The Austrian School of Economics

Austrian school analysis shows that any interference or control of money by a central bank or government agency will distort the interest rate and cause economic waste

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You cannot deeply understand economics unless you understand the market dynamics of the Austrian School of economic thought. Commencing with Carl Menger's book Principles of Economics in 1871, the school, originating in the Austro-Hungarian Empire, introduced subjectivist value theory, analysis using marginal utility, and a theory of the time structure of capital goods, among other concepts.

The conception of capital goods in the Austrian school has not been assimilated into neoclassical thought. Neoclassical economics tends to treat capital goods as a homogenous variable, often in two-factor models where it is paired with labor. The Austrians recognize a structure of goods starting with soon-to-be-consumed household goods as the lowest order, circulating inventory as the next order, and then ever higher orders as capital goods with an ever greater period of production or time duration, making them ever more responsive to the rate of interest.

Lower interest rates make the highest order of capital goods more profitable for investment. Greater savings induces a lower rate, and the extra investment is offset by less consumption, and all is well. But when the monetary authority injects excessive new money into the banking system, to the banks it is like additional savings, as they lower the interest rate to loan out the extra funds. The money flows to higher-order capital goods such as the construction of housing and office buildings.

But planned consumption has not changed, so the new investment competes with unchanged consumption and drives up prices, especially in the fields the new money flows into, such as the purchase of real estate. The excessive issuance of new money not only raises prices, but also changes relative prices, distorting the price structure, like land values rising much more than the prices of consumer goods or of wages.

When the monetary authority cuts back on the money creation to avoid price inflation, interest rates rise. With higher costs, investment in higher-order capital goods ceases and the speculative boom decelerates as some projects in the early stages are abandoned. This reduces demand for other goods, and the economy falls into a recession. That is the Austrian theory of the business cycle, which is complementary to the real-estate cycle.

Austrian-school analysis shows that only in a pure free market in money and banking can the natural rate of interest emerge to equalize savings and investment and allocate all production between consumption and investment. Any interference or control of money by a central bank or government agency will distort the interest rate and cause economic waste. The knowledge need to set the market rate of interest to its natural rate is unknown and unknowable to a monetary authority.

The Austrian critique of governmental central planning applies broadly to all government intervention. The pure free market adjusts all production to what is wanted by consumers. Any interference by government will skew production away from what provides the greatest benefit to consumers. Minimum wages, price controls, subsidies, taxes on productive activity, and restrictions on enterprise, intended to help particular groups of people end up with the unintended consequence of a less productive economy and less c satisfaction. These attempt to solve problems, such as unemployment or low incomes, caused by or made worse by other interventions.

Markets are needed to enable entrepreneurs to engage in economic calculation, to allocate factors and to price goods to reflect their scarcity and consumer valuations. Many of the services provided by government can be done as well or better by private enterprise, including schooling, medical services, and local security.

In his book Socialism, the leading Austrian economist Ludwig von Mises showed how state socialism could not possibly work. In that book, Mises also explained how the inequality of wealth originating in land was a result of conquest, not the market. Mises also notes that governments tend to tax income and goods more fiercely than land.

Aside from voluntary user fees and penalties for doing damage, the source of public revenue that does not impede the market is the social surplus that constitutes land rent. Austrian economists have been slow to recognize that tapping the rent would not interfere with economic calculation. On the other hand, geoclassical economists, while espousing free trade, have been slow to appreciate the futility of attempting to change any outcomes of the pure free market. Perhaps in the 21st century, the two camps will come to appreciate their complementarities.

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FRED E. FOLDVARY, Ph.D., (May 11, 1946 — June 5, 2021) was an economist who wrote weekly editorials for Progress.org since 1997. Foldvary’s commentaries are well respected for their currency, sound logic, wit, and consistent devotion to human freedom. He received his B.A. in economics from the University of California at Berkeley, and his M.A. and Ph.D. in economics from George Mason University. He taught economics at Virginia Tech, John F. Kennedy University, Santa Clara University, and San Jose State University.

Foldvary is the author of *The Soul of Liberty*, *Public Goods and Private Communities*, and *Dictionary of Free Market Economics*. He edited and contributed to *Beyond Neoclassical Economics* and, with Dan Klein, *The Half-Life of Policy Rationales*. Foldvary’s areas of research included public finance, governance, ethical philosophy, and land economics.

Foldvary is notably known for going on record in the *American Journal of Economics and Sociology* in 1997 to predict the exact timing of the 2008 economic depression—eleven years before the event occurred. He was able to do so due to his extensive knowledge of the real-estate cycle.