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The Long Shadow of the Austrian School

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The Marginal Revolutionaries: How Austrian Economists Fought the War of Ideas
by Janek Wasserman
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Mont Pelerin Society

The first meeting of the Mont Pelerin Society with founding members Friedrich Hayek (left, at desk) and Ludwig von Mises (front row, second from right), Mont Pèlerin, Switzerland, 1947

In view of the failure of modern economists to anticipate the Great Recession of 2008, the worst financial shock since the 1930s, it was perhaps inevitable that the Austrian School, a once favored branch of economics that had made a specialty of analyzing booms and busts, would enjoy a revival of public interest.

The theme of Austrians as outsiders runs through Janek Wasserman's *The Marginal Revolutionaries: How Austrian Economists Fought the War of Ideas*, a general history of the Austrian School from its beginnings to the present day. The title refers both to the later marginalization of the Austrian economists and to the original insight of its founding father, Carl Menger, who introduced the notion of marginal utility—namely, that economic value does not derive from the cost of inputs such as raw material or labor, as David Ricardo and later Karl Marx suggested, but from the utility an individual derives from consuming an additional amount of any good or service. Water, for instance, may be indispensable to humans, but when it is abundant, the marginal value of an extra glass of the stuff is close to zero. Diamonds are less useful than water, but a great deal rarer, and hence command a high market price. If diamonds were as common as dewdrops, however, they would be worthless.

Menger was not the first economist to ponder what is called the "paradox of value" (why useless things are worth more than essentials)—the Italian Ferdinando Galiani had gotten there more than a century earlier. His central idea of marginal utility was simultaneously developed in England by W.S. Jevons and on the Continent by Léon Walras. Menger's originality lay in applying his theory to the entire production process, showing how the value of capital goods like factory equipment derived from the marginal value of the goods they produced. As a result, Austrian economics developed a keen interest in the allocation of capital. Furthermore, Menger and his disciples emphasized that value was inherently subjective, since it depends on what consumers are willing to pay for something; this imbued the Austrian school from the outset with a fiercely individualistic and anti-statist aspect.

Menger's *Principles of Economics*, published in 1871, established the study of economics in Vienna—before then, no economic journals were published in Austria, and courses in economics were taught in law schools. From this less-than-marginal position, Menger and his followers, most notably Eugen von Böhm-Bawerk, achieved notoriety with polemical attacks on the German historical school of economics, led by Friedrich List, which questioned whether natural laws of economics applied to all nations and emphasized the study of statistics over abstract theorizing. Menger rejected the nationalist approach of German economists, calling for *Nationalökonomie ohne Nation*, which might be loosely translated as "economics without borders"—an approach well suited to citizens of the multinational Habsburg Empire of the late nineteenth century. This dispute became known as the *Methodenstreit*.

While the Austrian economists may have been outsiders in their field, they were very much members of the ruling elite in Austria. Menger acted as adviser to minister-president Prince Auersperg and tutored the Habsburg heir apparent Crown Prince Rudolf. Böhm-Bawerk served three terms as Austrian finance minister. In 1919 Joseph Schumpeter was appointed finance minister in a socialist government (he justified this appointment with the quip that "if a man wants to commit suicide, it is a good thing if a doctor is present").

The Austrian School was also bound together through family and social ties: Böhm-Bawerk was brother-in-law to Friedrich von Wieser, another leading economist, and a close friend of the statistician Franz von Juraschek, Friedrich Hayek's maternal grandfather. Young Austrian economists bonded on Alpine excursions and met in Böhm-Bawerk's famous seminars (also attended by the Bolshevik Nikolai Bukharin and the German Marxist Rudolf Hilferding). Ludwig von Mises continued this tradition, holding private seminars in Vienna in the 1920s and later in New York. As Wasserman notes, the Austrian School was "a social network first and last."

After World War I, the Habsburg Empire was dismantled by the victorious Allies. The Austrian bureaucracy shrank, and university placements became scarce. Menger, the last surviving member of the first generation of Austrian economists, died in 1921. The economic school he founded, with its emphasis on individualism and free markets, might have disappeared under the socialism of "Red Vienna." Instead, a new generation of brilliant young economists emerged: Schumpeter, Hayek, and Mises—all of whom published best-selling works in English and remain familiar names today—along with a number of less well known but influential economists, including Oskar Morgenstern, Fritz Machlup, Alexander

Gerschenkron, and Gottfried Haberler.

During the interwar years, Hayek went to the London School of Economics, Schumpeter to Harvard, and Mises and Haberler to Geneva, where the latter was employed by the League of Nations before joining Schumpeter at Harvard. The Rockefeller Foundation, whose program director John Van Sickle confessed to holding "a warm place in [his] heart for the little group down in Vienna," helped secure places for Austrian economists in US schools, sometimes paying their stipends. Although Hayek compared his arrival in England to "stepping into a warm bath," the United States became the Austrians' home away from home. In 1950 Hayek resigned from the London School of Economics and crossed the Atlantic.

After the Austrians entered permanent exile, it is unclear whether one could speak any longer of an Austrian School. Milton Friedman thought not, pronouncing in characteristic manner that "there is no such thing as Austrian economics—only good economics and bad economics." In his 1932 book, *An Essay on the Nature and Significance of Economic Science*, Lionel Robbins, who had brought Hayek to the LSE, absorbed the teaching of the Austrian School but didn't see it as an alternative theoretical structure to classical economics.[1] Mises likewise suggested that schools of economic thought differed only in their mode of expressing the same fundamental ideas.

It's true that the Austrian economists had much in common with the classical tradition. Menger's doctrine of marginal utility had been independently elaborated and absorbed into mainstream economics. The Austrians' advocacy of free markets, free competition, and control of inflation appeared little different from that of the Chicago School under Frank Knight. As Schumpeter wrote, "genuine schools are sociological realities—living beings." For Fritz Machlup, the Austrians were a family, a shared experience. Even Hayek doubted whether an Austrian School continued to exist once it was transplanted to foreign soil.

The picture is made more complicated by the tendency of certain Austrian-born economists, having settled in the United States, to plow their own furrow. After the war, it was possible to talk (as Machlup did) of "Austrian Austrians," "un-Austrian Austrians," and "non-Austrian Austrians." Mises, who adhered closely to the school's original dogmas, belonged to the first category; his American disciples, including Murray Rothbard and Israel Kirzner, to the last; while Schumpeter, who developed idiosyncratic views on interest, and the mathematically inclined Morgenstern, coauthor with John von Neumann of the groundbreaking *Theory of Games and Economic Behavior* (1944), became the most prominent of the un-Austrian Austrians.

Yet one should not overstate the similarities of Austrian economics with the mainstream, especially after 1945, when John Maynard Keynes's ideas were incorporated into orthodox economics, resulting in the so-called Neoclassical-Keynesian synthesis. As Hayek commented, monetarists such as Friedman had more in common with Keynesians, since they both dwelled on macroeconomic aggregates—whether the money supply (for monetarists) or government spending (for the Keynesians)—that might be directed by the state, than with his own, essentially laissez-faire, ideas. Several characteristics distinguished the Austrians from other economic schools, and also provided the basis for the new developments in economic thought, even for supposedly un-Austrian Austrians such as Schumpeter.

Menger's original idea of marginal utility was posited on the subjective preferences of consumers. This subjectivist position was retained by subsequent generations of the school. It inspired a tradition of radical individualism, which in time made the Austrians the favorite economists of American libertarians. Subjectivism was at the heart of the Austrians' polemical rejection of Marxism. Not only did they dismiss Marx's labor theory of value, they argued that socialism couldn't possibly work since it would lack the means to allocate resources efficiently. As Mises wrote, "Once society abandons free pricing of production goods rational production becomes impossible. Every step that leads away from private ownership of the means of production…is a step away from rational economic activity."

Hayek likewise rejected the idea that society could be planned. He saw the economy as a spontaneous order. In his 1937 essay "Economics and Knowledge," Hayek argued that central planning was bound to fail because planners lacked necessary objective knowledge. Only the market, which Hayek later called a "subtle communication system," could solve the problem of resource allocation, since it reflected "the spontaneous interaction of a number of people, each possessing only bits of knowledge." Similar ideas were expressed more forcibly in Hayek's 1974 Nobel Prize acceptance speech, entitled the "Pretence of Knowledge," in which he attacked the "charlatanism and worse" of economic scientists. Social sciences, said Hayek, differed from the physical sciences because they "deal with essentially complex phenomena" for which quantitative data were limited:

> To act on the belief that we possess the knowledge and the power which enable us to shape the processes of society entirely to our liking, knowledge which in fact we do *not* possess, is likely to make us do much harm.

Although Schumpeter was considered a heretic by Misesian purists, his theory of creative destruction, elaborated in his most famous work, *Capitalism, Socialism and Democracy* (1942), belongs very much to the Austrian tradition. Schumpeter, like Hayek, dismissed the concept of economic equilibrium, seeing the economy as an evolutionary process, naturally prone to shocks and disturbances. Schumpeter's hero was not Menger's consumer, but another individual, the entrepreneur—the essential agent of innovation and progress in a capitalist society, who creates new industries or improves the methods of existing ones. Schumpeter, like other Austrians, embraced the possibilities created by economic downturns, which he viewed as periods when outdated processes could be discarded and new, more efficient methods adopted. He objected to attempts to thwart creative destruction, for instance through government intervention meant to stabilize the economy by forestalling bankruptcies:

"Without that change or, more precisely, that kind of change which we have called evolution, capitalist society cannot exist."

Given their views on the complexity of economic activity and the unreliability of economic data, Austrian economists were naturally skeptical of macroeconomic planning and the ability of economists to make accurate forecasts. The *Methodenstreit* with the German historical school of economics imbued them with an enduring distrust of statistics. Austrians rejected the use of economic indexes, especially when attempting to measure the general level of consumer prices. As Oskar Morgenstern wrote, "the idea that as complex a phenomenon as the change in a 'price level,' itself a heroic theoretical abstraction, could at present be measured to such a degree of accuracy is nevertheless simply absurd."[2]

Their distrust of price indexes brought Austrian economists into conflict with mainstream economic opinion during the 1920s. At the time, there was a general consensus among leading economists, ranging from Irving Fisher at Yale to Keynes at Cambridge, that monetary policy should aim at delivering a stable price level, and in particular seek to prevent any decline in prices (deflation). Hayek, who earlier in the decade had spent time at New York University studying monetary policy and in 1927 became the first director of the Austrian Institute for Business Cycle Research, argued that the policy of price stabilization was misguided. It was only natural, Hayek wrote, that improvements in productivity should lead to lower prices and that any resistance to this movement (sometimes described as "good deflation") would have damaging economic consequences.

The Austrian theory of interest, as elaborated in Böhm-Bawerk's hefty three-volume *Capital and Interest*, holds that interest emerges from the time preference of individuals—the willingness to pay more to have something now rather than later. Given that people prefer instant to deferred gratification—as the saying goes, a bird in the hand is worth two in the bush—time preference, and hence interest, must always be positive. (Most Austrian economists have maintained this position, although Schumpeter took the view that interest derived from profits and that, under certain circumstances, the rate of interest might fall to zero.) Since investment takes time and time is valuable, people must be paid interest to induce them to save. According to the Austrian view, when the rate of interest is determined in the free market, time preference and the return on capital are brought into harmony, such that profits roughly match the rate of interest, and savings and investment are balanced—or, put another way, interest is required so that production and consumption are coordinated over time.

However, when interest is set by the monetary authorities at below its free market, or "natural," rate, then a destabilizing credit boom will follow *regardless* of whether consumer price inflation remains quiescent.[3] Although Hayek didn't predict the 1929 crash or the ensuing depression, his book *Monetary Theory and the Trade Cycle* (first published in German in the year of the crash) criticized the Federal Reserve's price stabilization policy, which, in his view, kept interest rates too low. Keynes took the opposite view. The Great Depression, he maintained, was brought about by a policy of excessively tight money, which discouraged investment and employment.

It was not this dispute over price stability and monetary policy, however, that brought about Keynes's famous conflict with Hayek, but rather their different views on how to respond to the Great Depression. As the world economy collapsed, while Keynes worked frantically on new ideas to alleviate the crisis, Austrian economists continued to maintain what came to be known as the "liquidationist" position. Their attitude was close to Treasury Secretary Andrew Mellon's, who wanted to "liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate" in order to purge the economy of the speculative excesses of the Roaring Twenties.

Since liquidationism resulted in widespread unemployment, it was unacceptable to Keynes and his followers. The dispute came to a head in early 1931 when Hayek visited Cambridge, shortly before taking up his post at the LSE. In front of a group of Keynes's disciples (the master himself was absent), Hayek delivered a complicated talk in faulty English, rendered more incomprehensible by his suffering a bout of flu, explaining why the Depression should be left to work its own cure. At the end of the lecture, an incredulous Richard Kahn, Keynes's most loyal supporter, asked whether what Hayek was in fact saying was that if he, Kahn, went out to buy a new overcoat in a very small effort to stimulate the economy, then unemployment would increase. "Yes," replied Hayek. "But," he continued, pointing to some triangles scrawled on the blackboard, "it would take a very long mathematical argument to explain why."

An unseemly spat followed Hayek's unsympathetic review of Keynes's *Treatise on Money* (1930), which prompted a sneering Keynes to describe a recent Hayek tome (*Prices and Production*) as "one of the most frightful muddles I have ever read…it is an extraordinary example of how, starting with a mistake, a remorseless logician can end up in Bedlam." The veteran Cambridge economist A.C. Pigou described the scrap as "conducted in the manner of Kilkenny cats." When Keynes published his *General Theory* in 1936, Hayek remained silent, leaving the field clear for the subsequent victory of Keynesian economics. Hayek's own attempt to redefine economics, *The Pure Theory of Capital* (1941), was widely considered a failure. (Paul Samuelson wrote that the book "was not stillborn. But it was a pebble thrown into the pool of economic science that seemingly left nary a ripple." Friedman deemed it "unreadable.")

As Hayek's assistant Ludwig Lachmann later wrote, "the more perceptive sensed that they were witnessing a clash of two irreconcilable views of the economic world." The Austrian focus remained on long-term analysis, microeconomics, savings, and free markets, while Keynesians emphasized short-run analysis, macroeconomic aggregates, consumption over savings, and government intervention to correct for market failures. The "clash that defined modern economics" is entertainingly related in Nicholas Wapshott's *Keynes Hayek* (2011), but Wasserman surprisingly downplays the significance of this conflict. This was the moment when the Austrian business cycle theory, which emphasized the beneficial aspects of economic downturns, was decisively rejected by mainstream economics. Decades later, Paul Krugman dismissed what he called the Austrian "hangover theory" as being as "worthy of serious study as the phlogiston theory of fire."[4]

The marginalization of Austrian economics within academia has lasted to the present day. At Chicago, Hayek was rejected by the economics department and took up a post as professor of social and moral science at the Committee on Social Thought, his salary paid not by the university but by a private foundation. Hayek's own interests turned away from economic theory to political science. When Hayek was awarded the Nobel Memorial prize in Economic Sciences in 1974, Samuelson remarked that his name was unknown to most of the inhabitants of the senior common rooms of MIT and Harvard. John Kenneth Galbraith recalled asking the Austrian chancellor Bruno Kreisky what lay behind his country's remarkable postwar record of strong economic growth, low unemployment, stable consumer prices, and robust welfare spending. "I explain it by our attention to export," a deadpan Kreisky replied. "We exported all of our economists."

Outside of academia, however, the postwar Austrians continued to exercise great influence. Born into a multinational empire but coming of age in an era of nationalistic strife, they sought to recreate the conditions of their youth for a post-imperial era. In his 2018 book, *Globalists: The End of Empire and the Birth of Neoliberalism*, Quinn Slobodian reveals how Austrian economists played an important part in setting up the postwar international economic order. In 1947 Hayek gathered together a small group of like-minded types at the Alpine resort of Mont Pèlerin. The group's statement of aims (written by Lionel Robbins) called for "the creation of an international order conducive to the safeguarding of peace and liberty and permitting the establishment of harmonious international order." Early members of the Mont Pelerin Society (MPS) included de Gaulle's economic adviser Jacques Rueff, Germany's minister for economic affairs Ludwig Erhard, and future Italian president Luigi Einaudi. To its critics, the MPS is seen as a type of masonic order of neoliberal fanatics.[5]

The liberal international order, as envisaged by Hayek and his fellow Austrians, was one in which the economic sovereignty of states would be constrained by supranational agreements protecting free markets. Gottfried Haberler produced the 1958 GATT report, which laid the foundations for the emergence of the WTO and the era of globalization. Austrian ideas were also reflected in the Treaty of Rome, signed a year earlier, which legislated for the freedom of movement of capital, goods and services, and labor among members of the European Economic Community (later the European Union). Because they held that economic freedom was ultimately more important than democracy, Austrians were not above endorsing repressive regimes. In the 1920s Mises praised Italian fascists and welcomed the bloody suppression of Austria's 1927 General Strike. Nearly half a century later, Hayek courted controversy by visiting Pinochet's Chile. Wasserman describes how in recent years so-called paleolibertarians—renegade followers of Mises—have consorted with members of America's far right.

Business-friendly Austrians such as Mises were never short of rich sponsors seeking to restrain the reach of the state. Their economic outlook was espoused by a number of free market think tanks on both sides of the Atlantic, including the American Enterprise Institute, the Mises Institute, and the Institute of Economic Affairs (for which Hayek wrote a number of pamphlets). In the United States, the Cato Institute, founded in 1977 by Murray Rothbard with money provided by Charles Koch, brought libertarian ideas into the Republican Party. The Koch brothers also funded a center for the study of Austrian economics at George Mason University. Austrian influence in the United Kingdom was far more significant. The Centre for Policy Studies, cofounded by Margaret Thatcher and Keith Joseph, her intellectual mentor and later cabinet minister, helped elaborate future Thatcherite policies. On one occasion, Thatcher brandished a copy of Hayek's *Constitution of Liberty* in front of senior Conservatives, declaring, "This is what we believe." It is a fitting coincidence that Thatcher came to power in early May 1979, a few days before Hayek's eightieth birthday. Replying to Hayek's congratulatory telegram, the incoming prime minister wrote, "I am determined that we should succeed. If we do so, your contribution to our ultimate victory will have been immense."

The lingering influence of the Austrians can be found in many recent criticisms of contemporary economic nostrums. Back in 2006, William White, the chief economist for the Bank of International Settlements, revived Hayek's 1920s complaint that central bankers who directed their attention solely at keeping inflation low were ignoring the dangers posed by a credit boom.[6] The subprime crisis broke out a few months later, so this turned out to have been a prescient warning. William Easterly of New York University also drew upon Hayek in his *Tyranny of Experts*, an attack on Western foreign aid policies in which he argued that, since governments have little knowledge of how programs will affect people or societies, aid programs have often led to unexpected and undesired results.[7] In a recently published book, Thomas Mayer, a former chief economist for Deutsche Bank, criticizes modern finance theory from an Austrian perspective.[8] Wasserman's accessible history of the Austrian School would have been more complete had he considered its continuing intellectual impact. The Austrians' view of the economy as a complex, evolving system continues to inspire new research.[9] It seems that they may not be as marginal as the title of his book suggests.

An earlier version of this piece incorrectly named the Bolshevik Nikolai Bukharin. The text above has been amended.

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1 See Israel Kirzner's Introduction to *Classics in Austrian Economics* (Routledge, 1994, volume 1). ↩

2 See Morgenstern, *On the Accuracy of Economic Observations* (Princeton University Press, 1950). ↩

3 A fundamental weakness of Austrian interest-rate theory, exposed by Piero Sraffa's review of Hayek's *Prices and Production*, is how to discover what the natural rate of interest is. Since the Austrians didn't believe in averaging economic data, the natural rate of interest appeared indiscoverable (see "Dr. Hayek on Money and Capital," *The Economic Journal*, 1932). ↩

4 Paul Krugman, "The Hangover Theory," *Slate*, December 4, 1998. ↩

5 See, for instance, Philip Mirowski's *Never Let a Serious Crisis Go to Waste: How Neoliberalism Survived the Financial Meltdown* (Verso, 2013). ↩

6 See William R. White, "Is Price Stability Enough?," BIS Working Paper 205, April 2006. A number of subsequent papers from the Bank for International Settlements, under the direction of White's successor, Claudio Borio, examine whether creative destruction has been thwarted by the policy response to the Great Recession. ↩

7 *The Tyranny of Experts: Economists, Dictators, and the Forgotten Rights of the Poor* (Basic Books, 2013). ↩

8 *Austrian Economics, Money and Finance* (Routledge, 2018). ↩

9 See, for instance, David Simpson's *The Rediscovery of Classical Economics: Adaptation, Complexity and Growth* (Edward Elgar, 2013). Simpson concludes that "the congruence of Austrian economics and complexity theories is indeed remarkable." ↩