Human Needs, the Market and the Crisis—
Some Thoughts from an ‘Austrian’ Perspective

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The paper discusses parallels between the Austrian School of Economics’ teachings and the current crisis and argues for decision makers to take economic theory into consideration. Menger, putting the human being and his desires at the center of economic theory, advocates an allocation allowing utility for a maximum of individuals, excluding extra profits for only a few, thus a “perfect” market. Hayek says markets will function if prices – important signals to the agents – are formed without interference. Tempering (money injection, deficit spending, fiscal expansion, interest rates lowering) distorts their informative nature, lead into malinvestment and depression. Schumpeter predicts the downfall of capitalism because the chances for extra profits through innovations create imitators until the system collapses. An “economical”, votes maximizing, behavior of politicians adds to that. And he warns of some of the very policies being applied in today’s crisis.

INTRODUCTION

With a view to the international financial and economic crisis which had started in the US financial markets in 2006 with the burst of a mortgage bubble, turned into a world real economy crisis in 2008 and into a state debt and Euro currency crisis in 2009, I would like to offer some thoughts, mainly from an Austrian School of Economics background.

The article does not intend to suggest that the Austrian, in particular Hayekian, view is “right” and that other, in particular Keynesian, views are “wrong”. Nor does it suggest that the Austrians can comprehensively explain the contemporary difficulties. It merely wants to draw the attention to some of the Austrian School’s ideas, connect them to the current crisis and exhort decision makers not to be one-sided while looking at recipes how to overcome the difficulties. It does

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so in times of a “return to Keynes” (Bateman et al. 2010) in which non-Austrian School arguments are currently more *en vogue* than Austrian ones (see e.g. Aiginger 2010, Streissler 2010, Jandl 2010a, b). Being convinced that Austrian School explanations deserve an equal chance in the policy debate, I am concentrating mainly on contributions by its first four generations – from Carl Menger through Friedrich August von Hayek – though without intending to “sell” them. In this context, one should recall Ludwig von Mises’ discomfort if economics are seen “no longer [as] a matter of knowledge and ability, but of good intentions” (Mises 1999 [1926], p. 271), as well as Paul Samuelson’s bid for reason winning out over tradition and dogma (Samuelson 2003).

**MENGER – THE INDIVIDUAL AND THE PERFECT MARKET**

Carl Menger (1840-1921), the originator of the Austrian School of Economics – in his *opus magnum* “Principles of Economics” (Menger 1871), the foundation stone of that School – defines economic activity as the activity of human beings which exploits goods for the satisfaction of needs or wants. For the qualification of a given thing as a good in the economic sense, the agent must be aware of the nexus between his/her want and the quality of the good to fulfill it and he/she must be in position to dispose of the good. Of course, goods normally are understood in a material sense like products or merchandise or raw materials, and as services. Additionally, there are immaterial goods which help us satisfy some of our needs, e.g. leisure which grants us more time with our family, or an honorary office which will allow us to satisfy our desire for social prestige (at least if we see the agent as more than a mere *homo oeconomicus*). The term “immaterial goods” is used more in the private law sense than in the economic sense, as there are opportunity costs involved with such goods, insofar as one forgoes income by spending time with the family or while executing honorary functions. Menger calls those immaterial goods “useful human actions”. Only goods which do not incur any costs because they are not scarce are – according to Menger – no goods at all in the economic sense.

The Austrians have hardly ever formulated policy recommendations (Streissler 2008b, Socher 2008). For our purpose, though, one could derive from the above definition that the state should set conditions which allows satisfaction of needs (= utility) at a constant degree for a maximum number of individual agents and with a given endowment, or the maximization of utility for a given number of people and a given endowment, or the minimization of the input necessary to create utility at a constant degree for a constant population.¹ Regretfully
one has to be a bit pedantic in this definition but this seems necessary as many politicians try to have optimization in two or even three directions – something that is mathematically impossible, or in other words: you can’t have the cake and eat it too.

Let’s assume that probably a vast majority of European citizens would consider a society as desirable if it is organized in a way that allows for the first of the above-mentioned optimizations (that is the maximization of the number of individuals enjoying utility at a constant degree and with a given endowment) because it would grant the well-being of as many people as possible. For the young Friedrich August von Hayek, still being under the influence of his experience in World War One, the aspiration to a “better world” was one of the reasons for his indulging in economics (see Böhm 2009).

From an “Austrian” point of view, it is important to stress the concept of methodological individualism (Schumpeter 1908) which concentrates on the individual agent’s decisions and actions as they ultimately form the basis of the macroeconomic situation – nowadays called the microfoundation of macroeconomics. As Leube (1999) points out, for the Austrians, it is man but not the *homo oeconomicus* who is the centerpiece of economic analysis. Already Carl Menger has considered the human being the alpha and the omega of every economy, as he noted in his preliminary notes to the “Principles”. I have tried to show in another publication (Jandl 2006) that Menger and the other early Austrians who had all studied law at the universities of the Hapsburg Empire were influenced by the Roman- and Natural-Law inspired Austrian Civil Code and its focus on the *persona* and his/her autonomy. Menger (1883) claims that all social and economic phenomena can be explained as outcomes of individual human action directed at individual human purposes. Drawing on thoughts developed largely by Ludwig von Mises (e.g. 1940, in particular p. 31 ff, 172 ff), Hayek pleads, mainly in his “Road to Serfdom” (1979 [1944]), very strongly in favor of such individualism.

It is interesting that, due to the current crisis, behavioral economics which incorporates elements of psychology to explain why people make specific decisions in specific circumstances are now on the rise (Loewenstein and Ubel 2010). In a way, this is a posthumous support for the view of economic theory as a sort of “applied psychology”, as coined by Menger’s successor at Vienna University, Friedrich von Wieser (1884, p. 39).

The question of allocation and distribution of goods (for the satisfaction of individual needs) leads us now into the field of welfare
economics which is being intensively discussed in light of the ongoing international financial and economic crisis. Austrian School ideas have not really penetrated welfare theory which is hence neo-classically dominated (Kirzner 1986). I will thus – for the purpose of this article – only outline a few sketches without deeper analysis. In approximation to a “just” allocation, economic theory works with the notions of efficiency and equilibrium. It is standard knowledge that an allocation is Pareto efficient if there is no way to make anyone better off without making someone else worse off. The market is in a Walras equilibrium if there is no excess demand and no excess supply, that is, if there is a price set under which all producers and consumers realize their maximum utility given their budget constraints. One can mathematically prove³ that all Walras equilibriums are Pareto efficient (First Theorem of welfare economics) and that, under certain conditions⁴, all Pareto efficient allocations are Walras equilibriums (Second Theorem of welfare economics). Trade allows the agents to reach higher indifference curves providing for an efficient allocation, and a bargaining or auctioneering of prices allows for the equation of supply and demand which leads to market clearing and equilibrium.⁵ As Varian (1996, p. 510) puts it, “a competitive market will exhaust all of the gains from trade” and achieve both equilibrium and Pareto efficiency. Thus, there are “strong arguments in favor of the use [of competitive markets] as a way to allocate resources” (ibid., p. 517). In short, the two Theorems argue in favor of market processes, from a welfare economics point of view. This brings us back to Menger and his view of the market process as being ultimately driven by the choices of the consumers (and the subjective value they attribute to goods). He arrives at that conclusion through theoretical-analytical research, an approach contrasting the then up-to-date historical method which tried to explain economic phenomena only historically-empirically and regarded general abstraction as inadmissible (Menger 1871, 1883).

In real life, the above-mentioned concepts of equilibrium and efficiency have limits. First, even if equilibrium can be achieved, it is hardly ever stable over time. Hayek (1937) put it bluntly by saying that equilibrium could only exist if everybody knew everything. Second, an efficient allocation is not necessarily a fair allocation. It is widely argued that an efficient allocation could be called fair if it were also equitable, that is, if no one prefers anybody else’s bundle of goods to his/her own bundle. But to aggregate all consumers’ utility functions into a social welfare function would require a dictatorship, as Nobel laureate Kenneth Arrow has demonstrated in his Impossibility
The contribution of education to human resource:  

Theorem (Arrow 1963). Hayek had voiced similar concerns (e.g. Hayek 1979 [1944]). Thus, the alternative seems to rely upon a market that allows for a free exchange of goods, and to hopefully arrive, under the conditions of reality, at the most efficient and most equitable, hence the “fairest”, distribution possible. As Wieser (1889) and several other Austrians including Hayek (1980) have underlined, the functioning of the market requires strong protection of property rights by the state. Many will agree today that the government’s task is additionally to calibrate the above-mentioned fairness by a “just” taxation, transfers and subsidies system which helps the ones in need but, according to the Ramsey Principle, avoids too much taxation-caused net welfare loss.  

Regarding the proposals to use measures of protectionism (impediments to the free exchange of goods among countries) as a reaction to the economic crisis, one might historically refer to the description of the welfare losses due to protective measures by some Austrian School representatives. Fritz Machlup (1934), for example, has outlined how tariff barriers not only lead to less goods on the market (which is disadvantageous for the satisfaction of consumers’ wants), but eventually also to lower levels of production both at home and abroad since the chances for selling products in export markets is lower and this, because of the usual retaliation measures, is true for both sides. More recently, Hungarian Prime Minister Gordon Bajnai – an economist, not a professional politician – at a conference in Austria in 2009 called protectionism not only a threat to the growth potential of the economy after this crisis, but also the first step towards chauvinism, and the revival of chauvinism a real and big threat to the European way of life (Bajnai 2009, p. 7), a reference to the losses to be expected also in “political” welfare.  

It is standard knowledge that in a market under perfect competition, no “extra” or “surplus” profits for the producers are possible, and that the lowest price level for the consumers will be achieved. Moreover, under perfect competition, there is no deadweight welfare loss which otherwise occurs under a monopoly. Monopolies are therefore often described as having “undesirable distributional effects” and as an “unambiguous evil” (Nicholson 1992, p. 582 f). Already Menger (1871) has drawn the attention to the fact that, the stronger the monopolistic structures, the more consumers will be crowded out from market participation due to rising prices. Böhm-Bawerk (1889) has shown how difficult or even impossible it can be in a monopolist seller’s market for the consumer (in concreto: for the buyer
of a horse from a monopolist supplier) to maximize his/her utility – because the buyer does not have all the relevant information about the health status of the horse and might later find out that it could not fulfill his/her expectations. Additionally, he has discussed (Böhm-Bawerk 1999 [1914]) the negative effects of a monopolist employer on the labor market, in particular the lower wage levels for the employees and, under certain circumstances, higher rates of unemployment.

It is certainly clear that in reality, a truly “perfectly” competitive market cannot be accomplished. Perfect competition – or as the early Austrians said I think more accurately: fully efficacious competition – requires that no agent has dominating power in the market, that nobody can set prices; something that does not occur in real life. The recent financial markets debacle has started exactly because some had overriding predominance which they exploited to the detriment of others. By the way, an interesting parallel to Wieser who saw the deficiencies of capitalism as a consequence of the lack of vigilance by the state in ensuring perfectly competitive markets and of “the brutal progress of the urge to enrich oneself” (Wieser 1926, p. 156).

Because of the current troubles, many interlocutors argue nowadays that the market has demonstrated it doesn’t function and that hence one should turn away from the market economy altogether. The above findings of economic science, however, suggest that the opposite is true: one does not need “less” market, but so to speak “more” market instead; that is, more perfect competition with less or no prevailing power for the big players – including appropriate state measures to ensure more perfect competition, as insisted upon for example by Wieser (1884, 1926), Böhm-Bawerk (1881, 1999 [1914]), Hayek (1980/81) and others – in order to create the conditions under which the consumers get closer to reaping the said benefits.

HAYEK – THE PRICES AND THEIR DISTORTION BY GOVERNMENT ACTION

At this juncture, I would like to involve in some more detail Friedrich August von Hayek (1899-1992), who is because of his Nobel Prize internationally the best known of the Austrian School economists. Amplifying on other Austrians, in particular Friedrich von Wieser (1889), Eugen von Böhm-Bawerk (1884/89) and Ludwig von Mises (1999 [1926]), Hayek puts the element of price into the center of his considerations on the functioning of markets (Hayek 1931a and 1931b). Prices are so important, according to Hayek, because they send signals and information which the agents need in order to make their economic
decisions. Of course, the individual agent can neither have all information nor even the bits and pieces of information required for their intended economic actions. The agent might not even be aware of what concrete elements or kinds of information he/she would need to make a rational and well-founded choice. But that doesn’t matter because prices contain in themselves this amalgam of information in a condensed and concise way. The agents use the prices as their orientation points and, through their ensuing actions, create what Hayek calls the spontaneous order (Hayek 1960). It is the market process which leads to “the combined knowledge of all the individuals” (Hayek 1937, ch. IX). In other words, the market “makes possible the fullest utilization by members of society of knowledge which is not given to anyone in its totality” (Kirzner 1986, p. 151), and “the use of competitive markets economizes on the information that any one agent needs to possess” (Varian 1996, p. 516).

Such prices are formed, according to Hayek, through competition in the market, and he adds that competition should not be confused with laissez faire. Competition and choice – the latter as the realization of the agent’s dreams, aspirations and expectations – lead to individual knowledge being mutually completed and enhanced through interpersonal coordination. “The combination of fragments of knowledge existing in different minds (...) brings about a distribution of resources which can be understood as if it were made according to a single plan, although nobody has planned it” and creates a “tendency toward equilibrium” (Hayek 1937, ch. IX). Already Wieser had underlined the need to have an informative price system and the ensuing “calculability of relationships” (Wieser 1924, p. 283, see also Wieser 1889) as the basis for the agent’s decisions. And he had stated, together with Mises, that such a reliable price set cannot be developed in socialist societies with their central planning. Mises (1999 [1926]) argues that prices are being formed by the laws of the market and cannot be “made” by decisions of authorities. An attempt to that end would be nothing less than a command to use economic resources in a different way than the agents had intended to, and this would not only be senseless but indeed counterproductive as it would create the exact opposite of what had been desired and would lead ultimately to a “destruction” of economic activity.

Hayek also criticizes socialist systems in which the market-based formation of prices is distorted by interventions of the state. The fatal flaw of socialist planning, according to Hayek (1935, 1979 [1944], etc.), is that the planning authority must, in order to be able to plan, impose
upon people a detailed code of values; and that even democratic planning would require a variety of means by the authority, from propaganda to coercion (see Caldwell 2007). This would be contrary to the functioning of the price system (of a liberal setting) as an information and coordination mechanism between the agents. Thus, the prices cannot perform their vital role in a central planning or “socialist” society.

Hayek does not address his critique of collectivist planning only to socialists as such but to “the socialists of all parties” (Hayek 1979, p. iv), that is to all advocates of interventionism even coming from liberal or conservative parties. When the state interferes in the formation of market prices – e.g. by injecting new money –, prices get distorted, they send out wrong signals to the market participants, lead to misallocation of resources and eventually to an economic crisis. Hayek illustrates that by considering an injection of money through the lowering of the interest rates below the equilibrium level. Interest rates fall, credits become cheaper, and more producers borrow money and invest in capital goods. Resources are being directed away from consumer goods, agents are hence being “forced” to forgo consumption and to save. The cheaper the credit, the higher the investments in the early stages of production (because investment in lengthier production methods is even more profitable – a feature that Böhm-Bawerk [1999/1914] has explained in detail) and the lower the output of consumer goods. The credit expansion lasts until commercial banks, due to reserves requirements, cannot fulfill demand any longer. The consequence is the need to liquidate the earlier malinvestments and what is called in German the Investitionsruinen (funny that there is no English expression for that term), which creates a bust. Adjustment is slowly occurring through a redirection of investment to the production of consumer goods. If government, in the middle of the said process, tries to smoothen the downturn by increasing demand for consumer goods (through, say, subsidies or social transfers), it will only increase the tendency to shorten the production process and further deepen the depression.

Contemporary economists from Germany (Fuest/Hellwig/Sinn/Franz 2010) view the membership of a number of South European states in the Euro system as having artificially lowered their respective interest levels which first created an investment and building boom and later a bubble which exploded at the end. And, they argue that the same contributed to the outflow of capital from Germany, holding down much needed investments at home; Hayek would have spoken of
forced saving. Finally, they see both the initial absence of risk premiums for the bonds of the said states and the recent interest rates convergence due to the Eurozone’s bailout programs as having exactly the same effect as the distorted prices in Hayek’s theory.

In light of the turmoil from 2006 onwards and its attempted management by governments, there is good reason to discuss whether a similar crisis would flow from an artificially high fiscal expansion by the state – in particular by “deficit spending” which was being heavily advocated, in particular after the crisis had moved from the financial markets to the real economy in 2008. Artificially high spending in this connection means budget expenses which are beyond a certain steady-state and therefore “healthy” average.12

Why should this deficit spending be comparable to Hayek’s injection of money by cutting the interest rates? Because – as Machlup (1934) has observed for the twenties’ crises and as can be seen today as well – the state tries to help more those industries which produce investment goods rather than those that produce consumer goods, thus taking capital away from consumer goods production. The state investments contained in most of the stimulus packages are devoted to a large degree to the construction of roads, bridges, public buildings, railway facilities, etc.13 The same, by the way, would apply to the injection of money by the state into the banking system, intended to make the credit markets work again properly after they have partly broken down. This new government money could have the same effect as the one mentioned above. The fact that, in spite of the numerous bank aid programs, it is continuously becoming harder for European enterprises to get loans (see e.g. the ECB’s report for quarter 2/2010) supports this view. And the lowering of the interest rates, repeatedly done both by the Federal Reserve and the ECB, are perhaps those actions which are the closest ones to Hayek’s scenario. No surprise that Professor Erich Streissler as a contemporary “Austrian” has been explicitly drawing the attention to the detrimental consequences of the cutting the interest rates down to a de facto zero level (Streissler 2008a). Already at the eve of World War One, Böhm-Bawerk (1999 [1914]) had shown how the combination of a high wage level with low interest rates leads – by way of an increased profitability of capital intense production methods – to a rise in unemployment.

Although the evolving financial and economic crisis has already plunged many countries into severe debt problems, it is still too early to finally determine in how far Hayek’s concerns are applicable to the prevailing bust and whether the instruments which states were utilizing
had the same effect as suggested by the Austrian Nobel laureate. Yet from a policy point of view, it would certainly be advisable for the decision makers to take these theories into consideration and to investigate whether their own actions would perhaps aggravate instead of sooth the situation. Even non-Austrian authors – for example the London “Economist” in the fall of 2006, or BIS chief analyst William White in various papers and speeches between 2003 and 2007 (see Balzli and Schiessl 2009) – have drawn on Hayek’s model as an explanation how lower-than-equilibrium interest rates were leading to what was then (mid-decade) a slowly emerging bubble in the US mortgage market, warning of the prospect of a real slump and a global recession.

Of course there were economists who disagreed with Hayek, most prominently John Maynard Keynes who is currently being turned to very frequently. As Professor Heinz Kurz has shown in detail (Kurz 2000a, 2010b), Piero Sraffa – although he did not share Keynes’ clinging to the Marshallian supply-and-demand apparatus – was particularly instrumental in refuting the “Austrian” assault on Keynes’s thoughts, being highly critical of Hayek’s concept that money would only be a “loose joint” in the establishment of equilibrium, but not a means of store of value or an asset in itself. For Sraffa and Keynes, money was thus an important means to create demand and thereby increase output and employment. Especially Sraffa criticized Hayek’s distinction between a natural and an artificial level of the interest rate and between “natural” and “forced” saving as not standing the test of logic (Sraffa 1932). More generally, Sraffa was very critical of the marginalists’ view of subjectivism altogether, since he regarded this as a deviation from scientific and objective analysis and as paving the way for “ideology”.14 Hayek in turn reproached Keynes for having understood neither Pareto’s equilibrium thinking nor the intertemporal structure of production (Hayek 1931a and 1931b). Menger (1871) had underlined that the more time is being needed in economic processes, the higher the uncertainty and the probability of erroneous decisions – the time/error paradigm.

This historical controversy has a striking parallel to the current debate insofar as the element of time – which is so central to the Austrian School thinking – is these days often being ignored. Reflecting the “notorious inattention of modern economics to intertemporal structure” (Garrison 1998, p. 115), many decision makers seem to disregard both the fact that the fiscal packages need time – several years at least – to show all their effects (and side effects) and the fact that the ensuing national debts will negatively influence economic
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development for decades. But paradoxically, nowadays debt-increasing behavior of many governments speaks in favor of Böhm-Bawerk’s (1884/89) postulation that agents value today’s needs higher than tomorrow’s needs and that they, in light of present urgencies, tend to systematically underestimate future requirements.

Hayek warned against the belief that economic variables like the price level, aggregate demand, aggregate output, employment, etc., could be engineered by government action. He stood firmly on the grounds of the Austrian School’s conviction that all economic activity was rooted in the individual’s preferences and choices on which the state has only limited influence. This conviction is also the reason why the Austrian economists have generally shown “policy abstinence” (Streissler 2008b), focussing in theory instead.

Hayek’s theory drew on the experiences of the late 19th, early 20th century. To his disadvantage, it was published during the Great Depression, at which time his recommendation to “wait it out” was regarded as outdated if not merciless. Keynes, being Marshallian to a considerable extent, advocated the creation of full employment through the creation of demand in the labor market, and this in turn through creation of demand in the real market by what became famous as deficit spending. In the eyes of the public, Keynes was the hero and Hayek the looser – an interesting parallel to the public conception of the recession and possible remedies from 2008 onwards.

SCHUMPETER – BUSINESS CYCLES AND THE DOWNFALL OF CAPITALISM

Hayek’s critique vis-à-vis Keynes was partly mirrored by Joseph Alois Schumpeter (1883-1950), another Austrian economist largely influenced by Böhm-Bawerk’s theory of capital and interest and Wieser’s marginal value theory – and interestingly by Karl Marx whom he conceded to be one of the few trying to offer a reasonable explanation for economic development (Schumpeter 1954a). Keynes, however, was reproached by Schumpeter, as he had been by Hayek, for drawing far-reaching political recommendations from trivial models and again for ignoring the element of time in his models (Schumpeter 1936).

Yet Schumpeter did not agree with Hayek on the reasons for booms and recessions. And, again in contrast to him, he argued that crises are not accidents in economic development, but an integral and necessary part of it, the “beat of the economic heart” (Schumpeter 1939, p. v). Schumpeter (1926) says that business cycles are being created by “entrepreneurs”, daring and dynamic spirits who swim against the
current and spontaneously start innovations – “new combinations” as he calls them – which provide for upswings and economic development altogether.

According to Schumpeter (1926), the “new combinations” distort the equilibrium because they draw credit from the banking system which means that purchasing power is directed away from the old sectors of the economy and is given to the new, innovative, more productive ones. Due to the success of the innovations, the entrepreneurs earn surplus profits. Because of these extra profits, many others feel attempted to imitate the new combinations so that the innovative impulse and the competitiveness are slowly eroding and the economy falls into a zero-growth situation or even into a recession. Nevertheless, Schumpeter as an “undisciplined Walrasian” (Kurz 2005, p. 39) presumes that there is equilibrium in the economy (which excludes surplus profits), but only in the very long run. And he insists his analysis does not support the *laissez faire* principle – a striking parallel to Hayek, by the way.

One will easily see the differences in how Hayek and Schumpeter look at the banking sector: for Hayek it stands at the origin of distortions because it tempers with the equilibrium interest rate. For Schumpeter it is an indispensable element because it provides the entrepreneur with the required credit to finance his innovations and is therefore at the origin of boom. In the current crisis, both aspects are to be observed: Many view the (particularly American investment) banks has having created the disaster in the first place by going far beyond any “natural” commercial behavior; and most governments have later spent humongous sums of taxpayers’ money to save the (systemic business) banks from bankruptcy in order to sustain their credit providing role and thus the real economy markets and to overcome the recession. Machlup describes how state action to save commercial banks creates a sequence of problems in other areas (debt, trade deficit, budget deficit, etc.) requiring a continuous series of further government interventions: the rescue of the commercial bank increases the indebtedness *vis-à-vis* the Central Bank – which brings the currency under pressure – which calls for foreign exchange restrictions – which in turn leads to increased imports – which worsens the trade balance – which necessitates trade policy action – which bring down imports as well as exports – which again is detrimental to production, output and employment – which furthermore requires costly government intervention, and so on (Machlup 1934). This example is a picture from the thirties, and so it differs in technicalities and mechanisms, but not really in the effects,
from today’s situation. As one can observe presently, banks salvation by the state leads to higher sovereign debt, thus to severe fiscal pressure (and, as shown above, often also to unintended credit restrictions), bringing about a reduction of output and employment together with tax increases, and that in turn suggests further government action to ease the situation. The results are ultimately pretty much the same as in Machlup’s model.

The dying-down of the innovative impulse, by the way, is not only applicable to the business cycle, according to Schumpeter (1954a, 1950), but to very system of capitalism itself: the type of entrepreneur will occur more and more rarely; big multinational companies in which the manager is no longer the owner and has therefore different priorities, will take over instead. The societal layer which produces the entrepreneurs will erode. Economic development will become mechanical. Taylorization, routinization and bureaucratization will follow. Intellectuals will turn away from capitalism. This will eventually change the capitalist system into a socialist one; the “march into socialism” (Schumpeter 1950) cannot be avoided. Capitalism will “decompose” (Schumpeter 1954a, p. 156), not due to its weakness but rather because of its attractiveness. And the question “Can capitalism survive?” is to be answered by a simple “No” (ibid., p. 61).

Looking at politics with an economist’s mind, Schumpeter developed an economic theory of democracy (Schumpeter 1954a). He compared the politicians wanting to maximize their votes to the suppliers, and the voters to the demanders who wish to gain maximum utility in exchange for lending political support, both groups using economical optimization methods to get as much as possible. It seems difficult to contradict this interpretation if one looks at nowadays behavior patterns of political parties and governments and their measures, in particular when under pressure.

Is there anything in Schumpeter’s theory that we can learn from in the financial and economic crisis? Some are arguing that many predictions of the former Graz University professor have come true. Firstly, a couple of years ago, one could see a wave of innovations which took away purchasing power from other sectors of the economy which then began ailing. The innovations were imitated by too many others looking also for extra profits. The latter ones were not sustainable and the system eventually went into a bust. Examples are the so-called dot-com crisis a few years ago or the subprime disaster more recently. Moreover, when it comes to the appreciation of the principles of capitalism among intellectuals and to the shrinking significance of those
groups which produce the type of entrepreneur, one might argue that Schumpeter’s predictions are not out of reality. Is it now, in times of the international crisis, not truer than ever that, at least in some circles, “the atmosphere of hostility to capitalism (...) presently makes it much more difficult than it otherwise would be to form a rational opinion on its economic and cultural performance” (ibid., 1954a, p. 63)?

Given the critical stand of many Austrian School representatives vis-à-vis socialist thinking, it is startling that hardly any Marxist economist commented on that School. The exception is Nikolaj Bukharin who considered the Austrian (in particular Böhm-Bawerkian) marginal utility theories the expression of decadence of an eroding period. He argued that due to the accumulation of capital, the surplus value was reaped by people who had no role in production whatsoever and who were idly benefitting from the yields of stocks and from the gains of trading these papers (Bukharin 1926). It is hardly disputable that the said rentiers who had become more numerous due to the stock exchange boom in past years, and their typical behavior, were at the origin of the financial crisis from 2006 onwards.

Schumpeter (1954a) pointed out that the aftermath of the Great Depression was “felt, rightly or wrongly, to be beyond the remedies that would have recommended themselves to the men of the free-enterprise age” and that the society “has accepted now fiscal burdens, a mere fraction of which would have felt unbearable fifty years ago” (ibid., p. 420). In this very last article of his life, Schumpeter went on to caution against several policies which were suggested to cure the difficulties of the then post-war era and which are being suggested or already executed in many stimulus packages of our days as well: he thus advised against the acceptance of inflation to boost growth; admonished – in a pretty Hayekian way – of a “remedial recession” (ibid., p. 423) resulting from cheap-money policies; he counseled against increased taxation in such a situation because that would further enhance inflationary tendencies; and he cautioned of the expansion of subsidies as that would lead to price hikes, to increased government control over citizens’ lives and to the surrender of private companies to public authorities. Although he would have protested against being seen as a prophet (ibid., p. 416) – isn’t this series of alerts a striking prediction of many of the implications of the current disturbances as well?

A FINAL WORD

Irrespective of whether one is in agreement with the theories of the Austrian School of Economics – or any other school – or opposed to
them, I would consider it advisable if not imperative to explore whether and to what extent the thinking of the respective scholars can explain the prevailing recession and in how far one could find recipes for its cure or warnings of instrumental misconceptions. Schumpeterianly speaking, only the study of past economic thought enables a full understanding, appreciation and judgement of present economic phenomena as current problems and methods cannot be fully grasped without the knowledge of the previous problems and methods (Schumpeter 1954b). In this context, one should bear in mind how Keynes reminded of the mightiness of ideas: “The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood (…). It is the ideas, not vested interests, which are dangerous for good and evil.” (Keynes 1936, p. 383).

I would like to end with an appeal to the decision makers: that is to say, to take the insights of economic theory more seriously into account, and to realize that “preoccupation with the history of economic thought is welfare enhancing” (Kurz 2008, p. 13). It is to be strongly hoped that the last years’ unfortunate trend of mostly ignoring the science of economics be reversed.

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**Notes**

1. Standard models normally treat endowment as a constraint. In light of the limited or even shrinking resources currently available to States, I consider it appropriate to treat endowment as a variable instead.
2. …and as further developed later (Menger 1883).
4. …if preference relations are transitive, complete, convex and locally non-satiated, and if production sets are convex.
5. In this context, attention is drawn to the explanation for trade by marginal utility, a principle simultaneously but independently discovered by Carl Menger, Léon Walras and William St. Jevons. Due to its focus on marginal utility, the Austrian School is also known as the Marginal Utility School. Wieser’s (1889) treatment of the average marginal utility in a competitive society with equality of incomes as the “natural value” of goods and this natural value in turn as the yardstick for economic policy, are instrumental in this regard. As we will see later, this view provided the basis for Hayek’s and Mises’ concept of the informative nature of prices as well as for Schumpeter’s concept of the creative individual.
6. For a more detailed discussion on macroeconomic policy, see e.g. Burda and Wyplosz (2001).

7. A profit-maximizing monopolist will produce where marginal revenue equals marginal costs. That results in a higher price than in a competitive solution in which price is determined by the intersection of supply and demand (and in which output will be where price equals marginal costs and average costs). Output in a monopoly is less than the Pareto efficient amount occurring in competitive situations and consumers experience welfare losses. For a more detailed discussion, see Nicholson (1992, p. 425 ff and 561 ff) or Varian (1996, p. 215 ff and 233 ff).

8. It should be added in this context that Schumpeter (1954 [1942]) – although underlining that the market mechanism provides for a maximum of satisfaction in the short run – also discussed some beneficial aspects of monopolies for innovations and thus for economic development, for example the greater availability of funds for research, or cost-saving production methods for new products.

9. …if interest rates fall.

10. …that is knowledge relevant for an alteration in the agent’s original plans (Hayek 1937).

11. We leave aside the question how the equilibrium rate is concretely defined.

12. Where such an average should be fixed, remains to be discussed, but the well-known Maastricht criteria of the Euro zone (in particular the maximum financial deficit of 3% of GDP) could be an orientation.

13. In the most recent period, governments are at least trying to redirect some of their spending, away from mere infrastructure, and towards education and environment protection, as Erich Streissler has recently commended (Streissler 2010).

14. This is contained in Sraffa’s yet unpublished papers. I am grateful to his editor Professor Heinz Kurz for this hint.

15. The Austrians’ emphasis (rooted in an almost psychological understanding) on the individual’s role and on the comprehension of individual calculations as the center of research (Leube 1999), furthermore the marginalist theory of value and its application by the agents (Mises 1940, p, 129 ff), and thirdly the generation and sharing of knowledge as an explanation for development (Streissler 2008b), are the main differences to Classical concepts (to Smith’s “invisible hand” that would most appropriately direct resources, to Ricardo’s formulation of the theory of comparative advantages, and to Smith’s view of the division of physical labor as the driver for development). True, both the Classical and Austrian Schools share reservations vis-à-vis government intervention.

16. …something which is not reconcilable with the concept of a perfect market, of course.

17. Wieser (1926) in his critizism of the behavior of banks went as far as to suggest that one ought to search the archives of the banks in order to find the real culprits of World War One.
18. It is from the pre-Mundell-Fleming period, obviously. For modern Eurozone models, see e.g. Burda and Wyplosz (2001). The main difference between Machlup’s example and the contemporary reality is the starting point of the chain: whereas the former contemplates salvaging action by the Central Bank, it is nowadays mainly the governments who are rescuing troubled commercial banks with budget money.

19. Schumpeter being a certain exception as he answers the question “Can socialism work?” in the affirmative, but he also insists he does not advocate socialism (Schumpeter 1954a, part III, and 1950, p. 416).

20. Bukharin (1888-1939) was exiled from his native Russia, came to Vienna and studied i.a. under Böhm-Bawerk.


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