University of Vienna, published the book, *Principles of Economics*. This work helped revolutionize economic thinking by demonstrating that the prices of goods are determined by the valuations people have of them and not their costs of production as most economists before Menger had maintained.

Human action v. mathematical modeling

Menger also pioneered a new way to think about economics, one that insists on the realism of theory. Austrian economic thought begins with basic truths about the nature of man and the world. The fundamental truth, upon which all economic theory rests, is the fact of human action. With action a person aims to attain an end by employing means. By reflecting on our own experience of acting, we can understand its meaning. We comprehend action in terms of value, cost, success, failure, scarcity, choice, preference, foresight, and so on. From the meaning of human action, all economic theory can be derived. Increasingly complex phenomena, such as prices, costs of production, profits, patterns of production, the division of labor, the capital structure, economic expansion, and the business cycle, can be explained by building ever more elaborate deductive structures upon the fundamental truth of human action. This method of developing economic theory is called *praxeology*, the logic of action, and conceives of economics as a body of non-quantitative propositions justified by logical proof. By starting with true propositions about human action and reasoning correctly, one arrives at true conclusions about the real world. In contrast, most other economists try to directly model complex phenomena, like economic expansion or the business cycle, using mathematics. Such a method requires unrealistic assumptions and conceives of economics as a body of quantitative propositions justified by empirical testing. Proceeding in this way, one cannot know whether or not he has arrived at true conclusions about the real world.

Liberal arts

In keeping with their approach to economics, Austrians see their discipline as part of the liberal arts, not as a branch of applied mathematics. Economic theory provides the conceptual, logical structure of human action. For example, every possible action aims at attaining an end, which the person values, by using means, which have costs. And in every possible action, the person anticipates that the value of the end will exceed the costs of the means, else the action would not be chosen. This logical structure is the framework for understanding any and all actions, but it does not address the specific, concrete aspects of particular actions. Psychology seeks to provide this feature of human action. Why did Benedict Arnold betray his country while George Washington defended it, are questions answered by psychology, not economics. Ethics examines whether actions are right or wrong, while economics tells us only what actions, and their consequences, are. Political philosophy and sociology look at the social, cultural, political, and institutional conditions in which action takes place, while economics treats

those aspects of action that are universal and thus, independent of these conditions. History combines knowledge of all these disciplines to render an understanding of events brought about by human actions.

Distinguising features

There are several distinguishing features of Austrian economic theory. Stress is placed on the determination of actual market prices instead of prices that would exist under hypothetical conditions or will emerge in the future. Actual prices form the basis of entrepreneurial judgments about which goods consumers value highly enough to justify their production and which combinations of factors of production have costs low enough to justify their use. The role of entrepreneurs in anticipating the future conditions of markets and organizing production to produce the highest-value goods in the least-cost ways occupies center stage.

Together the production processes overseen by entrepreneurs form a complex latticework of interrelated capital goods, called the capital structure, to produce consumer goods. For example, trees are felled by a lumber company, shipped to a mill by a trucking company, milled into planks by a lumber mill, finished and stained by a woodworking company, and fitted together to make a wood floor in a newly-constructed house by a construction company. The capital structure is the "microeconomic" foundation for "macroeconomics." Explanations of what happens to the economy as a whole, such as economic expansion and the business cycle, are built upon the actions people take that constitute it. The capital structure is built up via the capital markets in which capitalists channel savings into the lines of investment most highly valued by people as consumers. Greater demand for automobiles, for example, makes it profitable to invest in building new factories with better equipment to build them.

Emphasis is placed on the role of time in action, which implies both the uncertainty of the future and a preference people have for sooner as opposed to later attainment of their ends. Profit is earned by those entrepreneurs who most accurately anticipate the future and interest is earned by capitalists who lend the funds they have saved to the people with the most intense preference for sooner attainment of their ends.

The market economy is a system of social cooperation in which each person employs his property in voluntary associations with others to attain his own ends by satisfying the ends of consumers. A factory worker earns income, the spending of which leads other producers to satisfy his consumption ends, by supplying his labor which, in conjunction with other workers, capitalists, and entrepreneurs, produces automobiles for consumers. When the order of the market economy, founded on private property and brought forth by voluntary exchange, is unhampered by government intervention, the market economy makes the best use of factors of production in the service of everyone as consumers. The unhampered market economy suffers neither from booms and bust nor from systematic failures to make the best use of factors of production.

Government intervention

Welfare

Government intervention into the market economy, far from overcoming its alleged failures and instabilities, proves to be either counterproductive to its own goals or detrimental to the market process of satisfying consumers. Welfare programs that tax producers to subsidize non-producers, for example, reduce production and increase the number of non-producers and thereby, aggravate the original problem. Because it fails to achieve its social ends, Austrians advocate the absence of all government intervention.

Money & banking

Some of the most pernicious government interventions are in money and banking. In the unhampered market economy, money would be commodities, such as gold and silver, selected by people for their superior properties in being a medium of exchange. Like the supply of all goods on the market, the supply of money would be regulated by the profitability of its production. Banks would provide money substitutes, such as checking accounts, demanded by people for their superior convenience over coins. These substitutes would be fully redeemable into gold and silver. Banks would also serve as middlemen between savers and investors and thereby, improve the operation of the credit markets in allocating savings to the most profitable investments. In contrast, governments impose their own irredeemable paper money on the market economy, via central banks, and grant special privilege to commercial banks to issue money substitutes only partially backed by money. These interventions result in monetary inflation, which redistributes incomes and causes prices to rise, and credit expansion, which leads to malinvestment and sets in motion the boom-bust cycle.

Austrian school economists

In addition to Menger's revolutionary insights, Austrian school economists have made some notable contributions to economics. Theories of the capital structure and the rate of interest, mentioned above, were developed by Eugen von Boehm-Bawerk in his three volume work, *Capital and Interest*, published between 1884 and 1912. In his 1922 book *Socialism*, Ludwig von Mises, arguably the greatest 20th century Austrian economist, demonstrated why government central planning, as under socialism, cannot organize and operate an economy with an advanced capital structure. He explained the economic case for capitalism in his 1927 book, *Liberalism*, and showed, in his 1929 book *Critique of Interventionism*, why there can be no "third-way" system between capitalism and socialism. Mises developed a theory of the business cycle, beginning with his book *The Theory of Money and Credit* in 1912, in collaboration with F.A. Hayek which traced the cause of booms and bust to monetary inflation and credit expansion, as mentioned above. For his work on this theory, primarily in his 1931 *Prices and Production*, Hayek won the Nobel Prize in Economics in 1974. Hayek also pioneered analysis of the nature and use of knowledge in society and the role of competition in discovering and disseminating knowledge. His seminal articles on these topics are reprinted, respectively, in his books, *Individualism and Economic Order*, published in 1948 and *New Studies in Philosophy, Politics, Economics, and the History of Ideas*, which appeared in 1978.

Treatises on Austrian economics include Menger's, *Principles of Economics*, Mises's, *Human Action*, published in 1949, and Murray Rothbard's, *Man, Economy, and State*, which first appeared in 1962.

Jeffrey M. Herbener, Ph.D. is a fellow for economic theory and policy at The Center for Vision & Values. He is a professor of economics and chair of the economics department at Grove City College. He is also a senior fellow at the Mises Institute.