



VIENNA & CHICAGO

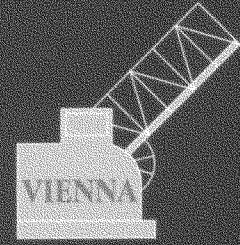
Friends or Foes?

A Tale of Two Schools
of Free-Market Economics



by Mark Skousen

Is the bridge between
the Austrian and Chicago schools
coming together or moving apart?



The Austrian and Chicago schools have played a successful role in advancing classical free-market economics and countering the critics of capitalism during crucial times in the battle of ideas. The Austrians, led by Ludwig von Mises and Friedrich Hayek, are major critics of Marxism and socialist central planning, while the Chicagoans, led by Milton Friedman and George Stigler, have pursued a counterrevolution to Keynesian economics and activist big government. Economists from both schools have won Nobel Prizes in economics for their work.

Yet these two schools of free-market economists heatedly disagree in their theories of money, business cycle, government policy, and methodology. The Austrians favor a subjective market-process approach; the Chicagoans a quantitative, empirical science. The Austrians support a market-oriented gold standard and

free banking; the Chicagoans a state-controlled monetary rule based on a fiat paper money standard. The Austrians argue that monetary inflation creates asset bubbles and other structural imbalances in the capital markets that are unsustainable; the Chicagoans reject the Austrian theory of the business cycle in favor of a monetary disequilibrium model. They even sometimes disagree on their favorite economists.

In this timely book, Mark Skousen interviews economists in both camps, uncovers their strengths and weaknesses, and determines who's right and who's wrong at the end of each chapter by declaring either "Advantage, Vienna," or "Advantage, Chicago." The results are surprising, and Professor Skousen ends his provocative work by attempting to foster common ground between these two warring schools.

Two views of Vienna and Chicago, Friends or Foes?

FROM THE CHICAGO SCHOOL:

This tale is thorough, thoughtful, even-handed, and highly readable. All economists, of whatever school, will find it both instructive and entertaining.

—Milton Friedman

FROM THE AUSTRIAN SCHOOL:

In his upbeat tale of two schools, Skousen gives us a delightful blend of theory, history, and political science, and shows that there is much common ground and scope for development.

—Roger W. Garrison



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Chapter Ten

THE FUTURE OF FREE-MARKET ECONOMICS

HOW FAR IS VIENNA FROM CHICAGO?¹

Without significant changes in its traditional research topics and strategies, Austrian economics will become increasingly irrelevant to the major intellectual currents in the next century and will ultimately fail to survive.

—Mario Rizzo (1992:245)

The Next Economics will have to be again micro-economic and centered on supply. Both productivity and capital formation are events of the micro-economy.

Both also deal with the factors of production rather than being functions of demand.

—Peter F. Drucker (1981:13)

If we have learned one thing from this study, it is how a school of economics can overcome heavy odds and achieve spectacular success. The Chicago school, under the direction of Milton Friedman and George Stigler, among others, did just that. It was the Age of Keynes in the generation after World War II, a time when free-market economists had difficulty in gaining recognition and acceptance. By staying within the profession, rigorously developing market theories, and backing up those models with powerful evidence, Friedman and the Chicago school were able to convince a growing number of economists and policy leaders of the correctness of their position. Their persistence paid off. By the turn of the 21st century, the Chicago school had achieved

¹ To borrow a phrase from Karl-Heinz Paqué (1985).

success in the profession not unlike the rapid recovery of Germany and Japan after World War II. Today, based on citations in the leading journals and the granting of the highest awards, the Chicago school and its graduates dominate the thinking and agenda of the discipline.

The Austrian school has the ability and the tools to emulate Chicago's success, although it will require a change in research topics and strategies, as NYU professor Mario Rizzo warns at the beginning of this chapter. The fact that the Austrians gained prominence twice in their history, in the late 19th century with the marginalist revolution, and between the great world wars (1920-40), with the great debates over socialist central planning and the Great Depression, offers reason to be optimistic.

Looking Outward

What would it take for the Austrians to duplicate Chicago's success? First, the Austrians need to look outward instead of inward, to be more of a town welcoming outsiders rather than a fortress closing out the rest of the world, to use Richard Wagner's metaphor. This means making a deliberate effort to submit papers to the top academic journals, such as the *American Economic Review* and the *Quarterly Journal of Economics*, before they submit them to the *Quarterly Journal of Austrian Economics* or the *Review of Austrian Economics*. It means their first priority should be participating in the annual meetings of the American Economic Association and other mainstream professional conferences, before presenting papers at their own meetings, or organizing their own separate sessions. The Marxists are known for organizing their own sessions at the annual AEA meetings, but attendance is small and their influence is waning, primarily because the Marxists are viewed as ideologues, not scientific in their approach and not to be taken seriously. Austrians have suffered from the same criticism, and need to focus on their contributions to economic science more than policy or methodology.

This new strategy would suggest that the Austrians should seek research grants from the National Bureau of Economic Research (NBER) and other established organizations pursuing scientific analysis. Austrian leaders should encourage their students to attend top ivy league universities and graduate schools, and then with Ph. D. in hand, apply for positions at major institutions. Just as Chicago graduates now teach at Harvard, Yale and Stanford, so Austrians need to follow suit. Austrians are already linked with New York University and George Mason University, creating a stimulating environment with other schools of thought. GMU, for example, offers students of Austrian economics an opportunity to associate with centers of public choice and laboratories in experimental economics, and is rapidly moving up in the ranks of top economics departments in the United States.

Building an Austrian Model

Second, Austrians need to develop and advance their micro and macro models of the economy. The fact is that the economics profession has opened the door for the Austrians in this regard. Many teachers are hungry for new micro and macro models of the economy, and the Austrians are in a good position to fill this need. Economists across the spectrum have expressed dissatisfaction with the aggregate supply and demand (AS/AD) found in most textbooks, and the failure to link micro with macro. David Colander, a prominent "neo-Keynesian," recently repudiated the standard AS/AD textbook model in an article in the *Journal of Economic Perspectives*, the most read economics journal in the world. "The AS/AD model...is seriously flawed," he writes, "a model of the worst type—a model that obscures, rather than clarifies" (Colander 1995:1969). He shows how AS-AD analysis is internally inconsistent because it relies on contradictory assumptions. The supply relationships packed into AD are at war with the supply assumptions underlying AS. Moreover, he

states, the textbook model implies that supply and demand are totally independent of each other in the aggregate economy, a theory that contradicts all common sense. So what to do? Many of Colander's colleagues favor complete banishment of the AS/AD model. Reuven Brenner, an economist at McGill University, not only dismisses textbook macro as "pseudoscience" but seriously suggests astrology as its closest allied field (Colander and Brenner 1992:123-151). Mark Blaug, considered the premier historian of economics, lambasts modern economics for the "noxious influence" of Swiss economist Leon Walras in creating the "perfectly competitive general equilibrium model," or GE for short. Most textbook writers, including Paul Samuelson, are enamored with GE, because of its mathematical precision. So is the Chicago school. Blaug, however, joins Austrians in labeling perfect competition a "grossly misleading concept" that ignores the role of the entrepreneur. He urges economists to "rewrite the textbooks" and replace the current Walrasian GE model with a dynamic Austrian view of the competitive process (Blaug 1997:78-81). Austrians should jump at this opportunity.²

The Austrians have developed useful, rigorous macro and micro models to replace those taught in the textbooks. The intertemporal capital-using model, known as Hayekian triangles, offers a powerful way to illustrate graphically the dynamics of the whole economy, one that students can relate to. In his book *Time and Money* (2001), Roger Garrison creatively combines Hayekian triangles, the loanable funds market, and the production-possibility curve to demonstrate a variety of dynamic changes in the economy, such as how the saving rate can lead to higher economic growth, or how monetary inflation by the Federal Reserve can cause a business cycle (see figure 10.1).

² N. Gregory Mankiw's popular textbook, *Principles of Economics* (2004) has taken a step in the right direction by placing the classical model of long-term growth up front in his textbook and the short-term AS/AD model in the final chapters.

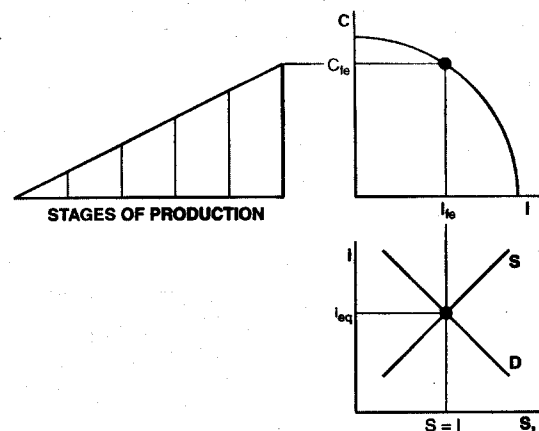


Figure 10.1. Garrison's graphics in macroeconomics

Moreover, Wicksell's natural rate of interest hypothesis is an excellent graphic tool for analyzing saving/investment trends, interest rate changes, and monetary policy (see figure 6.1). Since monetary policy dominates the textbooks when it comes to discussing recessions and inflation, Wicksell's model is another ideal pedagogical device.

My own college textbook, *Economic Logic* (2006[2000]), creates a four-stage macro model of the economy as an updated version of Hayekian triangles (see figure 10.2), and applies Garrison's graphics and Wicksell's natural rate of interest model to discuss macro issues. Similarly, in chapter 8 of *The Structure of Production* (1990), I introduce a new tool, the aggregate supply vector (ASV) and the aggregate demand vector (ADV), as a theoretical way to illustrate macroeconomic instability and an Austrian-style business cycle. Peter Boettke and David Prychitko, new co-authors of the late Paul Heyne's popular textbook, *The Economic Way of Thinking* (2003), have introduced a variety of Austrian concepts, including entrepreneurship, spontaneous order, the Austrian theory of the business cycle, and a price-making market process model as an alternative to the price-taking perfect competition model.

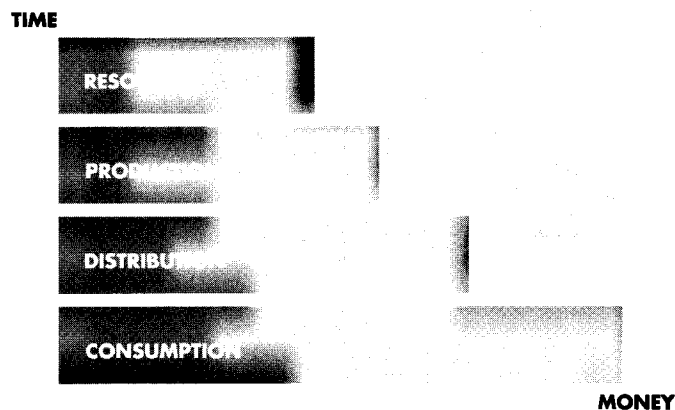


Figure 10.2. Skousen's 4 stage model of the economy

Advancing Empirical Work

Third, the Austrians need to include more empirical work to support their economic theories. In the debate over methodology in chapter 4, we conclude that one reason the Chicago school has succeeded is because of the quantitative work of Friedman, Stigler, Fogel, Coase, Becker, and others. Austrians and Austrian fellow-travelers who have engaged in statistical and historical work include Murray Rothbard, Richard Vedder, Lowell Galloway, Robert Higgs, George Selgin, Lawrence White, Robert A. Lawson, and Gerald P. O'Driscoll, Jr. We need to see more of it. The Austrian theory of the business cycle, in particular, is conducive toward more empirical work to demonstrate its efficacy. Economists need to examine the extent to which easy-money policies lead to structural imbalances in various sectors of the economy, and to determine if sectors with high capital requirements or industries further removed from final consumption are subject to great volatility, as the Austrian model implies. The few studies done in this area seem to support the Austrian theory of the business cycle (Wainhouse 1984; Skousen 1990; Mulligan 2002; Callahan and Garrison 2003; Keeler 2001). More journals may be receptive to this business-cycle research given the growing interest in the Austrian view on asset inflation. And

no doubt the Chicago school might be more accepting of the Austrian view of inflation if more empirical work were done in this vital area.

One potentially fruitful exercise has been to develop a new national income statistic that measures total spending in the economy, what Rothbard called the Aggregate Production Structure. The purpose of this new national statistic, which I have dubbed Gross Domestic Expenditures (GDE), is to measure spending at all stages of production, not just the final stage (see figure 10.4). Gross Domestic Product (GDP) is a Keynesian-inspired statistic that measures final output only. The widespread use of GDP as the primary measure of the economy's performance has led to much mischief, including the idea that an increase in government spending automatically increases economic growth, and the myth that consumer spending drives the economy, since personal consumption expenditures represents the largest part of GDP. By measuring total spending in the economy, including the intermediate as well as final stages, we find that consumer spending actually represents less than 40% of the economy (GDE), while total business investment, which includes intermediate production, equals over 50% of total spending in the economy (Skousen 1990:185-92). Using GDE would do much to shift the emphasis away from the consumer-driven economy toward a more business-oriented growth model.

Austrian economics can also be useful in disaggregating the economy and determining the sources of instability, structural imbalances, the business cycle, and identifying the best leading and lagging economic indicators. Studies would concentrate on disaggregating the economy into various sectors of the economy in terms of their distance from final consumption, and then determining how volatile these intertemporal sectors of the economy are. Researchers could look at the resource, manufacturing, construction, wholesale distribution, and retail markets, and to see how much change

takes place in employment, prices, inventories, revenues, and profits historically over the business cycle, and how changes in monetary/fiscal policies affect these intertemporal markets. This could be an exciting new area of empirical research for Austrians.

Another promising research area is in the search for an ideal monetary system. Leland Yeager, emeritus Ludwig von Mises Professor of Economics at Auburn, edited a volume on this subject in the early 1960s, and the search continues (Yeager 1962). Lawrence White (1996), George Selgin (1988), and Steve Horwitz (2000) have led the way in developing a sophisticated theory of free banking and examining historical evidence of free-banking regimes.

Finally, Peter Boettke has focused on the unique contributions of Austrian economics in the realm of public policy and the benefits of decentralized decision making in government, based on his exhaustive works on Soviet economics and socialist central planning (Boettke 1993, 2001).

All in all, advances in high theory and empirical studies will help dispel the notion that Austrian economics is nothing more than ideology, and does in fact have a major role to play in developing economics as science, and can indeed develop a *wertfrei* (value free) science, the cherished belief of Weber, Mises and most Austrians (Boettke 2001:9-18).

The Next Economics

In the early 1980s, Daniel Bell and Irving Kristol invited a group of policy makers and economists to consider the growing crisis in economic theory. Representatives of each major school (Keynesian, Chicago, Austrian, etc.) were invited to present papers, which were later published (Bell and Kristol 1981). The most penetrating paper was presented by managerial guru Peter F. Drucker entitled "Toward the Next

Economics." Drucker criticizes Keynesianism for its inability "to tackle the central policy problems of the developing economies—productivity and capital formation." He claims that none of the alternatives, including monetarism, rational expectations, or Marxism, could respond to the most severe problem in today's world, namely, the decline in capital formation. In sum, Drucker concludes, it is time for a new economic theory: "That there is both a productivity crisis and a capital-formation crisis makes certain that the Next Economics will have to be again micro-economic and centered on supply. Both productivity and capital formation are events of the micro-economy. Both also deal with the factors of production rather than being functions of demand" (Drucker 1981:13).

In the summer of 1988, I had the opportunity to meet 84-year-old Sir John Hicks, the Nobel laureate who transformed Keynesian economics into the grand neoclassical synthesis with his 1937 article in *Econometrica*, "Mr Keynes and the 'Classics.'" Despite his age and physical ailments, Hicks's mind was alert and, during our meeting, he recounted how he had gradually become disenchanted with many aspects of the modern economic theory he helped to develop. In particular, he seemed greatly displeased by the failure of orthodox economists to teach the importance of time and the stages-of-production concept in macroeconomics, a subject he learned from the Austrians and one he emphasizes in his own textbook, *The Social Framework*, and more recently in his treatise, *Capital and Time* (1973). He called it a great mistake that most economists had abandoned this essential doctrine.

The Austrian school is ideally suited to fulfill Drucker's dream of the next economics, and Hicks's desire that time and capital be taught once again in the classroom. The Austrian school is indeed the only school founded on microeconomic principles, and can therefore solve the "missing link" between micro and macro that economists have long sought (Skousen

1990:207-08; Horwitz 2000:40-61). It treats genuine saving as a virtue and as one of the key elements, along with productivity, of sustainable economic growth. It is the only school that focuses on the time structure of production — the production process from the resource stage to the retail stage — as a focal point in economic performance. It is the only school that preaches Say's law, that saving and investment are the most important ingredients to future economic growth, and that an increase in consumer spending is the effect, not the cause, of prosperity. If there is one word to describe Austrian economics, it is "capital." And if there is anything lacking in today's global economy, it is capital formation.

Austrian economics is the only school that applies the general rule, "There is no such thing as a free lunch," to the monetary sphere. Government cannot create genuine long-run prosperity with the printing press. The results of monetary mischief are in fact the opposite, a boom-bust cycle that has lasting ill-effects on the economy. It is the first school to recognize the inherent weakness in command-and-control systems in government and business, and the need for every developing nation to build a constitution of liberty and property rights.

If Austrian economists will recognize the powerful tools they have at their disposal to generate a new economic way of thinking, they will join the ranks of the Chicago economists as accomplished performers in modern economics. To do so will require Austrians to advance their model building and empirical work to a new level.

The Bridge Between Vienna and Chicago

On the back cover of this book is a draw bridge linking the Austrian and Chicago schools. In researching and writing this book over the past few years, I've often wondered if the draw bridge is going up, indicating a growing gap and less communication between the two schools, or coming down,

allowing both schools to communicate more and gain from trade. I think you can now tell which way the draw bridge is going. It is coming down and integrating a dynamic prosperous community of scholars in both camps.