

## The Austrian School © 2001 Mises.org

The story of the Austrian School begins in the fifteenth century, when the followers of St. Thomas Aquinas, writing and teaching at the University of Salamanca in Spain, sought to explain the full range of human action and social organization.

These Late Scholastics observed the existence of economic law, inexorable forces of cause and effect that operate very much as other natural laws. Over the course of several generations, they discovered and explained the laws of supply and demand, the cause of inflation, the operation of foreign exchange rates, and the subjective nature of economic value--all reasons Joseph Schumpeter celebrated them as the first real economists.

The Late Scholastics were advocates of property rights and the freedom to contract and trade. They celebrated the contribution of business to society, while doggedly opposing taxes, price controls, and regulations that inhibited enterprise. As moral theologians, they urged governments to obey ethical strictures against theft and murder. And they lived up to Ludwig von Mises's rule: the first job of an economist is to tell governments what they cannot do.

The first general treatise on economics, *Essay on the Nature of Commerce*, was written in 1730 by Richard Cantillon, a man schooled in the scholastic tradition. Born in Ireland, he emigrated to France. He saw economics as an independent area of investigation, and explained the formation of prices using the "thought experiment." He understood the market as an entrepreneurial process, and held to an Austrian theory of money creation: that it enters the economy in a step-by-step fashion, disrupting prices along the way.

Cantillon was followed by Anne Robert Jacques Turgot, the pro-market French aristocrat and finance minister under the *ancien regime*. His economic writings were few but profound. His paper "Value and Money" spelled out the origins of money, and the nature of economic choice: that it reflects the subjective rankings of an individual's preferences. Turgot solved the famous diamond-water paradox that baffled later classical economists, articulated the law of diminishing returns, and criticized usury laws (a sticking point with the Late Scholastics). He favored a classical liberal approach to economic policy, recommending a repeal of all special privileges granted to government-connected industries.

Turgot was the intellectual father of a long line of great French economists of the eighteenth and nineteenth century, most prominently Jean Baptiste Say and Claude-Frederic Bastiat. Say was the first economist to think deeply about economic method. He realized that economics is not about the amassing of data, but rather about the verbal elucidation of universal facts (for example, wants are unlimited, means are scarce) and their logical implications.

Say discovered the productivity theory of resource pricing, the role of capital in the division of labor, and "Say's Law": there can never be sustained "overproduction" or

"underconsumption" on the free market if prices are allowed to adjust. He was a defender of laissez-faire and the industrial revolution, as was Bastiat. As a free-market journalist, Bastiat also argued that nonmaterial services are subject to the same economic laws as material goods. In one of his many economic allegories, Bastiat spelled out the "broken-window fallacy" later popularized by Henry Hazlitt.

Despite the theoretical sophistication of this developing pre-Austrian tradition, the British school of the late eighteenth and early nineteenth centuries won the day, mostly for political reasons. This British tradition (based on the objective-cost and labor-productivity theory of value) ultimately led to the rise of the Marxist doctrine of capitalist exploitation.

The dominant British tradition received its first serious challenge in many years when Carl Menger's *Principles of Economics* was published in 1871. Menger, the founder of the Austrian School proper, resurrected the Scholastic-French approach to economics, and put it on firmer ground.

Together with the contemporaneous writings of Leon Walras and Stanley Jevons, Menger spelled out the subjective basis of economic value, and fully explained, for the first time, the theory of marginal utility (the greater the number of units of a good that an individual possesses, the less he will value any given unit). In addition, Menger showed how money originates in a free market when the most marketable commodity is desired, not for consumption, but for use in trading for other goods.

Menger's book was a pillar of the "marginalist revolution" in the history of economic science. When Mises said it "made an economist" out of him, he was not only referring to Menger's theory of money and prices, but also his approach to the discipline itself. Like his predecessors in the tradition, Menger was a classical liberal and methodological individualist, viewing economics as the science of individual choice. His *Investigations*, which came out twelve years later, battled the German Historical School, which rejected theory and saw economics as the accumulation of data in service of the state.

As professor of economics at the University of Vienna, and then tutor to the young but ill-fated Crown Prince Rudolf of the House of Habsburg, Menger restored economics as the science of human action based on deductive logic, and prepared the way for later theorists to counter the influence of socialist thought. Indeed, his student Frederic von Wieser strongly influenced Friedrich von Hayek's later writings. Menger's work remains an excellent introduction to the economic way of thinking. At some level, every Austrian since has seen himself as a student of Menger.

Menger's admirer and follower at the University of Innsbruck, Eugen von Boehm-Bawerk, took Menger's exposition, reformulated it, and applied it to a host of new problems involving value, price, capital, and interest. His *History and Critique of Interest Theories*, appearing in 1884, is a sweeping account of fallacies in the history of thought and a firm defense of the idea that the interest rate is not an artificial construct but an inherent part of the market. It reflects the universal fact of "time preference," the tendency

of people to prefer satisfaction of wants sooner rather than later (a theory later expanded and defended by Frank Fetter).

Boehm-Bawerk's *Positive Theory of Capital* demonstrated that the normal rate of business profit is the interest rate. Capitalists save money, pay laborers, and wait until the final product is sold to receive profit. In addition, he demonstrated that capital is not homogeneous but an intricate and diverse structure that has a time dimension. A growing economy is not just a consequence of increased capital investment, but also of longer and longer processes of production.

Boehm-Bawerk engaged in a prolonged battle with the Marxists over the exploitation theory of capital, and refuted the socialist doctrine of capital and wages long before the communists came to power in Russia. Boehm-Bawerk also conducted a seminar that would later become the model for Mises's own Vienna seminar.

Boehm-Bawerk favored policies that deferred to the ever-present reality of economic law. He regarded interventionism as an attack on market economic forces that cannot succeed in the long run. In the last years of the Habsburg monarchy, he three times served as finance minister, fighting for balanced budgets, sound money and the gold standard, free trade, and the repeal of export subsidies and other monopoly privileges.

It was his research and writing that solidified the status of the Austrian School as a unified way of looking at economic problems, and set the stage for the School to make huge inroads in the English-speaking world. But one area where Boehm-Bawerk had not elaborated on the analysis of Menger was money, the institutional intersection of the "micro" and "macro" approach. A young Mises, economic advisor to the Austrian Chamber of Commerce, took on the challenge.

The result of Mises's research was *The Theory of Money and Credit*, published in 1912. He spelled out how the theory of marginal utility applies to money, and laid out his "regression theorem," showing that money not only originates in the market, but must always do so. Drawing on the British Currency School, Knut Wicksell's theory of interest rates, and Boehm-Bawerk's theory of the structure of production, Mises presented the broad outline of the Austrian theory of the business cycle. A year later, Mises was appointed to the faculty of the University of Vienna, and Boehm-Bawerk's seminar spent a full two semesters debating Mises's book.

Mises's career was interrupted for four years by World War I. He spent three of those years as an artillery officer, and one as a staff officer in economic intelligence. At war's end, he published *Nation, State, and Economy* (1919), arguing on behalf of the economic and cultural freedoms of minorities in the now-shattered empire, and spelling out a theory of the economics of war. Meanwhile, Mises's monetary theory received attention in the U.S. through the work of Benjamin M. Anderson, Jr., an economist at Chase National Bank. (Mises's book was panned by John Maynard Keynes, who later admitted he could not read German.)

In the political chaos after the war, the main theoretician of the now-socialist Austrian government was Marxist Otto Bauer. Knowing Bauer from the Boehm-Bawerk seminar, Mises explained economics to him night after night, eventually convincing him to back away from Bolshevik-style policies. The Austrian socialists never forgave Mises for this, waging war against him in academic politics and successfully preventing him from getting a paid professorship at the university.

Undeterred, Mises turned to the problem of socialism itself, writing a blockbuster essay in 1921, which he turned into the book *Socialism* over the next two years. Socialism permits no private property or exchange in capital goods, and thus no way for resources to find their most highly valued use. Socialism, Mises predicted, would result in utter chaos and the end of civilization.

Mises challenged the socialists to explain, in economic terms, precisely how their system would work, a task which the socialists had heretofore avoided. The debate between the Austrians and the socialists continued for the next decade and beyond, and, until the collapse of world socialism in 1989, academics had long thought that the debate was resolved in favor of the socialists.

Meanwhile, Mises's arguments on behalf of the free market attracted a group of converts from the socialist cause, including Hayek, Wilhelm Roepke, and Lionel Robbins. Mises began holding a private seminar in his offices at the Chamber of Commerce that was attended by Fritz Machlup, Oskar Morgenstern, Gottfried von Haberler, Alfred Schutz, Richard von Strigl, Eric Voegelin, Paul Rosenstein-Rodan, and many other intellectuals from all over Europe.

Also during the 1920s and 30s, Mises was battling on two other academic fronts. He delivered the decisive blow to the German Historical School with a series of essays in defense of the deductive method in economics, which he would later call praxeology or the logic of action. He also founded the Austrian Institute for Business Cycle Research, and put his student Hayek in charge of it.

During these years, Hayek and Mises authored many studies on the business cycle, warned of the danger of credit expansion, and predicted the coming currency crisis. This work was cited by the Nobel Prize committee in 1974 when Hayek received the award for economics. Working in England and America, Hayek later became a prime opponent of Keynesian economics with books on exchange rates, capital theory, and monetary reform. His popular book *Road to Serfdom* helped revive the classical liberal movement in America after the New Deal and World War II. And his series *Law, Legislation, and Liberty* elaborated on the Late Scholastic approach to law, and applied it to criticize egalitarianism and nostrums like social justice.

In the late 1930s, after suffering from the worldwide depression, Austria was threatened by a Nazi takeover. Hayek had already left for London in 1931 at Mises's urging, and in 1934, Mises himself moved to Geneva to teach and write at the International

Institute for Graduate Studies, later emigrating to the United States. Knowing Mises as the sworn enemy of national socialism, the Nazis confiscated Mises's papers from his apartment and hid them for the duration of the war. Ironically, it was Mises's ideas, filtered through the work of Roepke and the statesmanship of Ludwig Erhard, that led to Germany's postwar economic reforms and rebuilt the country. Then, in 1992, Austrian archivists discovered Mises's stolen Vienna papers in a reopened archive in Moscow.

While in Geneva, Mises's wrote his masterwork, *Nationalökonomie*, and, after coming to the United States, revised and expanded it into *Human Action*, which appeared in 1949. His student Murray N. Rothbard called it "Mises's greatest achievement and one of the finest products of the human mind in our century. It is economics made whole." The appearance of this work was the hinge of the whole history of the Austrian School, and it remains the economic treatise that defines the School. Even so, it was not well received in the economics profession, which had already made a decisive turn towards Keynesian.

Though Mises never held the paid academic post he deserved, he gathered students around him at New York University, just as he had in Vienna. Even before Mises emigrated, journalist Henry Hazlitt had become his most prominent champion, reviewing his books in the *New York Times* and *Newsweek*, and popularizing his ideas in such classics as *Economics in One Lesson*. Yet Hazlitt made his own contributions to the Austrian School. He wrote a line-by-line critique of Keynes's *General Theory*, defended the writings of Say, and restored him to a central place in Austrian macroeconomic theory. Hazlitt followed Mises's example of intransigent adherence to principle, and as a result was pushed out of four high-profile positions in the journalistic world.

Mises's New York seminar continued until two years before his death in 1973. During those years, Rothbard was his student. Indeed, Rothbard's *Man, Economy, and State* (1963) was patterned after *Human Action*, and in some areas--monopoly theory, utility and welfare, and the theory of the state--tightened and strengthened Mises's own views. Rothbard's approach to the Austrian School followed directly in the line of Late Scholastic thought by applying economic science within a framework of a natural-rights theory of property. What resulted was a full-fledged defense of a capitalistic and stateless social order, based on property and freedom of association and contract.

Rothbard followed his economic treatise with an investigation of the great depression, which applied Austrian business cycle theory to show that the stock market crash and economic downturn was attributable to a prior bank credit expansion. Then in a series of studies on government policy, he established the theoretical framework for examining the effects of all types of intervention in the market.

In his later years, Mises saw the beginnings of the revival of the Austrian School that dates from the appearance of *Man, Economy, and State* and continues to this day. It was Rothbard who firmly established the Austrian School and classical liberal doctrine in the U.S., especially with *Conceived in Liberty*, his four-volume history of colonial America

and the secession from Britain. The reunion of natural-rights theory and the Austrian School came in his philosophical work, *The Ethics of Liberty*, all while he was writing a series of scholarly economic pieces gathered in the two-volume *Logic of Action*, published in Edward Elgar's "Economists of the Century" series.

These seminal works serve as the crucial link between the Mises-Hayek generation and the Austrians now working to expand the tradition. Indeed, without Rothbard's willingness to defy the intellectual trends of his time, progress in the Austrian School tradition might have come to a halt. As it was, his wide and deep scholarship, cheerful personality, encyclopedic knowledge, and optimistic outlook inspired countless students to turn their attention to the cause of liberty.

Though Austrians are now in a more prominent position than at any point since the 1930s, Rothbard, like Mises before him, was not well treated by academia. Although he held a chair in his later years at the University of Nevada, Las Vegas, he never taught in a capacity that permitted him to direct dissertations. Nonetheless, he managed to recruit a large, active, and interdisciplinary following for the Austrian School.

The founding of the Ludwig von Mises Institute in 1982, with the aid of Margit von Mises as well as Hayek and Hazlitt, provided a range of new opportunities for both Rothbard and the Austrian School. Through a steady stream of academic conferences, instructional seminars, books, monographs, newsletters, studies, and even films, Rothbard and the Mises Institute carried the Austrian School forward into the post-socialist age.

The first issue of the Rothbard-edited *Review of Austrian Economics* appeared in 1987, became a semiannual in 1991, and becomes a quarterly in 1998, *The Quarterly Journal of Austrian Economics*. The Mises Institute's instructional summer school has been held every year since 1984. For many of these years, Rothbard presented his research into the history of economic thought. This culminated in his two-volume *An Austrian Perspective on the History of Economic Thought*, which broadens the history of the discipline to encompass centuries of writing.

Through the Mises Institute's student fellowships, study guides, bibliographies, and conferences, the Austrian School has permeated, at some level, virtually every department of economics and the social sciences in America, and in many foreign countries as well. The annual Austrian Scholars Conference at Auburn University attracts scholars from around the world to discuss, debate, and apply the entire Austrian tradition.

The fascinating history of this great body of thought, through all its ebbs and flows, is the story of how great minds can advance science and oppose evil with creativity and courage. Now the Austrian School enters a new millennium as the intellectual standard bearer for the free society. That it does so is thanks to the heroic and brilliant minds that make up the family history of the School, and to those who are carrying that legacy forward with the Ludwig von Mises Institute.