

Chapter Two

OLD AND NEW VIENNA
THE RISE, FALL AND REBIRTH
OF THE AUSTRIAN SCHOOL

*No book since Ricardo's Principles has had
such a great influence on the development of economics
as Menger's Grundsätze.*

—Knut Wicksell (1958:191)

*Mises and Hayek articulated and vastly enriched the
principles of Adam Smith at a crucial time in this century.*

—Vernon L. Smith (1999:208)

The Austrian and Chicago schools were born in the midst of crises in economic theory, at times when the classical laissez-faire model of Adam Smith faced unprecedented challenges from the critics of capitalism. The Austrians rescued classical economics from the socialist/Marxist threat in the late 19th century, while the Chicago school countered the Keynesian challenge of the 20th century. Let's begin by examining the roots of the Austrian school.

**Adam Smith and the
Origin of Classical Economics**

Classical economics, led by Adam Smith, J.-B. Say, David Ricardo, and John Stuart Mill, revolutionized and transformed Western civilization in the 18th and 19th centuries. The

classical economists introduced the principles and policies of the enlightenment within the field of political economy. Rejecting the old mercantilist policies of protectionism, state monopolies, and colonialism, they proposed a radical change favoring free trade, limited government, balanced budgets, the gold standard, and laissez faire; in short, maximum economic freedom.

Adam Smith (1723-90), a student of the Scottish enlightenment and founder of the classical model, built a "system of natural liberty" in his magnum opus, *The Wealth of Nations*. Published in 1776, *The Wealth of Nations* was a declaration of economic independence against the prevailing doctrines of protectionism and state interventionism.¹ Very little progress had been achieved over the centuries in Europe because of the entrenched system known as mercantilism. The commercial and political powers believed that wealth was finite and thus one nation grew only at the expense of another. Consequently, they favored government-authorized monopolies at home and supported colonialism abroad, sending agents and soldiers into poorer countries to seize gold and other precious commodities. Smith carefully delineated the host of high tariffs, duties, quotas, and regulations that aimed at restraining imports, production, and employment.

A former Professor of Moral Philosophy at Glasgow University, Adam Smith denounced high tariffs and other restraints of trade as counterproductive. Trade barriers hurt the ability of both countries to produce, he said. For example, by expanding trade between Britain and France, traditional enemies, both nations would gain. "If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them" (Smith 1965 [1776]:424).

¹ Adam Smith was the most famous classical liberal to advocate economic freedom, but not the first. Other predecessors, including the Spanish Jesuit priest Juan de Mariana, the Irish banker Richard Cantillon, and French official A. R. J. Turgot advocated free markets and often elucidated economic principles more consistently than Smith. In some ways, Abbe Etienne Bonnot de Condillac's book, *Commerce and Government*, published in the same year as Smith's (1776), is a more consistent exposition of sound economics.

Smith favored a controversial solution, the free movement of labor, capital, money, and goods. Milton Friedman states, "Adam Smith was a radical and a revolutionary in his time—just as those of us who preach laissez faire are in our time" (Friedman 1978:7). Critics contended that Smith's radical idea would lead to economic disaster and instability. To the contrary, Smith promised that the dismantling of state regulations of trade, prices and employment would lead to "universal opulence which extends itself to the lowest ranks of the people" (Smith 1965 [1776]:11).

His eloquent advocacy of natural liberty fired the minds of a rising generation. His book literally changed the course of politics over the next hundred years, dismantling the old mercantilist doctrines of protectionism and human bondage. It was a perfect companion to the American Revolution of 1776 and precursor to the Industrial Revolution of the 19th century. "The Invisible Hand" (Smith 1965 [1776]:423) has come to represent Adam Smith's model of economic freedom. In *The Wealth of Nations*, Smith argues that if individuals are left to their own devices, pursuing their own self interest, they will generate a self-regulating and highly prosperous society. George Stigler calls Smith's invisible-hand doctrine the "crown jewel" of economics. "Smith had one overwhelmingly important triumph: he put into the center of economics the systematic analysis of the behavior of individuals pursuing their self-interests under conditions of competition" (Stigler 1976:1201).

The French Advance Adam Smith's Model

The French laissez-faire school of Jean-Baptiste Say (1767-1832) and Frederic Bastiat (1801-1850) advanced the classical model of Adam Smith by championing the boundless possibilities of open trade and a free entrepreneurial economy. J.-B. Say, known as "the French Adam Smith," developed in particular Say's law of markets, which became the

fundamental principle of classical macroeconomics. Say's law, often simplified as "supply creates its own demand," focuses on the notion that savings, capital investment, and entrepreneurship — all elements of the supply-side of the economy — are the keys to economic growth, and that rising consumption is the effect, not the cause, of prosperity.

Bastiat, a brilliant French journalist, was an indefatigable advocate of free trade and laissez-faire policies, a passionate opponent of socialism, and an unrelenting debater and statesman. Bastiat was unrivaled in exposing fallacies, condemning such popular clichés as "war is good for the economy" and "free trade destroys jobs." In his classic essay, *The Law* (1850), Bastiat established the proper social organization best suited for a free people, one that "defends life, liberty, and property...and prevents injustice." Under this legal system, "if everyone enjoyed the unrestricted use of his faculties and the free disposition of the fruits of his labor, social progress would be ceaseless, uninterrupted, and unfailing" (Bastiat 1998:5).

The British economists Thomas Robert Malthus (1766-1834), David Ricardo (1772-1823), and John Stuart Mill (1806-73) continued the classical tradition in supporting the virtues of thrift, free trade, limited government, the gold standard and Say's law of markets. In particular, Ricardo vigorously and effectively advocated an anti-inflation, gold-backed British pound sterling policy as well as a repeal of both the Corn Laws, England's notoriously high tariff wall on wheat and other agricultural goods; and abolishing the Poor Laws, England's modest welfare system.

Classical Economics Takes a Wrong Turn

Yet there was a problem. Classical economics after Adam Smith suffered from a serious theoretical flaw that provided ammunition to Marxists, socialists and the critics of capitalism.

Smith himself supported an optimistic model favoring the harmony of interests and universal prosperity. However, Smith's disciples, especially Malthus, Ricardo, and Mill, promoted an antagonistic model of capitalism that gave classical economics a bad reputation, leading English critic Thomas Carlyle to label it "the dismal science." Instead of focusing on Smith's positive view of wealth creation and harmony of interests, his British disciples emphasized the distribution of wealth, the conflict of interests, and a labor theory of value.

In his famous *Essay on Population* (1798), Robert Malthus asserts that pressures on limited resources would keep most workers close to the edge of subsistence. His thesis underlines the gloomy and fatalistic outlook of many scientists and social reformers who forecast poverty, death, misery, war, and environmental degradation due to an ever-expanding population and "unbridled" economic growth. Malthus remained true to Smith's laissez-faire roots by opposing government programs to alleviate poverty and control population growth, but he failed to comprehend the role of prices and property rights as an incentive to ration scarce resources. He also misunderstood the dynamics of a growing entrepreneurial economy through technological advances. Medical breakthroughs, the agricultural revolution and economic growth have postponed the Malthusian Armageddon, perhaps indefinitely.

David Ricardo, apart from his many positive contributions to technical economics, created an alternative "distribution" model, wherein workers, landlords, and capitalists fought over the economy's desserts. He endorsed a Malthusian "iron law of wages," where wages are constantly under pressure from an excess supply of labor. In his classic work, *On the Principles of Political Economy and Taxation* (1817), he proposes a labor theory of value: "with few exceptions the quantity of labor employed on commodities determines the rate at which they

will exchange for each other” (in de Vivo 1987:193). In Ricardo’s fatalistic system, wages tend toward subsistence levels, profits decline long term, and landlords reap unjust returns. Karl Marx and the socialists exploited Ricardo’s hostile system of class conflict and labor theory of value, concluding that all interest and profit obtained by capitalists must be treated as “surplus” value, unjustly extracted from the “whole product” created by the working class.

John Stuart Mill perpetuated the Ricardian system in his *Principles of Political Economy* (1884 [1848]), the standard textbook until Alfred Marshall’s *Principles of Economics* (1890). In his favor, Mill wrote eloquently in support of Say’s law, free trade, the gold standard, and individual liberty, especially in his classic work, *On Liberty* (1859). Yet his textbook, thoroughly steeped in Ricardian economics, preaches that prices are determined by labor costs, wages and profits vary inversely, and long-run wages tend toward subsistence levels. Most significantly, Mill separated the “immutable” laws of production from the “arbitrary” rules of distribution, which led intellectuals to support grandiose tax and confiscation schemes aimed at redistributing wealth and income, convinced that such radical measures could be accomplished without disturbing economic growth (Mill 1884 [1848]:155). For this reason, Friedrich Hayek comments, “I am personally convinced that the reason which led the intellectuals to socialism, was John Stuart Mill” (in Boaz 1997:50).

Adam Smith recognized that economic freedom and limited government would create “universal opulence,” but the founder of classical economics struggled to develop a sound theoretical framework (other than the division of labor) with which to explain how consumers and producers work through the profit-and-loss system to achieve this “universal opulence.” Ricardo and the British disciples took Smith’s parenthetical statements (such as his labor theory of value in a crude economy, and his criticism of landlords) and created a

model of class struggle rather than one of harmony of interests; the iron law of subsistence wages instead of universal economic growth. They viewed the economy as if it were a large cake, where a larger dessert for capitalists and landlords could only mean a smaller piece for workers.

Using the famous diamond-water paradox, Smith and the British economists separated production “in use” and production “in exchange.” Why is a useful commodity like water so cheap and of little value in price, while an impractical commodity like diamonds is so expensive and treated with such high value in the marketplace? This puzzler gave rise to the socialist complaint that in the marketplace capitalists are more interested in “making profits” than providing a “useful service,” as if profitable exchange is unrelated to consumer use. In short, the classical economists may have supported laissez faire policies, but their economic theories undercut laissez faire and gave ammunition to the socialist/Marxist causes of redistribution, nationalization, and state central planning. As Murray Rothbard observes, “Economics itself had come to a dead end...having thus given hostage to Marxism...” (Rothbard 1980:7-8).

The flaw in the classical model had a serious impact. Economics as a science reached a point of stagnation in England. The French abandoned Say and Bastiat, and embraced socialism. Germany rejected the very idea of economic theory. “Under the onslaughts of the [German] Historical School,” Friedrich Hayek writes, “not only were the classical doctrines abandoned—but any attempt at theoretical analysis came to be regarded with deep distrust” (Hayek 1976:13).

Meanwhile, the Industrial Revolution of the 19th century had catapulted England and the West into a new world of wealth and capital, and clearly all classes, including workers, were making advances. Average real wages rose between 0.6%

and 1.5% a year during the 19th century, and the average workers enjoyed a gradual increase in their standard of living.

If capitalism was to survive and prosper, it would require a breakthrough in economic theory. The classical economists desperately needed a new model that could explain how all classes gain and all consumers benefit, a theory that could conform to their *laissez faire* policies. But where would it come from?

Old Vienna: The Setting of a Revolution

By the 1870s, the political economy of the classical school was ripe for a revolution. That revolution developed in a surprising place—old Vienna, the capital of the Austro-Hungarian empire. The Austro-Hungarian Empire covered the territories of today's Austria, Hungary, the Czech Republic, Slovakia, and parts of Poland, Ukraine, Romania, Bosnia, Serbia, Yugoslavia, and Italy. It was the crossroads between East and West, North and South, witness to invasions from the Celts, Romans and Turks. The empire's aristocratic leaders, the Habsburgs, ruled Eastern Europe with an iron fist for over 400 years. But why would the land of the Habsburgs serve as the nesting ground for a revolution in economic thought?

It was a gradual process. The rise of Protestantism divided the region into Lutheran and Catholic sects, with the Catholic monastic orders (Franciscans, Dominicans, and Jesuits) moving into Austrian lands, and along with them, a great flow of art, architecture, and ideas. This set the stage of Vienna as the center of art and intellectual thought. Under Leopold I (1658-1705), Vienna became the European center of music and theater. Travel became more common and explorers brought home fantastic tales. Rulers all over the world, including Peter the Great, and Louis XIV, were interested in sharing ideas, art, and architecture. In the Golden Age of Baroque, the nobility built magnificent summer palaces.

The First Holy Roman Empress

The most significant Austrian monarch, however, was not an emperor but an empress—Maria Theresa (1740-80), a mighty Holy Roman Empress who produced 16 children, including Marie Antoinette. It was said that men expanded territories, while women improved living conditions. Maria Theresa abolished serfdom and torture, and established public education and public parks. She built the Imperial Theatre, the Schonbrunn Palace rivaling Versailles, and hosted 40 balls a year. Her son, Joseph II, was emperor at the time of Mozart.

After the Turkish wars ended, the people had time and money to spend on culture, and music thrived. It was a status symbol to have a resident composer and orchestra for after-dinner entertainment and chamber music. The Viennese had an insatiable desire for Italian composers, especially opera. When William Gluck (1714-87) returned from Italy, he developed uniquely German operatic forms that laid the groundwork for Wagner and the post-romantics. Later the Viennese composers developed operetta, combining French humor and Viennese wit with stirring music. As the 19th century approached, a period of revolution was in the air. It was the age of Joseph Haydn (1732-1809), the classical Viennese composer; Wolfgang Mozart (1765-91), child prodigy who played before Maria Theresa at the Schonbrunn Palace, and returned at age 27 for his most creative nine years; Ludwig van Beethoven (1770-1829), a native of Bonn who came to Vienna at age 22 and flourished as never before; Franz Schubert (1797-1828), a brilliant native Viennese composer who died prematurely; Johannes Brahms (1833-97), spiritual father of Vienna Philharmonic Society; and Johann Strass (1804-49) and Johann Strauss, Jr. (1825-1899), the father and son famous for their waltzes and operettas, which would encourage the Operetta craze, culminating in Franz Lehar's "The Merry Widow" in the early 1900s.

Then came the most significant figure in modern Austria, Franz Josef (1848-1916), and his 68-year reign. He was famous for his mutton chops and stern authoritarian manner. His brother was the emperor of Mexico. His only son, Prince Rudolf, was tutored by Carl Menger, founder of the Austrian school. And his nephew, Archduke Ferdinand, heir to the throne, was assassinated in Sarajevo, Yugoslavia, by a Serbian patriot, on June 28, 1914.

Why Vienna as the birthplace of a revolutionary idea? Vienna offered a great flourishing of architecture, art, music, and education. The Habsburgs established Vienna as the political, cultural and intellectual center of Eastern Europe. Vienna, located on the beautiful Danube River, became the third-largest city in Europe, next to London and Paris, famous for its magnificent museums, palaces, parks, opera houses and cafes. Most significantly, in 1867, Austria, in alliance with Hungary, established a constitutional government that expanded economic and political freedom. Early in the 19th century, until 1820, Austria prohibited books by Adam Smith, John Locke, Rousseau, and Hobbes; after 1867, Austria, under constitutional democratic reforms, flourished economically. For half a century, from the 1870s until World War I, there occurred an extraordinary intellectual flowering within the Austro-Hungarian empire. Vienna attracted some of the world's most creative musicians, scientists, philosophers and economists. The philosopher Ludwig Wittgenstein and the psychologist Sigmund Freud lived and worked in Vienna.

Carl Menger Founds the Austrian School

In the 1870s, the University of Vienna was considered one of the largest and most prestigious schools of learning in Europe. It was there, during the reign of Franz Josef, that Carl Menger (1840-1921), the founder of the Austrian school, began his groundbreaking work. A man of extraordinarily impressive appearance, Carl Menger (sometimes spelled Karl) graduated

from the University of Vienna in 1860 and worked as a lawyer, journalist and civil servant. But it was as a reporter on economic conditions and the stock market that he discovered a startling breakthrough that would herald a revolution in economics. The result was a book, *Grundsätze der Volkswirtschaftslehre*, published in 1871 (translated into English as *Principles of Economics* in 1950).

His purpose was highly ambitious: At the youthful age of 31, Menger sought to replace the classical model of Adam Smith with an entirely new theoretical framework that would more clearly define Adam Smith's system of "universal opulence." He was no Karl Marx; he wished no harm to the great founder of classical economics, but solely to restore the theoretical soundness of Smith's "system of natural liberty." Menger shared Smith's belief in maximum freedom. And like Smith, Menger's great interest was economic growth, "the causes of progress in human welfare." But the classical economists' price theory was defective and needed repair, if not outright replacement. Menger saw it as his duty "to set himself the task of countering the theories of Adam Smith which he saw to be erroneous" (as his son put it). He wrote furiously in "a state of morbid excitement" (Skousen 2001:175, 181n).

The outcome was a book of monumental achievement. His primary goal was to demonstrate to his colleagues, and especially his German counterparts, the leaders of the German historical school, that universal principles of economics do exist. The German historical school contended that there could be no scientific economic laws separate from politics, customs, and the legal system (Streissler 1990). Menger wished to prove otherwise. To do so, he did things differently than Smith and his disciples. The classical economists had focused on the distribution of wealth and income between classes (landlords, workers, and capitalists), which gave ammunition to the socialists and Marxists in promoting an economics of class warfare and inequality. Ricardo and Mill in particular

separated production from distribution, and developed a divisive conflict of interests. For example, they maintain that if profits or rents increased, they did so only at the expense of workers' wages.

In sharp contrast, Menger introduced a new approach. He focused on individual behavior and how people achieve a higher standard of living as measured by the quantity, quality, and variety of goods and services. Rather than focusing on the average wage or salary earned by one group or another, Menger stressed the utility or maximum benefit enjoyed by each individual according to the value and utility of goods and services produced and consumed. In his first chapter, he began by focusing on goods, not classes. In "The General Theory of the Good," he showed how landlords, workers, and capitalists — the factors of production — had to cooperate in order to transform unfinished commodities into final useful goods and services through the stages of production. By doing so, Menger reestablished Smith's "harmony of interests."

In developing this "general theory of the good," he uncovered a new theory of price. Using tobacco as an example, he demonstrated that prices are determined by the subjective valuations of final users, thus rejecting the Ricardian chimera of labor units as "the invariable measure of value." What would happen if people stopped smoking, Menger asked (a question that sounds modern). He concluded that it doesn't matter how much labor is put into the production of cigarettes; the price of cigarettes, tobacco, and tobacco seeds would fall to zero. Using the tobacco example, Menger also discovered the principles of marginal utility and opportunity cost. He noted that farm land used to grow tobacco doesn't fall to zero, but is valued according to its next best, or marginal, use, such as growing wheat or raising cattle. Thus, Carl Menger is one of the founders of the Marginalist Revolution and co-discoverer, with William Stanley Jevons in England and Leon Walras in Switzerland, of the marginal utility/cost principle.

The Marginalist Revolution solved another quagmire in economic theory: Menger taught a new generation of economists that production and distribution could once again be linked together. The demand of consumers ultimately determines the final prices of consumer goods, which in turn sets the direction for productive activity. Final demand establishes the prices of the cooperative factors of production — wages, rents, and profits — according to the value they add to the production process. In short, income is not distributed, it is produced, according to the value added by each participant. Under this new brand of microeconomics, profits and use are directly connected through their marginal utility. Prices reflect the consumer's most highly valued (marginal) utility, and profit-driven production seeks to meet those needs.

It was a brilliant move, and Menger's *Grundsätze* solved many problems in classical economics, reversing the Marxist/socialist broadside against the capitalist system. It restored Adam Smith's harmony of interests and the benefits of his "system of natural liberty." Neo-classical economics became a science that integrated the Austrian principles of marginal utility, opportunity cost (next best use), and subjective consumer demand. After publishing his *Grundsätze*, Menger was offered a position at the University of Vienna, and a few years later, became the tutor to Crown Prince Rudolf of Austria. At the youthful age of 33, Menger became a professor of law and political science at the prestigious University of Vienna, based in part on the publication of his magnum opus written in 1871.

Menger and the Marginalist Revolution

Menger introduced and popularized the Marginalist Revolution in economics. Menger is usually listed third, behind Britain's William Stanley Jevons and France's Leon Walras, as the co-discoverer of the principle of marginality, but

in truth, Menger was the chief protagonist of subjective marginal analysis. Jevons, though first to write about marginal utility, ran up against Ricardian orthodoxy in England, and Walras was largely ignored because his writings were mathematically obtuse.

What determines prices? In his book, Menger broke away from the classical school. Smith, Ricardo and Mill claimed that exchange prices of goods and services are unrelated to their practical uses; yet they were unable to explain adequately the value of those goods and services. They failed to resolve the diamond-water paradox referred to earlier. Why is the value of a diamond so high when water is essential to life? Menger answered this question definitively a hundred years after Smith raised it. He showed that the value of goods is determined by their marginal utility rather than by their total utility. In other words, diamonds are more expensive than water because, given their relatively scarcity, an extra diamond generally has far greater utility than an extra bottle of water. That is, the greater the quantity, the lesser the marginal value. Thus price is determined by marginal or extra use. Water is cheap because it is plentiful: diamonds are expensive because their supply is so limited. All prices, whether for shoes, real estate or stocks, are determined by the marginal buyers and sellers at any given moment.

Finally, Carl Menger formulated the basis of Austrian capital theory and macroeconomics by emphasizing the critical role of time and interest rates in economic activity. In his masterpiece, Menger noted that all consumer goods, from automobiles to food on the table, go through many stages of production, from raw materials to final products. The process may take months or even years, depending on the product. It may also take months or years to use up or consume a product. This time structure forms the basis for a correct understanding of macroeconomics and how the economy operates as a whole. Menger divided the economy into consumer goods (called

“first order” or “lower order” goods) and producer goods (called “higher order” goods). But he did not simply lump all producer goods into a single homogeneous category called “investment,” the standard approach in neoclassical economics. Menger noted that there are many stages in the production process, and that once capital is converted into an array of capital goods, capital becomes heterogeneous. Once produced, capital goods are specific in use and cannot easily be switched to another use, as labor and land often can. Menger’s time-oriented heterogeneous capital theory would play a vital role in the Austrian theory of the business cycle later developed by Mises and Hayek.

Menger retired from teaching at the University of Vienna in 1903 and died in 1921, following World War I. He was disillusioned at the end of his life because the Great War left his beloved country in chaos and under the control of socialists, where the capital was known as “Red Vienna.” In my judgment, Carl Menger is the greatest economist of the 19th century because by correcting the theoretical errors of Adam Smith and the classical economists, he established the marginalist/subjectivist revolution in microeconomics, and by formulating a time-structural capital-using model, he identified the correct vision of modern macroeconomics. Few economists can claim breakthroughs in both micro and macro economics.

Böhm-Bawerk Takes on Marx, and Introduces a Non-Marxist Theory of Capitalism

Eugen Böhm-Bawerk (1851-1914), a pupil of Carl Menger, advanced economics further as Marxists came on the scene with talk of exploitation, alienation, and crisis. Böhm-Bawerk made contributions to the theory of capital, interest and economic growth. He was Menger’s most illustrious student and became the most famous economist on the European

continent at the turn of the century. He is the only Austrian economist well-known in his native country, with his face appearing on the Austrian 100 Schilling currency (before the Euro currency was issued). Böhm-Bawerk was Austria's finance minister three times in the 1890s, and helped restore Austria to the gold standard. After retiring from government, he became a professor of economics at the University of Vienna. He died suddenly in 1914 right before the beginning of World War I.

Böhm-Bawerk's theory of capital and interest has had a major impact on economic growth theory, and his critique of Marx's exploitation theory is considered so devastating that Marxian economics never really took hold of the economics profession as it did in other fields. He demonstrated that entrepreneur/capitalists deserve the fruits of their labor because they take greater risks than workers fulfilling a vital creative use in the market system. His most significant work, *The Positive Theory of Capital*, published in 1889 and almost immediately translated into English, forms the basis of the modern theory of economic growth. Building on Menger's stages of production, Böhm-Bawerk argues that individuals and firms adopt more roundabout processes of production in order to achieve economic growth and a higher standard of living. By "roundabout," Böhm-Bawerk means the sacrificing of current consumption to produce more capital goods, adopt new technology, and institute longer processes of production, which in turn lead to greater consumption in the future. For example, it may take two days for a worker to sew a dress by hand. But suppose she builds a sewing machine (or buys one, which also involves sacrifice of time and money) that could allow her to sew five dresses a day. The building of a sewing machine may take six months — a long roundabout process — but once manufactured, it would increase productivity tremendously. Or, if she buys a sewing machine, she may need to postpone consumption and save up for six months to purchase the machine.

The Positive Role of Saving

Böhm-Bawerk was the leading defender of savings and investment during a period of increasing antipathy toward the traditional virtue of thrift. Böhm-Bawerk contended that increasing savings and postponing consumption did not hurt business, but was simply a more effective form of spending. Savings paid dividends indefinitely into the future if the funds were well spent on new businesses, technology and capital formation. Thus, capital formation is *sine qua non* to economic growth.

Following Böhm-Bawerk's lead, the Austrian school has persistently argued that a high level of voluntary saving, both individually and nationally, is the key to rapid economic growth. Austrians criticize Keynesian economists who denigrate savings and promote a high-consumption society, as well as monetary activists who emphasize the money supply as a key ingredient to economic growth. Austrians argue that more voluntary saving by individuals and retained earnings by firms are the key to long-term prosperity, not more monetary inflation, more consumption, or more government. By the same token, the Austrians have also criticized efforts by centralized governments to promote "forced saving" plans which artificially raise the investment rate. To be most efficient, all saving and consumption should be voluntary, based on the free desires of individuals to determine their own time preference.

Wieser and the "Great Man" Theory

Friedrich von Wieser (1851-1926) became Böhm-Bawerk's brother-in-law when his sister married Böhm-Bawerk. They went mountain climbing together, a hobby common to many Austrian economists of the older generation, and they were best friends. Wieser was appointed a professor at the University of Vienna in 1884, and in 1903 he succeeded Menger as chair of economic theory. Böhm-Bawerk, Menger and

Wieser served as members of the Austrian House of Lords. In 1917, Wieser became the Minister of Commerce. He died in 1926, outliving both Böhm-Bawerk and Menger.

Wieser's *Natural Value*, published by Macmillan in English in 1893, introduced the world to the subjectivist philosophy of the Austrians. Wieser's *Theory of Social Economy* (1918) was the standard Austrian textbook for many years. He invented modern terms such as "marginal utility," "economic planning," and "opportunity cost." Marginal utility led to mathematical prowess and economics as the "queen of the social sciences," and, it might be noted, Wieser's interpretation of marginal utility analysis provided a scientific justification for a progressive income tax (Caldwell 2004:142). Opportunity cost, the value of an alternative product or activity, is an extremely important concept in economics, finance, and business. Economic Value Added, or EVA, as a way to determine if a firm achieves real profit or value added in an economy.

But perhaps the most significant concept in Professor Wieser's repertoire was his recognition of the importance of the creative individual in commerce, industry, education, religion, and government. He was especially impressed with the contributions of inventors, pioneers, capitalists and entrepreneurs — individuals willing to take risks, sometimes big risks, to accomplish their lofty goals.² In the world of business, who are the creative individuals? They are the inventors, superior money managers, independent investment advisors who can beat the market, the chief executive officers who turn a company around, and the political leaders who adopt sound economic policies and lead their countries to a new destiny. Of course, sometimes the leader is a malevolent dictator who takes the nation down the road of destruction and

² In the spirit of Wieser, Ayn Rand, an admirer of Ludwig von Mises and other Austrian economists, created supreme individualists and high achievers in her novels. As Howard Roark declares in *The Fountainhead*, "Throughout the centuries there were men who took first steps down new roads armed with nothing but their vision."

chaos. (Recall Friedrich Hayek's chapter 10, "Why the Worst Get on Top," in *The Road to Serfdom*.) Leaders can make a difference, for good or for evil. Interestingly, Wieser loved the German word *Führer* and flirted with early German Nazism in the last few years of his life. Hero worship can work both ways.³

Ludwig von Mises, Founder of Modern Austrian Economics

Ludwig von Mises (1881-1973) represents the third generation of Austrians. He brought Austrian economics into the 20th century and is regarded as the father of the modern Austrian school. Mises taught economics at the University of Vienna, and was chief economist at the Vienna Chamber of Commerce. However, the Nazi takeover of Austria forced Mises to leave his beloved native land and eventually emigrate to New York in 1940, where he and his wife, Margit, lived the remainder of their lives. For a variety of reasons, Mises was a virtual exile in America; he was "visiting" professor of economics at New York University for several decades, with his salary subsidized by friends and the Volker Fund. He spent most of his time writing books and articles that went counter to the conventional wisdom of socialist and Keynesian thinking, but contributed little in developing technical economics.

Mises was an outspoken and dogmatic defender of *laissez faire* capitalism who often lashed out at his critics and his friends who disagreed with him (see chapter 9 on the problems these *ad hominem* disputes have created). Yet despite personal disagreements and intransigence, Mises made major contributions to economics in the 20th century. Mises came on the scene just as economists were debating the role of money in

³ Mises did not consider Wieser a true believer: "Wieser was not a creative thinker and in general was more harmful than useful. He never really understood the gist of the idea of subjectivism in the Austrian School of Thought, which limitation caused him to make many unfortunate mistakes. His imputation theory is untenable. His ideas on value calculation justify the conclusion that he could not be called a member of the Austrian School, but rather a member of the Lausanne School (Leon Walras et al and the idea of economic equilibrium" (Mises 1978:36; cf Huerto de Soto 1998:93).

the economy, and what should be the ideal monetary standard. With his book *The Theory of Money and Credit*, published originally in 1912 and translated into English in 1934, he became the first economist to apply Austrian theories to money and the business cycle. In addition, he wrote the first systematic economic critique of socialist central planning in his book *Socialism* (1922), which argues that central planning can never work efficiently and will ultimately collapse.

Mises's magnum opus is *Human Action: A Treatise on Economics*, a massive volume published in 1949 by Yale University Press and revised in 1966. A novice might better begin with *Planning for Freedom*, a compilation of speeches and articles, or *Economic Policy*, a series of lectures Mises gave in Argentina in 1960. *Human Action* establishes many key principles of Austrian economics—methodological individualism, rational human action, dualism between nature and man, subjectivism in value, uncertainty in economic behavior, sound money, and the case of limited government. One of Mises's major points is that human action is always purposeful and rational. Therefore, for every cause, there is an effect. The price of every commodity or security is based on the rational buying and selling by individuals. Prices are never random, even though price patterns may appear to be. Another Misesian concept is methodological dualism, the idea that social science (praxeology, the science of human action) is distinct from the physical and biological sciences. According to Mises, human beings think, adopt values, make choices, are conscious, make mistakes and learn from the past. In short, they act purposefully. On the other hand, the actions of animals and inert matter are essentially mechanical and predictable. They are acted upon. Mises states, "Reason and experience show us two separate realisms: the external world of physical, chemical and physiological phenomena, and the internal world of thought, feeling, valuation and purposeful action. No bridge connects — as far as we can see today — these two spheres" (Mises 1966:18).

In scientific experiments with animals, plants and physical elements, the results are often exact and repeatable. Not so with human action, which is often unpredictable and unreliable. In essence, Mises argues that human beings have free will, while animals and objects do not. Does this mean that the future is completely unpredictable? Can economic analysts make an educated guess about the direction of the economy and the markets? This is a hotly debated topic in the academic world. Some economists argue that the future of the economy and the markets are unknowable and no one can predict the future. Even some of the Austrian economists, such as Ludwig Lachmann, fit into this camp, known as "radical subjectivists."⁴

Mises was also famous for his uncompromising attack on socialism and central planning by communist regimes such as the Soviet Union. As early as 1920, Mises argued that, without prices and competitive bidding, a centrally planned totalitarian state could not operate an efficient, progressive economy. He followed his paper with a full-length book entitled *Socialism* (1922). He used the example of a bridge to prove his point. Where should it be built? What materials should be used? Without considering prices and costs, it would be impossible to know for sure.

Led by Oskar Lange, Paul Samuelson, and Robert Heilbroner, among others, the economics profession scoffed at Mises, but ultimately Mises was proven correct nearly twenty years after his death. In fact, Heilbroner admitted in 1989, when the Soviet union was near collapse, that the 50-year-old debate was over: Mises had been right; capitalism had won over socialism. "Capitalism organized the material affairs of humankind more satisfactorily than socialism" (Heilbroner 1989:98).

⁴ They argue that the markets are in such constant disequilibria and are so complex, it is virtually impossible to predict their direction (Lachmann 1977:190). Gerald O'Driscoll and Mario Rizzo wrote an entire book devoted to this kind of subjectivism in a book entitled *The Economics of Time and Ignorance*, in which they state: "A world in which there is autonomous or creative decision making-making is one in which the future is not merely unknown, but *unknowable*" (O'Driscoll and Rizzo 1985:2). British economist G. L. S. Shackle compared this state of uncertainty to a kaleidoscope, where every new scene is distinct (Shackle 1974).

Hayek, the Great Depression, and *The Road to Serfdom*

Mises's most famous student⁵ was Friedrich A. Hayek (1899-1992), who received two doctorates at the University of Vienna and worked under Mises as director of the Austrian Institute of Economic Research. In 1974, Hayek was the first free-market economist to receive the Nobel Prize in economics for his work on business cycle theory and the importance of knowledge in the economy. He is the only Austrian to win the prize.

World attention was drawn to Mises and Hayek when they forecasted the cataclysmic events of the 1930s. The 1929 stock market crash and subsequent worldwide depression took the mainstream economics profession by surprise. None of the top professors of the day foresaw the collapse of the world economy—not Frank Taussig at Harvard, Irving Fisher at Yale, or John Maynard Keynes at Cambridge. Fisher and Keynes, in particular, suffered heavy personal losses. On the other hand, Mises and Hayek anticipated serious trouble, although they never attempted to pinpoint the time of the crash. Austrian economics had first come to the forefront under Menger and Böhm-Bawerk. Now, a generation later, the Austrian school gained notoriety under Mises and Hayek. Lionel Robbins, chairman of the economics department at the London School of Economics, was impressed with Friedrich Hayek and invited him to lecture at LSE to help counter the growing influence of Keynes and his interventionist doctrines. Hayek and his family moved to England upon his appointment as the Tooke Professor of Economics at LSE.

Hayek's explanation of the depression in *Prices and Production* (1935 [1931]) was based on Mises's earlier work, but this time with diagrams called Hayekian triangles. Together

⁵ Some Austrians dispute this, noting that Hayek never attended any of Mises's classes at the University of Vienna. He worked for Mises at the Austrian Chamber of Commerce, but was never his student. However, Hayek did attend Mises's private seminars in Vienna, and regarded Mises, eighteen years his senior, as his mentor in economics.

Mises and Hayek developed what is known today as Austrian macroeconomics and the Mises-Hayek theory of the business cycle. It draws from Böhm-Bawerk's capital theory, Swedish economist Knut Wicksell's natural interest rate hypothesis, and the Ricardo-Hume specie-flow mechanism (see chapter 6). Essentially, the Austrian theory emphasizes how monetary inflation by the central banks artificially distorts the structure of the economy, causing an unsustainable boom that must end in a bust. Mises and Hayek demonstrated the non-neutral impact of money on relative prices, income and business activity. That is, when the government inflates the money supply or artificially lowers interest rates below their "natural" rate (Wicksell's term for the natural time preference), certain individuals and businesses benefit while others lose, and capital and labor are "misallocated." "Easy money" does not simply raise prices, but disrupts the economy and creates winners and losers. As Roger Garrison summarizes, "Padding the supply of loanable funds with newly created money [by the government] holds the interest rate artificially low and drives a wedge between saving and investment...The credit-induced artificial boom is inherently unsustainable and is followed inevitably by a bust, as investment falls back into line with saving" (Garrison 1996:114).

According to Mises and Hayek, increasing the money supply and lowering interest rates below the natural rate misdirects resources into "higher order" producer goods. However, this boom cannot last and eventually must collapse when the money supply stops growing or interest rates return to their natural rate, creating a "cluster of business errors." According to the Austrians, the government's monetary policy, not free-market capitalism, is primarily responsible for the boom-bust pattern of Western economies and market instability. In short, the Austrians argue that even in the monetary sphere there is no free lunch, a famous phrase borrowed from science fiction writer Robert Heinlein by Milton Friedman. An expansion in the money supply can only

create a destabilizing business cycle, not genuine long-term prosperity. As we shall see in chapter 6, Friedman and the Chicago economists agree with much of this analysis, but not all. The Austrians and the Chicagoans differ, sometimes strongly, in their interpretation of the business cycle.

Hayek's macro theory and business cycle explanation of the crash and depression took the profession by storm in the early 1930s, rivaling Keynes's theories. But when the world economy failed to recover quickly, as Mises and Hayek had predicted, economists and government officials looked elsewhere for explanations and cures, and ultimately switched allegiance from Hayek and the Austrians to Keynes and the Keynesians.

After the Keynesian revolution, Hayek became disillusioned with the economics profession and turned to philosophical and political interests. During World War II, he wrote a classic on political philosophy, *The Road to Serfdom* (1944), warning that the world's movement toward welfare statism and national dictatorship could lead countries down a dangerous "road to serfdom" and the loss of political and economic freedom. His book became a bestseller after *Reader's Digest* condensed it. Hayek followed this book with a seminal article, "The Use of Knowledge in Society," broadening his critique of socialist central planning. The article explains that prices communicate vital information to consumers and producers, and that specialized knowledge, vital to economic growth, is decentralized and local, and thus cannot be duplicated by industrial planners and technocrats. As Hayek states, "To assume all the knowledge to be given to a single mind...is to disregard everything that is important and significant in the real world" (Hayek 1984 [1948]:223). Hayek saw the market economy more as an organism that coordinates activities, which differed significantly from Keynes and most other economists who saw the economy as a machine that has broken down from time to time (Caldwell 2004:10).

Engaged in a bitter divorce and new marriage to his childhood sweetheart, Hayek left the London School of Economics and, in 1950, joined the faculty at the University of Chicago as a member of the Committee on Social Thought. There he wrote *The Constitution of Liberty* (1960), an extremely important work outlining his support for a written constitution that limits arbitrary power and preserves individual rights. Hayek debunked labor unions, progressive taxation, rent controls, and inflation, warning that even a "moderate degree of inflation is dangerous" (Hayek 1960:338). However, he surprised his libertarian friends by endorsing local building codes and a minimal "safety net" welfare state (1960:285-86, 354-57). In 1962, he left Chicago for the University of Freiberg, where he continued to work on a three volume work, *Law, Liberty, and Legislation* (1973-79). After winning the Nobel Prize, he began writing once again on economic issues—socialism, inflation, and monetary reform, culminating in his final book on a lifetime theme, *The Fatal Conceit: The Errors of Socialism* (1988).

Schumpeter and "Creative Destruction"

One Austrian economist who maintained his stature throughout the 20th century is Joseph Schumpeter (1883-1950). Born the year Marx died, Schumpeter studied under Wieser and Böhm-Bawerk at the University of Vienna, spent a year as Austria's finance minister, and left Europe for good in 1932 when he accepted an invitation by Frank Taussig to teach at Harvard University. A year after he became president of the American Economic Association, he died suddenly in 1950. Schumpeter is regarded as the *enfant terrible* of the Austrian school. He dressed impeccably, but was personally arrogant and unpredictable. He engaged in outrageous behavior, was an infamous womanizer, and once declared his personal goals to be the world's best horseman, best lover, and best economist. He said he accomplished two out of the three.

Schumpeter's economics were unpredictable. He defended socialist economics, forecast the demise of capitalism, and rejected the Mises-Hayek theory of the business cycle. Yet he was hostile to and professionally jealous of Keynes. "We all like a sparkling error better than a trivial truth," he wrote in his diary. Schumpeter, like Mises and Hayek, always maintained that the depression should run its course without interference from the federal government. He despised the New Deal of Franklin Delano Roosevelt. His writings are imbued with dynamic disequilibrium, entrepreneurship, and other Austrian themes, yet he named Leon Walras, not Carl Menger or his teacher Eugen Böhm-Bawerk, as the "greatest of all economists" for discovering general equilibrium analysis.

Schumpeter was prolific, and two of his books have achieved classic status: *Capitalism, Socialism and Democracy*, published in 1942 and updated in 1950, and *History of Economic Analysis*, published posthumously in 1954. *Capitalism, Socialism and Democracy* goes far beyond economics into political science and sociology, and has been translated into sixteen languages. It is a tortuous work sprinkled with brilliant gems and colorful concepts. Schumpeter writes eloquently about the dynamics of global capitalism and how the disruptive forces of technology undermine equilibrium conditions. Sometimes his phrasing, such as "creative destruction," sounds Marxian in tone. Borrowing from his Viennese teacher Wieser, he saw the entrepreneur as the central catalyst in the dynamics of the market system. Capitalism never can be stationary. The industrial process "incessantly revolutionizes the economic structure *from within*, incessantly destroying the old one, incessantly creating a new one" (Schumpeter 1950: 82-83). Schumpeter contradicted modern-day orthodoxy by defending big business. He rejected the Chamberlin-Robinson model of "perfect competition," standard fare in today's textbooks, as naive and wrong-headed. In Schumpeter's view, competition is a process constantly reinventing itself, not a point of static equilibrium. He concludes, "Now a theoretical

construction which neglects this essential element of the case...is like *Hamlet* without the Danish prince" (Schumpeter 1950:86).

Monopolistic firms in their embryonic growth stages are highly innovative and require enormous risk capital. Schumpeter would not be surprised to see Microsoft overtake IBM, or Toyota surge ahead of Ford, or WalMart surpass Sears. "Leap frogging," as Benjamin Rogge called it, is a common feature of the competitive process. Schumpeter was pessimistic about the long-term survival of capitalism because he feared that bureaucracy would dominate the entrepreneurial spirit in the corporate world. Large multi-national corporations are always vulnerable to oversized bureaucracy, but so far competition has countered this trend, and global capitalism has remained vibrant.

The Austrian Revival in America

It is a startling fact that in less than fifty years Austrian economics went from being perhaps the most influential school at the turn of the century to its virtually disappearance from the academic scene at the end of World War II. Austrian concepts such as marginal utility analysis and opportunity cost were integrated into mainstream economics, but its three distinctive contributions of the 20th century — capital theory, business cycle theory, entrepreneurship and the dynamic market process, and the economic theory of socialism — had been vanquished by the profession. As noted in this chapter and elsewhere in this book, Austrian capital theory was attacked by John Bates Clark and Frank Knight; its business cycle theory was eviscerated by Keynesians Piero Sraffa and Nicolas Kaldor; and Mises's critique of socialism was buried by Oskar Lange (Blaug 1992). Since then, Austrian economics had made a slow and painful recovery.

The recovery began with the establishment of the first free-market think tank in 1946 by Leonard E. Read, a Chamber of

Commerce executive. Ludwig von Mises became FEE's resident scholar and remained so until his death in 1973. FEE attracted a small number of students and business people from around the world and enjoyed a virtual monopoly as a libertarian economics organization in the 1950s and the 1960s. FEE's monthly publication, *The Freeman*, containing essays by Mises, Henry Hazlitt, Hans Sennholz, Gary North, Percy Greaves and other Austrian-oriented economists and business people. FEE also published and promoted many free-market books, including Frederic Bastiat's *The Law* and Leonard Read's *Anything That's Peaceful*, and his famous essay, "I, Pencil." They distributed Henry Hazlitt's bestseller, *Economics in One Lesson*, and other free-market books with an Austrian bent.

Mises, Hayek, and Schumpeter were pessimistic about the future of freedom and capitalism. But the next generation, led by Americans Henry Hazlitt, Murray N. Rothbard and Israel Kirzner, were more upbeat. Hazlitt befriended Mises in New York, wrote for *The Freeman*, and was closely aligned with the Austrians throughout his career in New York. Rothbard and Kirzner, students of Mises's private seminar in New York City, led a revival of Austrian economics in the post-war period, primarily in the New York area. Henry Hazlitt (1894-1993) was a modern-day Bastiat, a journalist who wrote editorials for *The New York Times* and *Newsweek*. In 1946, he wrote a bestseller, *Economics in One Lesson*, a book based on Bastiat's parable of the broken window. His theme: "The art of economics consists in looking not merely at the immediate but at the longer effects of any act or policy; it consists in tracing the consequences of that policy not merely for one group but for all groups" (Hazlitt 1979 [1946]:17).

Modern Austrian economics was resurrected in 1974, when Friedrich Hayek won the Nobel Prize, and a meeting of some fifty Austrian scholars was held near Royalton College in South Royalton, Vermont (Vaughn 1994:104-05). Sponsored by

the Institute of Humane Studies, the meeting attracted such luminaries as Murray Rothbard, Israel Kirzner, Ludwig Lachmann, Gerald P. O'Driscoll, Sudha Shenoy, and Roger Garrison. It culminated in an edited volume, *The Foundations of Modern Austrian Economics* (Dolan, 1976). Kirzner (1930-), a British-born professor at New York University, focused almost exclusively on Austrian microeconomics, with his most successful book, *Competition and Entrepreneurship* (1972). For years the Austrian Economics Graduate Program at New York University, organized by Kirzner, allowed graduate students to pursue an advanced degree in economics. Kirzner, a rabbi, retired from NYU in 2002, but the program continues under the guidance of Mario Rizzo and David Harper, though now under the less descriptive name "Program on the Foundations of the Market Economy."

Murray Rothbard and Libertarian Economics

Murray N. Rothbard (1926-1995) was the inspiration of many young economists and libertarians following the radical sixties. Raised in New York City by secular Jewish parents, Rothbard earned his Ph. D. in economic history in 1956 at Columbia University, and immediately proceeded to write prolifically on Misesian economics, especially a treatise called *Man, Economy, and State* (1962) and *America's Great Depression* (1963). These scholarly works broadened Austrian themes into a full-scale alternative to standard neo-Keynesian economics. *Man, Economy, and State* is often called an Americanized version of Mises's *Human Action*. It dissected Keynesianism and then introduced an Austrian version of micro and macro economics. *America's Great Depression* exposed the fallacies of Keynesian explanations of the 1929-33 collapse, and introduced the Austrian theory of the business cycle as a plausible explanation, fully elucidated by a history of the events that led up to the crisis. Rothbard's book was published in the same year as Milton Friedman and Anna J. Schwartz's *A*

Monetary History of the United States (1963). This is significant in the long-standing quarrel between Friedman and Rothbard because they took virtually opposite views of the cause of the Great Depression. While Friedman argued that the Federal Reserve during the 1920s acted benignly (“the high tide of the Reserve System”) and then reacted ineptly in permitting the deflationary policies of 1929-32 to destroy the economy, Rothbard claimed that the Federal Reserve’s inflationary policies during the 1920s planted the seeds of an inevitable Great Depression, and that the deflationary forces were beneficial in cleansing the system. (For more details about this debate, see chapter 6.)

In the 1972 (second) edition of *America’s Great Depression*, Rothbard asserted that neither the Keynesian nor monetarist schools could properly explain the new phenomenon of inflationary recession; moreover, the Austrian theory of the business cycle had a clear explanation of stagflation, arguing that consumer price inflation is “a general and universal tendency in recessions.” That is to say, “the prices of consumer goods always tend to rise, relative to the prices of producer goods, during recession,” only this time, in the early 1970s, government inflationary policies were so strong that consumer prices rose “absolutely and visibly as well” (Rothbard 1972: xii).

Short, headstrong, and bright, Rothbard took on the Keynesians, Marxists, and socialists of all stripes, and later on, the Chicago monetarist school. His lucid, powerful polemics attracted a large number of libertarians, gold bugs, and free-market economists. His pamphlet, *What Has the Government Done to Our Money?* (1964), touched the hearts of followers as much as *The Communist Manifesto* had affected the minds and hearts of Marxists. Rothbard was the next Mises, without the heavy German rhetoric. His essay on money was something every intelligent layman could comprehend. The mystery of money was no more.

I first encountered Rothbard’s writings in an anthology entitled *Views on Capitalism*. The “conservative” view was represented with writings by Adam Smith, Friedrich Hayek, Milton Friedman, and Murray Rothbard. The editors introduced Rothbard in colorful language: “Rothbard represents an extreme right-wing mini-faction whose critique of present American society reveals astonishingly close kinship with that of many radicals, closer in fact than with his fellow conservatives. Although he is strongly committed to a defense of laissez faire as other conservative figures..., his support of black power and his characterization of American foreign policy as ‘imperialistic’ would be eagerly assented to by many thinkers usually associated with the political ‘left.’” There followed a short essay, “The Great Society: A Libertarian Critique.” I shall never forget the impact this little essay had on my thinking. Rothbard cited Franz Oppenheimer’s *The State*, which outlined two, and only two, paths to the acquisition of wealth. “One route is the production of a good or service and its voluntary exchange for the goods or services produced by others. This method—the method of the free market—Oppenheimer termed ‘the economic means’ to wealth. The other path, which avoids the necessity for production and exchange, is for one or more persons to seize other people’s products by the use of physical force. This method of robbing the fruits of another man’s production was shrewdly named by Oppenheimer the ‘political means’” (Rothbard 1970:87). I had never thought of government in this light—it came as a shock to me. I was hooked on Rothbard and his version of Austrian economics, and devoured all of Rothbard’s economic and political writings. Libertarian students finally had a star to worship.

The best introduction to Rothbard can be found in his essays and short books. In addition to those listed above, “The Essential von Mises” (published in *Planning for Freedom* by Ludwig von Mises) is especially elucidating and forthright on how Mises advanced free-market economics and the theory of

money. Economics majors and serious students of Austrian economics look to Rothbard's major works, *Man, Economy, and State*; *Power and Market*; *America's Great Depression*; and *The Mystery of Money*, for insights. The Mises Institute continues to publish Rothbard's articles and books in new editions.

Rothbard, always more than an economist, wrote extensively on political theory, ethics, and libertarian politics. He helped create the Cato Institute in 1977 and the Ludwig von Mises Institute with Lew Rockwell in 1982, and stamped his own brand on Misesian economics. He and his wife Joey spent most of their life in New York, where he was professor of economics at the Brooklyn Polytechnic Institute, an engineering school. (They had no children.) In 1985, he moved to the University of Nevada at Las Vegas. While working piecemeal on his history of economic thought (only half finished when he died of a heart attack in 1995), he became embroiled in libertarian politics. He rejected Mises's belief in limited government and advocated "anarcho-capitalism." But like Mises, he had a poison pen and often engaged in *ad hominem* in-fighting and bitter rivalries. Today Murray Rothbard is better remembered for his economic writings and ideas.

The Austrian School Today

The Austrian school has made a significant comeback in academia since Hayek won the Nobel Prize in 1974. Traditionally, the longest standing program is the Austrian Graduate Program at New York University, mentioned earlier. George Mason University in northern Virginia has gained prominence as a place for undergraduate and postgraduate studies under the tutelage of Peter Boettke, a major contributor to Austrian economics who studied under Hans Sennholz at Grove City College and Israel Kirzner at NYU. Boettke has written extensively on the collapse of Soviet socialism and central planning (Boettke 1993, 2001), organized the well-

received *Elgar Companion to Austrian Economics* (1994), and edits *The Review of Austrian Economics*. Most importantly, he is the primary author of the late Paul Heynes's updated edition of his popular textbook, *The Economic Way of Thinking* (2003). Other major contributors to Austrian and libertarian economics at GMU include Walter Williams, Don Boudreaux, Bryan Caplan and Tyler Cowen. GMU is eclectic. It offers affiliated fields, such as the Center for Public Choice under Gordon Tullock and James Buchanan, experimental economics under another Nobel laureate Vernon Smith, and constitutional economics under Richard Wagner. Buchanan and Smith consider themselves "fellow travelers" with the Austrians.

The faculty of Auburn University in Alabama has included several well-known Austrian economists, such as Roger Garrison, Mark Thornton and Leland Yeager (recently retired). But note that Auburn recently discontinued its Ph. D. Program. Garrison is considered the most lucid proponent of Austrian macroeconomic theorizing today. His popular advanced text, *Time and Money*, creatively compares and contrasts Austrian with Keynesian and monetarist macroeconomics (Garrison 2001). My own work aims to rebuild a time-structural model of the economy in *The Structure of Production* (1990), and my textbook, *Economic Logic* (2000) is the first attempt to create a modern college textbook based largely on Austrian principles.

The Foundation for Economic Education, now under the able leadership of Richard Ebeling, continues publishing *The Freeman* and other Austrian-oriented publications and seminars, but has fallen behind in influence and size compared to other educational foundations. The Mises Institute, next door to Auburn University, is in the forefront of advancing Austrian economics. Under the direction of founder Lew Rockwell, the Mises Institute enjoys a large budget and a new building, where it publishes books, journals, and a variety of essays on its website. It publishes *The Quarterly Journal of*

Austrian Economics, and many other publications, including electronic materials in the tradition of Mises, Rothbard, and other Austrians. It holds numerous conferences on Austrian themes, including the annual Mises University, a weeklong series of classes. Other schools that offer strong Austrian ties include Hillsdale College in Michigan, which hosts the annual Ludwig von Mises lecture series; Grove City College near Pittsburgh, where Hans Sennholz was long-time chairman of the economics department; and Walsh College of Accountancy and Business Administration in Troy, Michigan, where chairman Harry Veryser has created a master's degree in Austrian economics. In California, Santa Clara University has an Austrian/libertarian bent and California State University at East Bay employs labor economist Charles Baird. Lawrence H. White, a specialist in free banking, is the first F. A. Hayek Professor of Economic History at University of Missouri-St. Louis, where a number of teachers are sympathetic to Austrian thinking.

How many economists are Austrian-oriented? Ohio University professors Richard Vedder and Lowell Gallaway guessed that less than 2% fit into this category. (One might be tempted to say the founders of marginal analysis have been marginalized.) See figure 2.1 below. "Even in its resurrected state," conclude Vedder and Gallaway, "only a very small proportion of economists today consider themselves Austrian" (Vedder and Gallaway 2000:33), probably because Austrians stress non-mathematical modeling in an age of high theory and econometric performance. "The more overly Austrian the paper is, the greater the probability of rejection" (2000:35). This is no doubt due to the Austrians' aversion to participating in the mainstream of modern economics: Keynesianism, econometrics and statistical analysis, and Walrasian general equilibrium analysis (Caldwell 2004:4; Kirzner 1997).

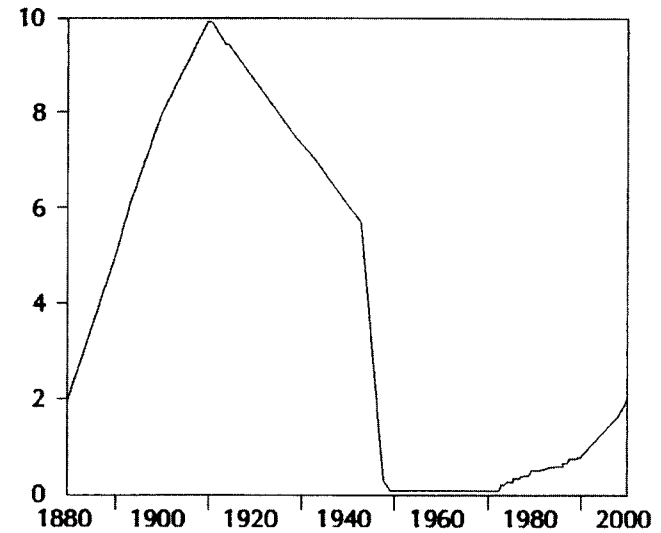


Figure 2.1—"Percent of Economists Who Are "Austrian": 1871-2000
Source: Vedder and Gallaway 2000:33

In writing *Economics on Trial* (1993), I estimated the various schools' influence in the textbooks, based on the combined references to specific theories and their leaders in the name and subject indexes. Figure 2.2 shows the results.

School	Index Frequency
Keynes and Keynesianism	442
Friedman and Monetarism	252
Marx and Marxism	131
Laffer and Supply Side	95
Austrianism	67
Galbraith and Institutionalism	53

Figure 2.2. Schools of Influence in Economics
Source: *Economics on Trial* (1993:275-76)

However, since this time, the references to Mises, Hayek, Schumpeter and other Austrians may have increased. For example, prior to the sixth edition, University of Houston professors Roy Ruffin and Paul Gregory made no mention of Mises and Hayek in their popular textbook, *Principles of Economics*. Since then, however, they cite these Austrians in reference to a “defining moment” in economic history—the rise and fall of socialism, and Schumpeter is highlighted in the “defining moment” of the Great Depression and the Welfare State (Ruffin and Gregory 2001:7-8). In addition, Peter Boettke and David Prychitko have introduced many Austrian concepts in the new edition of late Paul Heyne’s *The Economic Way of Thinking* (2003). More may be on the way.

What about the University of Vienna today? Since Mises and Hayek left Austria, the economics department in old Vienna has gradually lost its Austrian roots. Today most professors would consider themselves “Austro-Keynesian.” Erich Streissler is one of the few Viennese economists who has maintained an interest in the Austrian tradition, having written extensively on the works of Menger, Hayek, and Schumpeter. In a recent correspondence, Karl Socher, professor at the University of Innsbruck, comments, “Once, in the seventies, when economists in Vienna had been Keynesians, one of the Austro-Keynesians, Hans Seidel, said to me, Innsbruck is 500 km nearer to Chicago than Vienna (because we in Innsbruck were no Keynesians). I answered: No, we are still nearer to Vienna than to Chicago, but to the old Vienna. And Vaclav Klaus, after lectures in Linz and Vienna, when he discovered that Austrian Economics is not known any more in Austria, said: “Because you have forgotten the Austrian School, we will take it and revive it in Prague” (private correspondence, May 28, 2005).

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Cataloging-in-Publication Data on file with the Library of Congress

0-89526-029-8

Published in the United States by
Regnery Publishing, Inc.
One Massachusetts Avenue, NW
Washington, DC 20001

www.regnery.com

Distributed to the trade by
National Book Network
Lanham, MD 20706
Manufactured in the United States of America

10 9 8 7 6 5 4 3 2 1

Books are available in quantity for promotional or premium use.
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Cover design: Pitts•LaVigne Associates
Winter Park, Florida

Cover Photos:
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Economists from left to right:
Ludwig von Mises and Friedrich Hayek (Austrian),
Milton Friedman and George Stigler (Chicago).