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Basic Tenets of the Austrian School of Economics

Working Paper No. 26

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Prepared for Professor John Hall

Abstract: The Austrian school of economic thought has offered many ideas throughout its more than century old history. Beginning with Carl Menger’s *Principles of Economics*, the focus of this school dealt with individuals acting in a society for the benefit of everyone. With liberalism at their core, thinkers such as Friedrich von Wieser, Ludwig von Mises, and Friedrich Hayek saw economics as a practical approach to living. This inquiry seeks to establish that the Austrian school of economics advanced basic tenets. Building off of, and often creating their own ideas, Austrian economists gave rise to the principles of marginalism, significance of private property within a market economy, and how prices reflect information. Through their practical approaches, general theory—not mathematical calculations—are offered. Systems of control are also criticized according to their ability to allow for public prosperity. The link between capitalism and Austrian thought is also represented. In the same vein as the originator, Carl Menger, each of these three reflected on the world’s innate truths to uncover economic applications of liberalism.

JEL Classification Codes: B130, B310, P120, P220

Key Words: Austrian School, capitalism, Friedrich Hayek, Friedrich von Wieser, Ludwig von Mises

This inquiry seeks to establish that what can be identified as the Austrian School of Economics advanced basic tenets that prove foundation to Economic Science. The Austrian School's origination can be traced to the 1870s when Vienna served as the principal administrative center of the Austro-Hungarian Empire. It was in Year 1871 that Carl Menger published his *Principles of Economics*. This singular and even heroic effort on Menger's part has attracted the curiosities of great minds over the decades since, and as led to reconsidering different aspects of economic thought, affecting developments in both micro and macroeconomics. In particular, subjective utility and costs – otherwise known as marginalism – the importance of private property in a market economy, and the price system of information are three areas of contribution that will be considered in this inquiry.

Since its emergence in the 19th century, the Austrian School has battled against beliefs held dear by classical economics as well as extant and dreamed of political systems. Austrians have even challenged the tendency for an over-reliance on mathematical analysis that tends to obfuscate economic processes. We can identify that integral to contributing to the Austrian tradition, key exponents would consider the history of economic thought, pose pressing questions, and seek to initiate a more practical view and even better functioning economic system.

Contributions of Friedrich von Wieser

In his effort to advance the basic Austrian principle of subjective utility and costs, Friedrich von Wieser relies upon ideas advanced by W. Stanley Jevons. Wieser uses the concept of marginalism and reflects his thoughts through the lens of sociology. In the article *The Austrian School and the Theory of Value*, Wieser (1891, 2) discusses imputation with the purpose of expressing utility. Imputation means to assign a value to something. In the argument, the utility or price of an item cannot be calculated by the consumer, if he does not know the proportion of work and amount of value that the item would bring to him, so he cannot assign a value to pay for the item according to his returns.

Furthering his thoughts, Weiser (1891, 3) arrives at the conclusion that labor is not the only factor with value in the real world. An example of a farmer losing a cow is brought up in this article, illustrating the fact that the farmer loses only a *portion* of the return of the entire farm over time. The loss of capital clearly shows that capital affects both the produce and profit of ventures such as farming. This suggests that labor is not the only factor in increasing or diminishing returns, which breaks the historical premise of pure labor creating the production of a nation.

Moving toward the topic of marginalism in production, Wieser (1891, 5) also states that value cannot be derived from the cost of production alone. There is

simply no logic in going through each step of creating an item and tallying the individual costs to create a total of what it should sell for. Because value should be less than the utility of the buyer, to create an incentive for exchange, the buyer would not be able to calculate their preferred price. When an item is made and put to market, each person who sees the item for sale thinks of their personal marginal utility of the item, not the incremental steps of its creation. Along with this view of value, Wieser references Ricardo's view of rent and land by suggesting that Ricardo was describing imputation of the simplest form: the excess produce of a piece of land is, in part, derived from the land itself, and not the labor it took to yield the produce in full. This view of how profit is gained furthered economic knowledge, by accounting for capital instead of relying solely on human labor or production.

Austrian thinkers also had a view on interest with regard to capital. Wieser (1891, 8) notes that there are many such views, but explains his own by beginning at imputation once again. He argues that for there to be a net profit made off of the sale of an item, capital itself must yield profit, because the value of gross profits and capital are inherently different. By applying the idea of marginalism to money exchanges, the system of profiting off of money is explored in a more complete context. Wieser provides four conclusions of his views on interest. The first is a precise view of circulating capital, which finds its value by subtraction of interest

from the total in question. This notes the importance of gross profits, by accounting for the reality of interest. The second shows that an item has more value now as opposed to later. No person would want to wait for a year for the same amount of money they could get immediately. The third conclusion deals with future value. Wieser asserts that the total future value of a piece of land cannot be found easily. However, by using interest and the time by which the land has the future value of its present, the present value that accounts for a finite number of years of the land's future use is found. His last conclusion is as simple as the first, that the present value of some capital is affected by both discounting and capitalization. By allowing both capital and interest to play a role in value, either in the generation or through trading, a subjective and more complete exploration of marginal utility is created.

Contributions of Ludwig von Mises

To further the Austrian economic principle of private property, Ludwig von Mises uses Socialist ideas as a foil. From the outset of his insightful *Liberalism the Classical Tradition* [1927], Mises (2005, 2) describes the best system for the use of property as liberalism, because private property creates the most productive labor, and therefore wealth.

Starting from an ethical view, Mises (2005, 15-16) proposes that a lone man does not have any set morals to adhere to, meaning he can do whatever he wishes. This sort of freedom confines the effects of the man to only himself. When part of a society, however, there are consequences at play. If the man wishes to do something to further his gain at the expense of society, there are repercussions. Mises argues that if a man does not perform this “selfish” action, there is no inherent value in his morality until there is a real benefit to society. Along with this striking observation, he adds that there is an incentive to morally sacrifice his own wants, if he gained less from his selfishness than society as a whole would lose. This is the sort of cooperation that has kept societies intact. Finally, concluding his first approach to the value of private property by use of ethics, Mises argues that after something is deemed as socially beneficial, it cannot be viewed as immoral. Only after understanding the social logic of actions and morality can the comparison between capitalist and socialist theories on private property be compared.

Socialism has long been the foil for critics of capitalist economies. Mises (2005, 40) reflects on some available critiques of capitalism through a socialist lense in Chapter 2 of his *Liberalism*. Under Mises’ view, the critics of any structured society must begin at its core, which is the private property of its citizens. He continues by remarking that there are many reasons why blaming

private property seems to flow toward the means of production—the heart of modern civilization—even when the nature of the problem at hand is in the restriction of private property. To describe the mindset of socialist proponents, Mises alludes to the utopian ideals of someone who set out to change the world for the supposed benefit of everyone. This person genuinely believes that his plan would succeed, because he does not consider those who object to this control; does a slaveholder consider his servants' plight? By regarding supporters of socialism in this light, Mises scratches behind the often flouted endpoint of this system and reveals that without the complete consent of the people, through whatever means, the dissenting population would surely produce less than under the invisible market forces of a capitalist economy. In any case, Mises argues that an idea such as productivity is subjective, leading towards a discussion of the competing system's societal usefulness.

If it is argued that socialism would reach a better equilibrium of livelihood than capitalism, then it must be more productive than capitalism. Mises (2005, 42) holds that socialists believe their system to be at least as productive as capitalism, because of their unyielding view of a better life under their system. As background, he adds that the production of a capitalist system is tied to the system itself, leading to his theories on worker incentives. Mises describes a capitalist worker as having his wages inherently linked to his own production. This creates a basic incentive to

do the most work possible in order to yield the most value to spend on his wants and needs. Turning to socialism, he argues that there is no such tie, and that the lack of private property—along with whatever governmental force is acting on him to produce—reduces his incentive to work as hard. This cause and effect relationship is most aptly seen in Soviet Russia, when factory leaders performed the bare minimum to keep their jobs, at the expense of the entire country's production. This lack of production efficiency would undoubtedly lead to a regression of progress, not to mention the lack of competition under such a system. Continuing his dismantling of socialist economy incentives, Mises (2005, 43) digs deeper into the effects of such a system by considering two views of a capitalist's gain. From the individual's perspective, it does not seem "fair" that one man may be prosperous while others sleep in the street. This criticism does not look past the skin of capitalism. For one to prosper, they must provide a benefit to society in the process. Along with their profit, they also must compete with every other capitalist to provide the most benefit, further spurring society's gain. This is the reason that private property is an Austrian tenet: without the means of production in the hands of those who can use it most efficiently and in a mutually competitive system, the maximum production can not be created.

Along with inefficiency, socialist economies also face problems with prices. Specifically, Mises (2005, 49-50) realizes the impossibility of total public

ownership of the means of production. If production was publicly owned, there would be no commerce involved. Because there would be no exchange, progress would die off, and production would be stagnant at best. In addition, this would create a lack of prices, which would accompany a lack of economic information. It is this lack of information that is at the heart of socialist ideas of property.

Contributions of Friedrich Hayek

To further the Austrian economic principle of prices as a means for economic information, Friedrich Hayek uses a logical approach to the previous views on efficient economic systems. In *The Use of Knowledge in Society* [1945], published in the *American Economic Review*, Hayek dismantles the arguments for a centralized economic system in the process of describing how prices convey information from individuals to society at large.

Hayek assesses the root problem that economics attempts to solve, by proposing two worlds. In one world—similar to the unattained perfection of socialists—the leadership has perfect information. In the other, they have limited available knowledge. By juxtaposing these scenarios, Hayek (1945, 519) unearths the main economic problem of how to allow individuals to use resources most effectively. In a world with perfect knowledge, leadership would only be tasked with allocating resources throughout society. The problem is that this is not a valid

economic problem, because there is no perfect knowledge which is centralized into one body of power. A society which is determined to just allocate resources dismisses the information problem entirely, and fails to reach any sort of efficiency in product use. Because knowledge is dispersed among all individuals, Hayek (1945, 520) argues that economics should be viewed as more rational than a mathematical system.

Hayek views all economic activity as forms of planning which require information. Because of the aforementioned disbursement of information, any planner would need to collect pieces of information from individuals in some way. Hayek (1945, 521) asserts not whether planning should be done, but rather how the planning should be done. This reinforces his view of an inherent information problem in every society. There are three basic systems of planning: a centralized form, which converts individuals' information into one body's action, a monopolist system, where industries are moved to be the delegates of action, and the decentralized system of a competitive marketplace. To decide which system is better requires some sort of measure. Hayek defines the best system as one which uses information most efficiently. The problem with a centralized system lies within its nature. As discussed, perfect information may never be attained, so the individual pieces of information are all brought together in a simplified manner, therefore discarding the imperceptible details of life such as timing, quality and

scarcity. Hayek (1945, 521) also notes the flaw in delegating action to a group of entities—this only moves the information problem along to a few fallible beings. To tie these two systems into reality, Soviet Russia provides a clear example of delegation. This came at a massive cost in information output, as it was common to simplify whole industries and only take into account market movements to the order of one. To highlight the qualities of a decentralized arrangement, such as a competitive system, Hayek (1945, 522) points out that each person has unique knowledge about their personal situation along with their personal utilities for various things that are unknown to others. This makes individuals the best arbiters of their own information, cutting off the need for a centralized system.

Throughout the article, Hayek places value in the personal accumulation of knowledge. To have knowledge is an inherent trait, and the spread of personal knowledge should not be enforced. Hayek (1945, 523) mourns the view of an enforced distribution of knowledge and instead leads to the method by which this is naturally done. This is why a competitive system is so effective—personal gain is the driving force in the sharing of knowledge. Any business has costs that can overtake its profits due to many possible missteps that can lead competitors to replace them. The business' use of their information about their situation helps keep them ahead of the pack. On the other hand, in a society where businesses are dictated their production and costs, the businesses would not be able to use their

knowledge to improve their situation, along with the entire marketplace. This is where the true value of prices lies, in the disbursement of knowledge from individuals to society at large.

Hayek's famous tin example clearly shows how prices simplify information from individuals for any other actor to access. In the apex of his article, Hayek (1945, 526) supposes that a shortage of tin has occurred in an economy. The beauty of a decentralized system is that the reason for the shortage is unimportant. A mine may have caved in, a new use for tin may have been created, but very few individuals have contact with the facts. What people do see are prices. When a rail maker sees that his profit is being slashed by purchasing tin, he may switch to another metal, or quit his business entirely. With each person's reaction to the price increase, information is spread throughout the entire economy. Substitutes for tin that were cheaper before may face a new demand. Compliments of tin uses may face a stock that does not sell as quickly. In any case, new local prices for items automatically circulate through the system, finding each person's marginal utility of tin, and displaying the aggregate as the price. With no governance over the economy's use of production of tin, the entire economy has now both received the knowledge of the reduction in tin, and displayed their own reaction to this event.

Price information is one of the keys to efficient production. As Hayek has explained, there is no better system than a decentralized field of competition. This

system inherently spreads knowledge from individuals to everyone, through no force, coercion, or governmental rules.

Conclusion

This inquiry sought to establish some basic tenets of the Austrian School of Economics, through the works of three economists. Through viewing the world from an individual's perspective, these three thinkers uncovered economic truths. Friedrich von Wieser elaborated on the early principles of marginalism by applying it to subjective costs and utility. Ludwig von Mises used socialist ideas to establish the necessity of private property for a productive economy, by contrasting the incentive structures of workers and government planners. Friedrich Hayek pointed out that prices give everyone information that individuals have, by aggregating their reactions in the market. Through the pursuit of freedom, old theories were cast aside, systems were criticized, and practical economics was made the focus. While appearing as obvious rules of life, each of these contributions required a mindful view of the world.

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