# An Introduction to Austrian Economics

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## 1. Introduction

The French Physiocrats were the first modern school of economic thought. Classical economic thought, Marxism and socialism followed. In the latter part of the 19th century two new schools with opposite ideas arose, the Historical School and the Austrian School. The former sought to discover economic truth through the study of economic history and the latter thought that economic knowledge comes from theoretical analysis instead. The controversy between the two schools was called the *Methodenstreit.*

The Austrian School began with Carl Menger's 1871 publication of *Principles of Economics* in which he set forth a subjective theory of value, based on the principle of marginal utility. Value was not an objective property that was measurable, but something subjectively attributed to a good in terms of the satisfaction that the user expects to derive from its incremental use.

Menger's disciple, Friedrich von Wieser expanded on Menger's problem of imputation, which explained resource prices as being derived from the expected prices of the consumer goods that they were used for to produce.

Menger's other disciple, Eugene von Böhm-Bawerk, emphasized the significance of time in the economic process and defined capital as the produced factors oif production. By lengthening, through the use of capital goods, the structure of production people could increase productivity. Because production takes *time* and because people value present goods more highly than future goods BB was able to explain how the margin between selling price and cost was an interest payment for the capitalist who supplied the funds for capital goods, and so not an exploitation of workers, as Marx maintained.

Ludwig von Mises was a modern Austrian theorist who got widespread attention from other economists with his challenge that socialism was impossible because in the absence of market prices resources could not be rationally allocated.

Another modern Austrian economist was Friedrich von Hayek who focused on the role of knowledge in society in coordinating the actions of interacting market participants. Both Mises and Hayek contributed significantly in molding Austrian theory into an integrated whole.

Although the subjective theory of value is now accepted by all schools of thought, AE is still distinguished from other schools by:

1. Its theoretical deductive reasoning based on conceptual understanding
2. methodological individualism: only individuals act and theory give rise to economic phenomena.
3. its focus on uncertainty, the role of time, the facts of human error

## 2. Social Cooperation and Resource Allocation

*Calculations in Kind in a Primitive Economy*

The task of *economizing*, using scarce resources in such ways that they generate the greatest satisfaction is as applicable to an isolated self-sufficient person as it is to a complex economy. Robinson Crusoe however could make effective decisions based on observation and an intuitive grasp of the productive alternatives before him. Calculations in physical output would suffice since his resources are not very diversified. His decisions would be based on a subjective calculjjjus of profitability for each action and his own value scale is the sole determinant for action: he does not have to take into consideration the wants of others. All of the above also applies to a self-sufficient household.

*Calculations in Kind in an Advanced Economy*

Social cooperation in the form of specialization and the division of labor makes possible an enormous increase in productivity. But because scarcity persists here too actors need to *economize*

but the complexity and intricacy of resource employment in a modern economy require far more complicated decisions than in the ones described above. The increased complexity is attributable to: 1) the immense variety of consumer's goods and services 2) the immensely diverse ways in which resources can be used to produce consumer goods.

It would be impossible to decide between all the alternative ways of producing goods if calculations in kind were the only types of calculations. Instead *monetary calculation* will be used: it makes possible to translate the myriad of physically different resources and output into a common denominator so that they can be easily compared.

Ludwig von Mises showed that socialist thinkers had ignored the problem of how resources would be allocated under socialism and he challenged that without a market-based price system it is impossible to do so rationally. Socialists acknowledged their failure but thought they could solve the problem by having the authorities establish prices through trial and error, guided by the existence of surpluses and shortages for each particular good. These price adjustments would lead to proper production adjustments. Mises and other Austrians held that such prices are inept attempts to simulate market forces and are utterly arbitrary and of no use in rationally allocating resources.

*The Problem of Coordination and Knowledge*

Only through social cooperation can people enjoy the overwhelming benefits of specialization and the division of labor. Social cooperation also makes possible that producers produce products to satisfy other people. But this requires some means of unifying or coordinating all the separate plans and efforts of many actors,. Hayek then stated that underlying the problem of the division of labor is the problem of the division of knowledge, which he thought was the central problem of economic science. How can individual actions and decisions be synchronized throughout the economy?

But the neoclassical model of perfect competition assumes perfect knowledge, it assumes that all individual plans are meshing consistently with one another, and thus completely avoids the question how coordination is possible in a world where knowledge is imperfect because the knowledge that exists in society is scattered, dispersed over all the different minds in society and in a constant flux as people change their actions in light of experience and so the static long-run equilibrium model is totally unrealistic. What should be examined is not a static condition of equilibrium but the dynamic nature of the market process, striving unceasingly toward equilibrium. Decisions are made without perfect knowledge, which means that the underlying data far from being simply given are elusive and tenuous and available only by discovery and perception.

The driving forces of the market are entrepreneurs who see profit opportunities arising from potential improvements in market activities. This is an ongoing process as entrepreneurs keep searching for profit and change the market as they do so. Once the condition of imperfect knowledge is introduced, price theory and the picture drawn of the market are vastly changed from that of neoclassical discussions.

## 3. Economic Calculation

*The Role of the Price System*

The price system fulfills two roles in a complex economy:

1. being a common denominator which makes economic calculation possible
2. enabling coordination of individual plans based upon imperfect knowledge and information

These two functions are really of a piece; they relate the same problem of resource allocation under an arrangement of social cooperation and a system of market prices.

*Economic Calculation vs. Technological Calculation*

Technical calculations are of the type '6a+4b+3c+…xn' will likely create result 8p'. They are calculations in *kind.* Because they are devoid of any preferential quality they are not sufficient for human decisions and actions. Technological calculation may show that a bridge can be built out of gold, but economic calculation will show that this resource can be more profitably used in other

production plans.

*Subjectivity of Value*

How do we determine what the most important wants are that resource allocation has to satisfy? Since value is a subjective thing that eludes *cardinal* quantification, we cannot measure units of value (and so cannot say 'I value x twice as much as y'). Instead valuation is a matter of individual preference, expressed in ordinal numbers. Valuation necessarily is manifested in the *act* of choosing. The law of diminishing marginal utility tells us that a person will always value each additional unit of a good less than the prior unit's value.

*Economic Calculation Through Money Prices*

It is through the pricing process that the *relative* importance of the various resources and consumer goods is translated into common terms. All goods and services that are bought and sold are exchanged for money. Money prices then are not measurement of value but exchange ratios that are expressive of the ranking of the valuations placed upon increments of goods at a given moment by participants in market exchanges. Since people's valuations as well as the supply of goods constantly changes, prices are not permanently stable.

Economic calculation is a matter of providing a comparison between input and output. It includes both *retrospective* and *prospective* monetary calculations.

*Retrospective* calculation is the determination of past monetary profit or loss, i.e. income, resulting from actions already taken and serves two purposes: 1. to the extent that the past is assumed to be indicative of the future, it has *instructive* value, 2. the determination of monetary income reveals the extent to which the future capacity to produce can be maintained after current income is withdrawn. This latter function derives from the complementary concepts of *capital* and *income*, the ultimate mental tools of economic calculation. (see next section)

*Prospective* calculation is a matter of *anticipating* the money profit or lossexpected to result from specific actions being contemplated. Since economic calculation is an action and all action is geared toward the future, all calculation is geared toward the future.

*The Concepts of Capital and Income*

*Capital* is the determinable *amount of money equivalent* (so not the physical objects themselves) devoted toward productive activities (all assets minus all liabilities). *Income* is the amount that can be consumed without lowering the capital below the sum of the amount dedicated to the business at the start of a given period and any additional investments paid in during that period. *Capital maintenance* is the aim to keep at least this amount intact. *Capital consumption* is the case when consumption exceeds income and *capital accumulation* is when consumption is less than available income, i.e. when a portion or all of income is saved.

Among the main tasks of economic calculation are those of establishing the magnitudes of income, saving and capital consumption. The comparison of the calculations of capital prior to and after the actions yield the determination of profit (income) or loss. As said in the previous section, the determination of profit or loss resulting from past actions provides the only means by which the actor can ascertain whether or not the capacity of the business unit to produce in the future has been impaired (is more investment needed to offset dissipation of capital as a result of unprofitable operations or to achieve desired capital accumulation?)

*Risk and Uncertainty*

The lack of precision in economic calculation results from the fact that the future os uncertain. Frank Knight distinguished between *risk* and *uncertainty: Risk* is subject to numerical computation based on statistical data pertaining to a large number of similar events that are expected to occur (is the nature of *actuarial* probabilities) *Uncertainty* relates to situations that are unique (not recurring); each situation is a case in itself as opposed to being a member of a class or a large number of homogenous events or circumstances. Uncertainty is not numerically calculable because of the lack

of sufficient past experiences relating to the particular set of circumstances being considered.

Entrepreneurs face *uncertainty* as the overwhelming obstacle and his attempts to see foresee the future is a subjective matter that escapes mathematical equations and formulae. But this does not mean that the future is chaotic and every business decision is a gamble.

*The Tenuousness of Economic Calculation*

Even though economic calculation, due to the uncertainty of the future, is necessarily tenuous and indefinite it still fulfills its task of guiding future actions to a producer's view of what the future want-satisfactions of other people will be.