

Austrian Economics FAQ

Version 1.1

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Description: This is a collection of Frequently-Asked-Questions concerning Austrian Economics and the Austrian perspective on economic issues. It covers a wide range of issues, from the foundations of economic analysis to business cycle theory.

References: Most questions are accompanied by references to further reading on the topic as well. The most common references are to the two great treatises within Austrian Economics, *Human Action* by Ludwig von Mises and *Man, Economy, and State* by Murray Rothbard. All references can be found for free online in PDF form.

Foundations:

What is praxeology?

Praxeology is the study of all of the implications logically deducible from one singular statement: the action axiom. This foundational axiom simply posits that “man acts”. From this one statement, all the conclusions of the science of praxeology are logically and a priori drawn. These include the concepts of means and ends, marginal utility, the Law of Demand, and more.

*References: *Human Action Chapter I; Man, Economy, and State Chapter 1**

What does it mean for a person to act?

Action in the Praxeological sense of the word means that man seeks after ends, and that he employs means to attain those ends. The ends that man wishes to achieve could be almost anything imaginable. One could have the desire to make a sandwich, buy a new car, or solve mathematical equations. From a praxeological standpoint, we do not question the ends that acting man chooses. Praxeology does not approve or disapprove of a man’s desired ends, just acknowledge that he does seek after those ends.

Similarly, praxeology does not confer any sense of validation on the means that one chooses to attain his desired ends. One may believe that the best means to attain the end of graduating college is to sleep through lectures and ignore deadlines. It could result that these means are wholly unsuited to attaining the ends one seeks, but it is not the task of praxeology to discern the best means for the attainment of ends, only to analyze from an impartial perspective that actors do employ means to the attainment of ends.

*References: *Human Action Chapter I; Man, Economy, and State Chapter 1**

What is marginal utility?

Marginal Utility is the praxeological statement that the value that acting man confers upon any good is dependent on the end that particular good will satisfy. If I possess only one good of a particular stock, then I will value that particular good more than if I was in possession of ten goods of that stock. This is because as my stock of goods increases, the ends that I can satisfy with them decreases. The first good I acquire will naturally be

allocated to satisfying my highest desired end that good is fit to satisfy. The second good I acquire will satisfy the second-highest desired end, and so on. Thus, the value placed on any particular unit of a good is a function of the stock already in my possession, as contrasted with the ends I can satisfy with that stock. The value therein derived is the marginal utility of that good.

*References: *Man, Economy, and State Chapter 1.5; Human Action Chapter VII.1**

What is the law of Diminishing Marginal Utility?

The law of diminishing marginal utility is derived from the concept of marginal utility, and it states that as the stock of a good increases, the marginal utility of increasing the existing stock by another unit decreases. If I am in possession of a single good, the addition of one more unit of that good will be much higher than if I was already in possession of one hundred units of that good. As my stock increases, I can satisfy increasing amounts of my desired ends. As more and more of my ends are satisfied, the utility I derive from the newly satisfied ends decreases. Thus, as the stock of a good increases, the utility I derive from additional marginal units of that same good will decrease.

*References: *Man, Economy, and State Chapter 1.5**

What is the Law of Demand?

The Law of Demand is the praxeological law that states that as the price of a good increases, the demand decreases. The opposite is also true; as price decreases, demand increases. This law of economics can be derived from a simple understanding of action, utility, and costs. If the price of a good increases, this means that the amount of ends I would be able to satisfy if I purchased the good would be less than at the previous price. Thus, as the price increases, there will inevitably come a point where the costs of the ends foregone outweighs the utility provided by purchasing the good. Thus, we can say that as the price of a good increases, the demand for that good will decrease. This same logic applies to the increase scenario as well. As the price decreases, there will come a point where purchasing the good will generate greater utility than abstaining from that purchase. As a result, we can state that as price decrease, demand will increase.

What is the Law of Supply?

The Law of Supply is related to the Law of Demand, viewing the same phenomena through the lens of supply. The Law of Supply states that as the price of a good increases, the amount of that good supplied on market will increase. Vice versa, if the price of a good decreases, the amount of that good supplied on market will decrease. This law, similar to its demand-based counterpart, is also derived from praxeology. As the potential utility gained from undertaking an action increases, the likelihood of engaging in that action increases as well. We can see this very clearly in the production of goods and services. An increase in the amount of money paid for the purchase of a good represents an increase in the potential utility that one could gain from engaging in that production process. Therefore, as the price, also seen as the potential income for the producer, increases, the amount of that good supplied on markets will increase as well.

What is time preference?

The concept of time preference deals with the one's chosen ratio of immediate consumption to future consumption. If I choose to spend all of my time picking apples off of trees and eating them on the spot, I am only engaging in direct and present consumption. In other words, I am only consuming and not saving. If, however, I decide to put away some of my apples to eat in the future, I am no longer working only to eat in the present, but also in the future. I am engaging in saving so that I may have a stock of goods to consume in the future. One's degree of time preference depends on one's amount of consumption relative to one's saving.

*References: *Human Action Chapter XXVIII; Man, Economy, and State Chapter 6.3**

What does it mean to have high time preference?

Individuals with high time preference have very high levels of consumption relative to their saving levels. They relatively prefer to enjoy in the present as opposed to enjoying in the future.

*References: *Human Action Chapter XXVIII; Man, Economy, and State Chapter 6.3**

What does it mean to have low time preference?

Individuals with low time preference have low degrees of consumption relative to their savings. They prefer to consume in the future as opposed to consuming in the present.

*References: *Human Action Chapter XXVIII; Man, Economy, and State Chapter 6.3**

What does it mean for production to be roundabout?

Roundaboutness refers to the relative amount of stages that one utilizes in a production process. If I go into the woods to pick berries, this production process has only one stage. This single stage is that of my entering the woods and picking the berries. However, if I decide that building a bag to hold my berries in would allow me to carry more berries, then I must first construct a bag with the materials I have on hand, and then go into the woods to collect more berries. This production process is relatively more roundabout, as there are now two stages where there was previously only one. My first stage is to build a bag, and the second is to go and collect berries. Therefore, this production process takes more time and is more arduous than the first. I must go through the work and toil of creating a bag before I am able to collect my berries. However, this process is also more productive than the first. I am able to take more berries back with me, and thus, am able to consume more than I was before. Whether or not the time and labor associated with this more roundabout process will be outweighed by the additional consumption allocated to me is up to my own subjective utility and time preference.

*References: *Man, Economy, and State Chapter 6.2**

What is autistic exchange?

All action represents an exchange. For one to act, there must be a felt uneasiness about the future. One wishes for things to be different than the way that there are or will become. Therefore, one is impelled towards action. If there was no uneasiness about the future, one would not be driven to action as there would be no motivating factor. Consequently, we can say that in acting one is always attempting to trade the set of circumstances as they would have been in one had not acted for the set of circumstances one is looking to bring about as a result of acting. In this way, all action is an exchange. Acting means to exchange what one has for what one wishes to have. It is this exchange that is meant when we refer to "Autistic Exchange".

*References: *Human Action Chapter X.1**

What is Austrian Economics, and what makes it different from the mainstream?

Austrian Economics differs from Neoclassical (Mainstream) Economics in many different ways. Some of these are minor disparities, while others are major differences in thought. For the sake of summary, we will examine two of the largest points of

contention between Austrians and Neoclassicals: methodology and understanding of the market.

Austrians understand Praxeology to serve as the basis of economic analysis. We start from an understanding of the actions of man more broadly, and then apply this to questions relevant to economics. All of these conclusions are logically derived one from the other, all starting with the statement that “humans act”. Neoclassical thought has no such corollary to the Austrian embrace of praxeology. The methodology of the Neoclassical school is very empirical in nature, but also much less coherent than the Austrian approach. The Neoclassical approach to economic science is to apply the methods of the natural sciences to the actions of individuals to discover laws of economics. Just as the scientist performs experiments in the laboratory, the economist performs experiments of his own by examining and contrasting economic data and statistics.

The way in which Neoclassical economists and Austrian economists view the market is also different in both its nature and scope. Austrians view the market as being a process. The market takes place in time, and thus, is constantly in a process of moving and adjusting to the wishes of those that engage in it. It is constantly moving toward an equilibrium state, but never reaches this state. The Neoclassical view of the market is focused on examining equilibrium states within the market, even if those equilibrium states never actually result. When looking at the market or the economy as a whole, the Neoclassical will utilize general equilibrium models, in contrast to the singular partial equilibrium for a single market.

*References: *Human Action Chapter II and Chapter XV**

Why do Austrians think people are always rational?

The Austrian view of rationality and the Neoclassical understanding of rationality are very different in their scope and view of human nature. The Neoclassical view is that individuals are always looking to maximize their utility, discoverable through an analysis of indifference curves and budget restraints. This near-robotic view of action is the “homo-economicus”. Neoclassical economists would not claim that human beings actually act in this way, but that this model gives us fairly strong predictions about how people act.

Austrians view rationality in a completely different framework. For the Austrian, rationality is always a question of what the actor believes will maximize his utility. Because actors always look to maximize their utility in their action, we can state that

man's action is always rational. To even say "rational action" is unnecessary, as action is always rational by virtue of it being undertaken by the actor.

*References: *Human Action Chapter IV.1**

Why do Austrians rely on verbal logic not symbolic logic?

When speaking of praxeology and the nature of acting man, Austrians could very well utilize symbolic over verbal logic. When we state that an actor employs means for the attainment of ends, we could alternatively write that *A implies Q*, where A is anything that is an actor and Q is the achievement of ends through various means. However, there is nothing gained from this translation of verbal into symbolic logic. Everything that was contained within our verbal statement is equally present within our symbolic statement. Thus, the utilization of symbolic logic in the field of economics cannot provide us with any new information.

This does not mean that it cannot be useful, just that it reveals nothing new to us. We could write out all of the laws of economics in terms of symbolic logic, but such an exercise is doubtful to help our understanding of these laws in any tangible way.

*References: *Man, Economy, and State Chapter 1 Appendix A**

What is a Whig view of history in regards to science?

The Whig Theory of History is the idea that the progress of man kind is ever increasing as time moves along. Every now and then there might be a few bumps in the world, World War 2 and the Black Death being prime examples, but on net, mankind gets better as time moves along. Applied to science, the Whig theory would state that as time goes on, science becomes more and more correct in its theories and conclusions. Again, there might be a few regressions, but we will be smarter tomorrow than we were today, and smarter 10 years from now than we are today.

What is the difference between socialism, capitalism, and interventionism?

Socialism is the form of economic organization where all of the means of production are owned by the state. Private business does not exist, and the production of all the goods and services in the economy is overseen by a governmental central authority.

Capitalism is the exact inverse of Socialism. Under Capitalism, all production of goods and services is carried out by private businesses. The government has no presence at

all in the economy, and prices are free to move and fluctuate according to market forces.

Interventionism is Capitalism, but with a government presence in the market. This could be government-run services or utilities, such as the post office. This could also be government mandated floors or ceilings on prices; the most famous of these are minimum wage and rent control. Whatever the form it takes, Interventionism is marked by a government role in the affairs of the economy such that not all goods and services are subject to private production at pure market prices.

*References: *Man, Economy, and State Chapter 12**

What is uncertainty?

Uncertainty is a product of man's lack of knowledge concerning future events. In his action, he does not know with total assurance what his environment will look like in an hour, a day, or a year. As such, he must estimate to the best of his ability a picture of the future as it would affect him and his action. Because of the presence of uncertainty, however, this picture is never concrete. Uncertainty affects all of action, and particularly action on markets. Entrepreneurs are always uncertain about future market prices. However, in the pursuit of profits, they must continually look to predictions on what they believe the future may resemble, and adjust their actions accordingly. If they believe that the price of a certain good will rise, they will invest in the production of that good. If they believe the price will fall, they will divest themselves of that good's production.

*References: *Human Action Chapter VI**

Do Austrians reject empirical knowledge?

Austrians do not reject empirical knowledge per se. Utilization of empirical methods has generated great progress in the fields of the natural sciences. Empirical knowledge, as such, is perfectly fine and good. However, this does not mean that empirical knowledge is applicable evenly to all sciences. Just because a method of inquiry performs well in one area does not mean that this success can be replicated elsewhere. Economics is one such field where empirical methods fail. Praxeology reveals to us what action is and all that it entails. However, there are no constant laws concerning the content of human action. Because value judgments of man can always change, the actions we take are subsequently subject to eternal change as well. Consequently, any empirical findings we may discover are not necessarily true. They are information about past events. What happened in the past can certainly influence the present, but this does not mean that

past actions must be replicated in any way in the present. Any such “laws” derived from empirical findings concerning the past are therefore not laws at all, but fallacious interpretations of the actions of yesteryear. Empirical methods cannot reveal laws concerning the content of human action because no such laws can ever truly exist.

*References: *Human Action Chapter II**

Markets:

What is Catallactics?

Catallactics is the study of the market and market exchange. Praxeology grants to us laws concerning the nature of human action, and Catallactics is the application of those laws to market situations and circumstances. Topics such as exchange, markets, equilibrium, and interest all are Catallactic in nature. Even more complex subjects, such as business cycle theory or capital theory would also be considered Catallactics as well.

*References: *Human Action Chapter XIV**

What is Elasticity?

Elasticity refers to the change in the amount of a product sold as compared with a change in price. If the price of a good increases, and the quantity demanded decreases by more than the price increase, demand for that good is elastic. If the quantity demanded decreases by less than the price increase, demand for that good is inelastic. If the quantity demanded decreases by exactly the amount of the price decrease, then the demand is unit elastic.

*References: *Man, Economy, and State Chapter 2.5**

What does it mean for a market to be competitive?

The Austrian understanding of competition is process based. The competitive process involves firms all offering the best possible products to consumers at the best possible price. Consumers will buy from those entrepreneurs who fulfill their wants and abstain from buying from those that do not. All those that deliver goods the consumers wish to purchase will be “rewarded”, while those that do not are “punished”. The competitive process is the constant changing and evaluation of those entrepreneurs that satisfy consumer demand. Competition is not dependent on the number of firms present, but

on the continual process of creating and improving the development of goods and services to consumers

References: Man, Economy, and State Chapter 10; Human Action Chapter XV.5

Does competitive mean perfect competition?

When Neoclassical economists refer to “perfect competition”, they have a very particular model in mind. Under conditions of perfect competition, all firms in a market are producing a single homogenous product. None of them are large enough to influence the market price, so they are all price takers. One may notice that under this scenario, there is no actual competition! It has all been assumed away! All the products are the same, the prices are the same, and the firms producing them are the same. Austrians, recognizing competition as a process in markets and not a state of markets, reject this model.

References: Man, Economy, and State Chapter 10.5

What is equilibrium?

Equilibrium is the state of markets where the supply of a good equals the demand for that good. This is, by definition, the optimal state for a market to reach, as the sellers of a good find their psychic income optimized by having the greatest amount of goods sold, and the buyers’ psychic income is optimized by being able to procure the greatest amount of a good.

References: Man, Economy, and State Chapter 3.9

How are prices formed?

Prices are formed via the evaluation of a good on individuals' value scales, which is compiled into market-wide supply and demand schedules. We can demonstrate this with an example:

Suppose there is only one good in an economy: Widgets. It is the only good supplied and demanded on markets. Suppose further that there are only three people who supply widgets, and three people who demand them. To simplify the example as much as possible, we will also adopt dollars as our medium of exchange in this imaginary economy.

Person 1 is a widget enthusiast. He buys more widgets than anyone else. We can show this on his value scale, which is an ordinal ranking of all the goods he desires.

1. \$10
2. First Widget
3. Second Widget
4. \$9
5. Third Widget
6. \$8
7. Fourth Widget
8. Fifth Widget
9. \$7

This value scale shows that at a price of \$7, Person A will demand 5 widgets on markets. If the price rises to \$8, he only demands 3 widgets, he values keeping that marginal dollar more than purchasing those two marginal widgets.

Let us imagine that the other two individuals have value scales as such:

1. \$10
2. \$9
3. First Widget
4. \$8
5. Second Widget
6. Third Widget
7. \$7

1. \$10
2. First Widget
3. \$9
4. \$8
5. Second Widget
6. \$7

With this data, we can construct a demand schedule for the market for widgets. To do this, we look at each price and see how many widgets are valued by individuals above that proposed price. We add these up, and that tells us how many widgets will be demanded at each price.

- \$7 = 10 widgets

- \$8 = 5 widgets
- \$9 = 3 Widgets
- \$10 = 0 widgets

This gives us a demand schedule, which if graphed, would equate to a demand curve. The same can also be done with the supply of a good in the economy. However, the order in which the goods appear is reversed.

1. Fifth widget
2. Fourth widget
3. 10\$
4. Third widget
5. \$9
6. Second widget
7. \$8
8. First widget
9. \$7

For the suppliers of a good, the amount of widgets that they bring to market increases as the price goes up. As a result, the third first widget is on the bottom of their value scales, and their last widgets are on top, the reverse value scale of the buyers. Let us say that all of the value scales from the suppliers can be amalgamated into the following supply schedule:

- \$7 = 2 widgets
- \$8 = 5 widgets
- \$9 = 7 widgets
- \$10 = 9 widgets

Given both the demand and supply schedules, we can compare them and see where the market will be in equilibrium. At the price of \$8, there are 5 widgets supplied on markets and 5 widgets demanded. This is where the market will be in equilibrium and the price will settle. This example is simplified by dealing with only one good, but this framework can be easily applied to a much more complex economy with many goods. In such a scenario, the value scales are much longer and contain numerous kinds and quantities of goods. Even so, it can be examined with the identical method that we have utilized in our simple example above.

*References: *Man, Economy, and State Chapter 4.2**

What is the Evenly Rotating Economy?

Markets are always working to reach equilibrium, as a state of equilibrium is the most optimal market configuration. However, change is always being introduced to markets, and thus, equilibrium is never reached. The Evenly Rotating Economy is the mental image of an economy if there was no change and equilibrium was reached in all markets simultaneously. This model gives us insight and understanding into the nature of profit, as well as interest, by looking at an economy where there is no change. Profit disappears in the ERE, as the future prices of all consumer goods and inputs are all known beforehand. As such, profits will vanish altogether. This tells us that profits are a feature of uncertainty on markets, and not a permanent return earned by businesses. In the ERE, interest would still exist. If I lend out money for a year, I still expect a return on that money even if there is no risk associated with that loan.

*References: *Human Action Chapter XIV.5**

What is the function of the entrepreneur?

The central problem of an economy is deciding what to produce and in what quantities it should be produced. It is the economic question. The market economy answers this question through the entrepreneurs. It is the entrepreneur that oversees the production of goods and services throughout the economy, as well as the development and creation of new goods.

*References: *Human Action Chapter 10.8, Man, Economy, and State Chapter 8**

How do prices coordinate the economy?

The entrepreneur carries out the market function of what to produce and how to produce it. However, he utilizes a tool to evaluate his production decision's success or failure: prices. The entrepreneur observes two prices in particular: the prices of his outputs, and the prices of his inputs. The price of his outputs is a reflection of the consumer's valuation of his goods and services.

If the consumers value these outputs highly, then their price subsequently will increase. If they value them relatively lower, the price will decrease. Thus, he is always looking to the prices of his inputs to relay to him the value that consumers place upon his produce. The other price he must be attentive to is the price of his inputs. His inputs are the prices of all the tools and resources that contribute towards creating the final end product that he sells to consumers. Entrepreneurs are always in competition for these

resources and are always looking to employ the most productive inputs for the lowest price. Similar to consumers, the valuation that entrepreneurs place upon inputs will determine their price.

These two prices are utilized by the entrepreneur in his quest to make profit. His job is to find where a good can be produced that has a higher value judged by consumers than the value his inputs have been given by entrepreneurs. This process serves a vital societal function as well. This constant pursuit of profit ensures that goods will only be produced where the consumer's valuation of that good is equal to or higher than alternative goods those inputs could have created. If they are not, the entrepreneur will take a loss and look to changing the lines of production he oversees.

The profit/loss mechanism shows us how prices coordinate an economy. The valuations of consumers, their tastes and likes or dislikes, are reflected in the prices of consumer's goods, which is reflected in the prices of inputs for those consumers goods. Entrepreneurs look to these prices to tell them where they should invest and produce to make a profit. All of this operates through the market function of prices, and without them, economic calculation in an economy is impossible.

References: Human Action Part Three: Economic Calculation

Can demand curves slope upwards?

The Law of Demand would suggest to us that an upward sloping demand curve is an impossibility. After all, as price increases, demand decreases and vice versa. Some dispute this by bringing up examples where goods are seemingly in higher demand as the price increases. Designer clothing is an example of such a good; they keep to be more desired by consumers at higher prices than at lower prices. These goods are sometimes called "Giffen Goods". However, an explanation for this phenomenon is clear: these goods are not the same good! A stock of a good is defined as a stock where all the goods are equally serviceable. However, it is clear that in the case of a Giffen Good at a lower price is less serviceable at a lower price than at a higher price. Thus, the two goods are separate and have separate demand curves.

Do prices convey knowledge?

One of the functions of prices in a market economy is the transmission of knowledge. It is this fact that is the subject of one of Friedrich Hayek's famous papers, "The Use of Knowledge in Society". His point is that prices convey knowledge much more efficiently than word-of-mouth or direct transmission ever could. For example, let us say that an

iron mine that supplies 50% of the world's supply of iron collapses. Obviously, the world has much less iron to use now, and they must ration it much more scrupulously than they did before the collapse. One way to get the information out about the collapse of the mine and the lower supply of iron is by telling everyone that uses iron. You could send them emails or text messages individually telling them to use less iron. A much more efficient method, however, is present in the price system. If the price of iron rises by 50%, producers that use iron will automatically know that they must use less iron because they cannot afford to use as much as they did before. Additionally, the price system gives us a way of knowing who should now get the lower quantities of iron. Those that can afford the higher price will be able to do so only because the good they produce with it is valued by consumers highly enough to afford it. Those submarginal producers will be left without because consumers value their goods relatively lower than others. The price system transmits the knowledge of the collapse of the iron mine in an instantaneous manner and allows that information to be naturally incorporated into the production structure without the need for direct contact or fiat order.

*References: Hayek's *The Use of Knowledge in Society**

What about Monopolies?

The Austrian conception of monopoly is very strict and definable, something that the Neoclassical version is not. Austrians see monopoly as being a privilege granted by the government to favor one firm over all others. It allows one or a few firms to produce a good or service, such as in the case of broadband internet, but does not allow for a free market. The Neoclassical definition of a monopoly would accept that this is a case of monopoly, but that monopoly is much broader than this. They would argue that monopoly has to do with a monopoly price that a firm is able to achieve, which is higher than the price that would have resulted on a competitive market. A firm may grow too large on a free market and then raise its prices; everyone has to go to this firm to buy the good or service, so it can charge a monopoly price and raise its own income. This conception of monopoly was critiqued by Murray Rothbard in his "Man, Economy, and State", where he argued that there is no way to separate the "monopoly price" from the "market price". If there is an increase in the market price, this could very well be a result of higher demand or lower supply. In reality, there is no such thing as a "monopoly price". The only price we have is the market price, which ensures that we cannot make a rational distinction between two different types of prices.

*References: *Man, Economy, and State*: Chapter 10*

What is the pure rate of interest?

The Pure Rate of Interest is the rate of interest on markets abstracted from all kinds of risk. It is a reflection of the time preferences of individuals and nothing else, as there is no risk of non-repayment that would drive the rate up.

Man, Economy, and State Chapter 3.7

What is Says Law?

Says Law is the law of economics that states that the demand is a product of supply. For anyone to have money to demand other goods, one must first have produced something. I have to produce before I can buy anything. I receive money from producing, which is proportional to the amount of other goods I can demand; I can only buy as many goods as the amount of money I have. This situation is true for everyone in the economy as a whole. Thus, the entire demand for goods is equal to the entire supply of goods. Demand is derived from supply, and is equal to it. Therefore, aggregate demand and aggregate supply are always fused at the hip to each other. Consequently, there is no such thing as a general glut of goods. There cannot be "too many goods" on markets, because the demand necessary to purchase them is always present, as a function of supply.

Money:

What is money?

Money is that object in an economy which serves as a common medium of exchange. Whatever all other goods are trading against is money; it is fully one-half of all transactions. There are three main functions that money serves. It acts as a medium of exchange, which signifies that it exchanges for goods on markets. It acts as a unit of account, allowing for businesses to tabulate and record their revenues and costs. It also serves as a store of value, granting to individuals the ability to save money without the fear of it deteriorating or becoming unusable.

References: Man, Economy, and State Chapter 3.2

What is inflation?

Inflation is an increase in the supply of money in an economy. It is possible, and indeed quite probable, that this increase will result in price inflation, which is the increase of prices all throughout the economy. However, this does not necessarily result, as it is

possible that the demand of cash balances will increase at precisely the time the inflation occurs, and prices remain roughly stable. However, even in this scenario, prices are higher than they otherwise would have been.

*References: *Man, Economy, and State Chapter 12.11**

What is deflation?

Deflation is the opposite of inflation; it is the reduction of the supply of money in an economy. Similar to inflation, it often leads to a decrease in prices throughout the economy, but this is not a necessary result.

*References: *Man, Economy, and State Chapter 12.11**

Is deflation bad for the economy?

Certain economists, especially those in the Chicago tradition, hold that deflation negatively impacts the economy, and that a certain level of tempered inflation is necessary for the economy to function smoothly. Austrians reject this view, seeing deflation in its natural form as beneficial and good. Deflation embodied in individual prices serves as a boon for consumers, as it means that a good can be acquired for a lower price than previously. Even on a macro level, a decrease in all prices across the economy would indicate that society as a whole is richer, as more goods can be obtained with a fixed amount of money than before. However, deflation that occurs through artificial processes, such as a steady decrease in the money supply, can have harmful effects. Similar to a situation with an increase in the money supply through inflation, those who have their incomes reduced last will benefit at the expense of those who have their incomes reduced first. As long as deflation is through the natural, or good's side, of the equation and not through the artificial, or money side, of the equation, Austrians believe there is nothing to fear.

*References: *Deflation and Liberty by Jorg Guido Hulsmann**

What is the price level? Can you measure it?

Austrians soundly reject the entire notion of a "price level". Prices are individual points of exchange in a market economy. How could they be at any such level? They are all constantly changing and in flux; increasing and decreasing all the day. The "price level" is not anything that exists and is observable on markets. One could argue that if all prices rise, we can say that the price level has increased. However, we could just as

easily say that all prices have increased! There is no need to create a new concept for such a phenomenon. Additionally, not all prices will have risen in the same amount. Some will have risen more, some risen less. As a result, there is still no true way of measuring a price level in this scenario either.

*References: *Man, Economy, and State Chapter 11.13**

What is interest?

Interest is an ever-present phenomenon of the market, and represents the time preference of society as a whole. The interest rate is the rate on present goods saved up and available in exchange for future goods. If there are more saved goods, this interest rate will be lower, and vice versa. If society as a whole has lower time preferences, then there will be more savings, which lowers interest rates. The opposite case is also true. The interest rate pervades all time markets and has a tendency towards an equilibrium state and be equal everywhere across the economy.

*References: *Human Action Chapter XIX**

What is Mises' Regression Theorem?

Mises Regression Theorem is the solution proposed by Ludwig von Mises in 1912 to the problem of applying marginal utility to the value of money. The problem lies in that there appears to be an inescapable circle of reasoning in valuing money. I value money because I can buy things with it. The reason I can buy things with it is because it is valuable. However, the reason it is valuable is that I can buy things with it. I'm sure you see the problem here. There is no grounded explanation for how money comes to be valued by individuals.

Mises' solution is that the valuation we have of money today is based on what money was worth yesterday. We make our judgments of money's value based on the recent past. The money prices of yesterday are based on those of the day before, and so on. This process of regressing back in the past goes all the way until the point that the first commodity money, let us say gold, was not money at all, but simply bartered for on markets. Thus, the basis of valuation of money is based on the past, and this past itself extends all the way until the point where money became money.

*References: *Human Action Chapter XVII.4**

What is sound vs unsound money?

Sound money is that money which fulfills all of the requirements of a money in an efficient manner. These requirements are that it facilitates exchange, acts as a unit of account, and as a store of value. If a money can do all of these things well, it is sound money. Gold is the best example of sound money that humans have discovered thus far, but a better money may someday be invented or discovered. Unsound money is that which does not accomplish the functions of money particularly well. Most fiat money is unsound, especially in that it does not serve as a suitable store of value. Governments are fond of inflating the money supply of fiat monies, making them unsound as compared to alternatives.

*References: *The Case for the 100% Gold Dollar**

What are the merits of sound money?

The merits of sound money are that it serves all the functions of money particularly well. Having a medium of exchange in an economy allows for an efficiency of transactions that is simply not possible under a barter economy. A unit of account allows for rational economic calculation to be possible, without which an efficient economy is impossible. A store of value allows for savings to be securely held without their value be diminished as they are held.

*References: *The Case for the 100% Gold Dollar**

What is The Fed?

The Federal Reserve, or The Fed as it is often abbreviated, is the central bank of the United States. It was chartered in 1913, although it was not the first central bank of the United States. The mission of the Federal Reserve, as granted by Congress, is to foster the stability, integrity, and efficiency of the nation's monetary, financial, and payment systems.

How does The Fed lower interest rates?

This topic is a bit complicated, so some nuance will be required here to give an accurate and full picture of what the Fed does to lower interest rates. First, the Fed does not lower interest rates directly. It does not decree that banks lower their rates, even though the news might make it seem as if that is the case. The Fed controls the interest rates in the economy by indirectly controlling another important interest rate, the Federal Funds Rate. The FFR is the overnight rate at which banks lend to each other. Occasionally, a

bank may find that there was a disproportionately large number of deposits from its reserves one day, and as a result it is below the required reserve ratio set by the Fed. It needs to have reserves above this ratio, so it goes out and borrows liquid cash from another bank and pays back the money plus interest the next day. The rate it pays is the FFR. The Fed is interested in this rate particularly because it is a good indicator of how much liquidity is in the banking system. The level of liquidity also plays a large role in interest rates, varying inversely with the amount of liquidity present.

The way the Fed actually raises the FFR is by going out and buying securities from individuals on markets. The securities usually purchased are government bonds, and the Fed has an approved separate market of bonds dealers that it buys them from. The Fed is depending on that individual going taking that money they just received from the Fed, money that was printed out of thin air, by the way, and putting it in a bank. This usually happens, and when it does, the bank now has money that it can make loans off of. Remember, under a fractional reserve banking system, the bank doesn't keep all the money in its vaults. It keeps a small amount in its vaults, and the rest it loans out to people. So when the bank receives that deposit, that money represents an opportunity to make loans and create liquidity in the system. The amount of reserves and cash coming into the banks will be reflected in the FFR, which the Fed watches as an indicator of the banking system as a whole.

*References: *The Case Against the Fed: The Central Bank Buys Assets**

What are Cantillon Effects?

Cantillon Effects, named after the French Classical Economist Richard Cantillon, are the effects in the economy that result from an increase in the money supply. When the central bank or government increases the money supply, it starts off by increasing the money supply by giving the new money, or buying goods with, the new money to a select few individuals. It cannot hand over the new money to everyone in society simultaneously, so it starts off with a few people. However, this means that these individuals have had their incomes artificially increased as opposed to what would have prevailed on purely free markets. They predictably go out and spend this new money they have received, but will increase the price of goods that they go out and buy. The owners of these goods have had their incomes increased as well, as a function of their buyers having their income increased. They go out and buy goods, which in turn increases those goods owners' incomes. This process of increasing prices and incomes proceeds until all prices in the economy have increased to some degree as a result of the new money.

We can obviously see that this process increases the wealth who receive the money early on in this process. They have their incomes artificially inflated. But those who have their incomes raised towards the end of the process are hurt by these Cantillon Effects. This is because the prices of the goods they buy have increased, but their incomes have not. They have to pay more for all the same things they bought before, but don't have any more money to pay for them.

Additionally, not all prices will rise uniformly by the same amount. This is because when people receive increased incomes, they do not simply continue their exact current consumption. They go out and buy new things they did not purchase before. Some prices will rise more than others. As a result, incomes will not all be in the same proportion that existed before either. Some incomes will be higher than they were before the inflation, and some will be lower. Specifically, those who benefit from the first receivers of the money will benefit at the expense of those who receive it last.

*References: *Man, Economy, and State Chapter 11.3**

What does it mean for money to be neutral?

Neoclassical conceptions of money include that money is fundamentally neutral. This is to mean that money itself is not a influencing factor in the market economy. The term often used is that money itself is a "veil" which is placed over the actual exchanges of goods from person to person. Money is the instrument which facilitates this, but has no impact on it itself. Thus, if we inflate the money supply, there would be no short-term effects from this. Everyone's incomes would just increase, and that would be the end of it.

Austrians reject the concept of money being neutral; Cantillon Effects are one such example of the non-neutrality of money and how it can affect market processes. Austrian Business Cycle Theory is one such example.

*References: *Man, Economy, and State Chapter 11.8**

Market Intervention:

What is a price control?

A price control is a government intervention into a market where a price is no longer allowed to freely fluctuate according to market pressures. There are several types of price controls. There are price ceilings, price floors, and price freezes.

Price Ceilings are a result of a government body decreeing that a price may not exceed a certain amount. The most famous example of this type of price control is rent control, which is particularly common in urban cities. If the market price is below the ceiling price, it will have no effect. However, if the market price is above the ceiling price, then there will exist an excess of demand over supply and there will exist a shortage of that good or service on markets.

Price Floors are the inverse of a price ceiling. A price floor exists where the government does not permit the market price to go below a certain amount. The most widely-known version of price floors is the minimum wage. Similar to a price ceiling, if the market is above the price floor, there will be no effect. If the market price is below the price floor, there will be an excess of supply over demand and a glut of supply will be present.

A price freeze is the most extreme form of price control. Under a price freeze, no market price may exist other than the price set by the government. If the market price is above or below the freeze price, then there will be a market shortage or surplus, accordingly.

*References: *Man, Economy, and State Chapter 12**

What are externalities?

An externality is a consequence for an action that is involuntarily inflicted upon a third party. A famous example of an externality would be smoke and smog from a factory. It may soil the laundry of a third-party who lives next to the factory and inflict a cost on them even though they do not wish for this to occur. The best way to deal with such externalities is fairly simple: enforce property rights. Obviously, the factory neighbor has a right in their own clothes as their property. Therefore, if these clothes are ruined by the output of the factory, they should be able to take the factory to court to receive compensation for their loss. Externalities are not some special category deserving of new solutions, but rather, to solve these problems we should just enforce and extend property rights.

*References: *Law, Property Rights, and Air Pollution**

Business Cycle:

What is the Austrian Business Cycle Theory?

Austrian Business Cycle Theory is a theory of the trade cycle that emphasizes the important role that interest rates play in the economy and how interference with those rates will lead to malinvestments in the economy. To understand ABCT, there are three main components that must be explained: time preference, interest rates, and the capital structure of the economy.

Time Preference refers to the relative degree to which one consumes in the present versus saving to consume in the future. If one has high time preference, then one engages in large amounts on present consumption and saves little for the future. To have low time preference means that one consumes less and saves more for the future instead. The importance of having savings is that these savings can be invested to generate greater future consumption than is possible in the present. This leads us to the next component: interest rates.

Interest rates in the economy are a fairly common phenomenon. However, their true importance is not generally understood. The interest rate is a reflection of society's total time preference. This is because interest rates are always a phenomenon of future goods being traded for present goods. For this to occur, there must be savings that are stockpiled and ready to be lent out. If the supply of these savings increases as a result of society's time preference being lowered, then the interest rate decreases. Vice versa is also true.

The rise and fall of the interest rate is particularly important for the level of investment that occurs on the market. If this rate falls, it signals to the market that there are more savings available to be invested, and more investment projects subsequently begin. When this occurs, it causes a fundamental shift in the economy's capital structure. The capital structure of the economy is of great importance because we must recognize that capital is not just a homogenous pile of capital goods. Different producers goods serve different purposes, and as such, operate at different places in the economy. These places goods can work at are called "stages". The higher stages of production are those closer to the raw inputs and resources needed to create goods, and the lower stages of production are those closer to the final output of consumer goods.

When savings increase and consumption decreases, this causes a decline in the interest rate. As a result, investment increases. This causes a shift in the capital structure because there is less demand for consumer goods. Therefore, less factors and entrepreneurs will produce in later stages. However, because there is an increase in investment, there will be an expansion in the higher stages of production to produce more capital goods. Once these investment projects are completed, these capital goods will make labor more productive, increasing the total output of goods and making

society richer as a whole. Through a process of increasing their savings, individuals increase their consumption later in the future.

This mechanism of saving and investment works wonderfully on the free market. However, if the state interferes, the entire system can completely malfunction. What would occur if the state, through its operation of a central bank, artificially decrease the rate of interest? This would increase the investment in the economy, but the rate of real savings would not be increased at all! Thus, consumers would still be consuming their normal amount while the economy is trying to expand its production of capital goods at the same time! This entire economic position seems rife with the potential for disaster. While the state keeps the interest rate low, the new investments can continue as planned. However, once the state ceases its keeping the interest rate artificially low, what will happen? The interest rate will increase, and all of those entrepreneurs who invested under the allure of lower interest rates will find that their investment projects have just become much more expensive than originally planned! They will have to abandon their projects and take losses. This also means that those who worked in the production of these new capital goods will find themselves with much less business than before and forced to close down. This is the slump of the business cycle, and it is not until the economy begins to readjust according to the actual preferences of consumers that growth can begin again.

ABCT can be summarized in the following steps:

- Interest rates artificially decreased
- Investment increases, and the economy finds itself in a boom
- This unsustainable state of affairs continues until the the state beings interest rates back up to its natural level
- Investment opportunities that looked profitable under low rates are no longer profitable and must be abandoned
- The economy finds itself in a bust and must readjust and recover

*References: *Human Action Chapter XX; Man, Economy, and State Chapter 12.11**

If entrepreneurs knew the ABCT, would there still be a business cycle?

Let us say that all entrepreneurs throughout the economy were aware of ABCT. Would this prevent the business cycle from occurring? Even if somehow all entrepreneurs were aware of ABCT, it would not. This is because it is impossible to tell when a decrease in the interest rate is an actual reflection of time preferences or an artificial decrease by the government. In actual market data, the two are identical in their appearance. As such, the entrepreneur aware of ABCT has no way to distinguish between the two. He

could invest and find himself the victim of the bust or not invest and find himself left behind by his competitors. Because of this necessary lack of discernment, the knowledgeable entrepreneur cannot protect us from the business cycle.

*References: *Man, Economy, and State Chapter 12.11; Human Action Chapter XX**

Is there empirical evidence to support ABCT?

A plethora of work has been done in empirical work to support the Austrian viewpoint, from many different countries and points in time. The best place to find a collection of this work is on the Austrian Library website, in the Austrian Business Cycle Theory section.

References: <https://www.austrianlibrary.com/austrian-business-cycle-theory>

Capital:

What is capital?

Capital are all the produced goods that are not wanted for their own direct uses, but are wanted because they assist in the production of a good that is directly wanted. If I invest my financial savings into a new iron-smithing machine, I do not desire the machine for its direct services. I do not buy the machine for the same purposes that one may buy a new car or a new television. I am interested in the machine only insofar as it can help me produce iron, which is something that I do directly want. These goods are capital goods.

There are two defining features of capital goods. They are produced, and they wear out. All capital goods are the products of land and labor. Capital is not a primary factor of production; it is a secondary good. They are not given to us, as land and labor are. We have to create them. Secondly, capital goods experience depreciation. They wear out over time through their use. The more we use our iron-smithing machine, the more it will start to deteriorate and eventually fall apart. Thus, we have to eventually replace it with a new machine when this occurs. As a result, we cannot invest in capital and expect it to last forever; we always have to be aware of replacement costs.

*References: *Man, Economy, and State Chapter 1.9**

What are higher-order and lower-order goods?

Austrians view capital goods as being radically heterogeneous (in the words of Roger Garrison). This is to mean that capital goods can and are very different from each other in the purposes they have and the specific jobs they accomplish. This means that capital in an economy is never just a giant, generic blob. Capital is always arrayed in a structure, where different capital goods reside in various places according to the jobs they perform. Austrians classify these goods in two categories: higher-order goods, and lower-order goods. Higher-order goods are those that are relatively closer to the original means of production, and lower-order goods are those who are relatively closer to consumer goods. For example, a construction truck is a higher-order good, as the production that these trucks are generally involved with are distant from finished consumer goods. On the other hand, a grocery store refrigerator would be classified as a lower-order good, as the production it is usually involved in is much closer to the sale of finished consumer goods.

*References: *Man, Economy, and State Chapter 1.9**

Is there such a thing as the Marginal Product of Capital?

In the Neoclassical view of capital theory, the return bequeathed to capital is known as the “Marginal Product of Capital”. Just as labor earns wages for the work it contributes to production, so too does capital earn a return for its part in the production process. Austrians reject this view of capital and the notion of a return to capital based on its productivity. The Austrians instead attribute the return to capital as being based on time factors. The reasoning follows as such: in an equilibrium situation, the prices of all inputs and outputs are known to all. Therefore, there is no room for profit or arbitrage to take place. We are then left with the question as to why there would be a return to capital at all if all input and output prices are known? The Neoclassical productivity view cannot answer this question, as the fact that capital is productive does not answer why the sellers of inputs to create capital goods would not have their prices raised up to the point where capital goods no longer earn a return. Those who produce capital goods are only interested in making money, and the gap between the price of a capital good and its revenues appears to be an arbitrage opportunity.

The Austrian answer to this dilemma is that the owners of capital earn interest on the capital that they employ as a product of their capital being employed in a production process across time (For more info on the Austrian theory of interest, read the questions on interest answered above). This answers our question because the revenues paid out to purchase capital goods are measured in present dollars, whereas the revenues accrued to capital in production are in future dollars. As such, a discounting of these

future dollars takes place in buying capital goods, allowing for a return to capital to take place.

References: Capital and Interest by Eugen Bohm von Bawerk, Human Action Chapter XIX

What is reswitching?

It will be helpful to have some prior understanding of the Pure Time Preference Theory of Interest before tackling this topic. It is a niche subtopic within capital theory, and not all that relevant. 'Reswitching' came up during what is called the Cambridge Capital Controversy between the "Neo-Classical" economists (Paul Samuelson and Robert Solow at MIT Cambridge, Massachusetts) and the "neo-Ricardian" or "post-Keynesian" economists (Pierro Sraffa and Joan Robinson) at the University of Cambridge, UK. The debate was broadly over capital aggregation; the neo-Ricardians maintained that neoclassical capital theory involved improper aggregation of microeconomic concepts to the macro economy as a whole.

Examples of technique reswitching almost always involve either extremely unrealistic scenarios such as 50% interest rates or 30 year planning horizons, or the difference between the techniques involved is negligible. There is little evidence that the phenomenon is empirically relevant. As such, it is not even a particularly strong criticism of the neoclassical approach.

For the Austrian perspective, reswitching has been brought up by Robert Vienneau and Saverio Fratini as objections to the theory of the business cycle, with the charge being that interest rates do not affect production decisions linearly as their interpretation of the ABCT (Austrian Business Cycle Theory) tends to suggest, since compounding results in higher order polynomials that can have multiple roots.

However, this criticism is lacking on two fronts. For one, the focus of the ABCT is not on interest rates per se but on the expansion of credit, as Mises repeatedly emphasises. Expansion of credit does not simply push the rate down, it merely results in the rate being lower than it otherwise would have been. Non-linear relationships between interest rates and capital valuations do not affect the theory.

Secondly, the examples of reswitching that Vienneau and Fratini put forth assume constancy in all relevant prices other than the rate of interest. However, Austrian production theory tells us that the prices paid to the productive factors tend to move towards their discounted marginal productivity, and heavy emphasis is paid to the

unsustainable rise in wage rates as a result of credit expansion. Thus, the constancy assumption violates the theoretical underpinnings of the Austrian framework itself, and so is not entertained as a serious criticism. These are two of the reasons why it is such a niche topic in the first place

*References: *Macroeconomic Thinking and the Market Economy; Reflections on Reswitching and Roundaboutness; Man, Economy, and State Chapter 7**

ECP:

What is the Economic Calculation Problem?

The Economic Calculation Problem (or ECP for short) is argument first proposed by Ludwig von Mises in his famous 1920 article, "Economic Calculation in the Socialist Commonwealth". Mises here argues that economic calculation is not an optional, but a necessary feature of any efficient economy. In order for entrepreneurs to know what goods to produce and to not produce, they first be able to compare the prices of the inputs to the prices of their outputs in pursuit of profit. This calculation allows for goods to be correctly allocated according to the wishes of consumers, and for the entrepreneurs to react according to what these wishes are. If not for economic calculation, there would be no method whatsoever for entrepreneurs to know exactly what consumers want. It is only through the existence of prices and calculation that allows the free market economy to efficiently allocate resources.

The socialist economy, based not on prices but the directions and plans of a central board, does not have any prices that can be used as signals to direct resources. Any prices that might exist are arbitrarily set by the planning board, and are not reflective of the preferences of consumers. Thus, the socialist planners are presented with an ever-present problem? What goods are to be produced? What services are to be provided? How are they to be provided and in what quantities? The free market easily solves these problems through prices, but the socialist planners have no such recourse. They have a serious problem in that they have no method to determine an efficient allocation of resources. Consequently, Mises argues that the socialist economy as such is necessarily inferior to the free market economy, as a free market economy can economically calculate and a socialist economy cannot.

*References: *Economic Calculation in the Socialist Commonwealth by Ludwig von Mises**

Is the ECP and TKP the same thing?

The Economic Calculation Problem and The Knowledge Problem are not one and the same. They are both critiques of socialism, but they cover different topics, and one is much more stinging than the other.

The ECP states that in order for rational economic calculation to be possible, one must have private property and the exchange of goods. If an entrepreneur is trying to decide which of two production processes he should undertake, he needs to know the revenues and costs for both of them. Without these, he is unable to pursue profit and make production decisions according to the wishes and desires of consumers. Without them, he is unable to economically calculate. Socialism, a system of state ownership of the means of production, has no such way to economically calculate. Thus, rational and efficient production under an economic system of socialism is impossible.

TKP differs in its critique from the ECP. TKP states that prices can transmit information much more efficiently than centralized planning is able to do. If there is a sudden shortage of copper in the economy, a socialist system would have to transmit the information to everyone and tell them to use less copper. This would have to be done for all variations of supply for goods and resources that occur every single day. Spreading such information can easily be done through a market price system. If there is a shortage of a good, prices go up and entrepreneurs use less of it; easy as that. Socialism, however, cannot transmit this information nearly as efficiently, and as a result, makes the entire system impractical outside of theory.

As the reader can see, the ECP and TKP make different claims regarding the problems with socialism and how grave these problems are. TKP states that the knowledge problems socialism deals with makes it impractical. The ECP states that the lack of economic calculation makes socialism necessarily inefficient and inferior to a system of free market exchange. The two arguments are different, both in their scope and in their conclusions.

*References: Hayek's *The Use of Knowledge in Society*; *Human Action Chapter XIII* and *Chapter XXVI**

Austrians vs. Other Schools of Thought

What is the Austrian stance on Game Theory and what are the pitfalls of GT?

Game Theory is an interesting field of study in and of itself. However, it has little it can rightly say in the realm of economics. Game Theory assumes various outcomes as

given, first of all. Two or more individuals are placed in a situation where there are several outcomes that can result. This may be a fascinating logic puzzle, but it says little of actual market conditions. In all human action, including action on markets, the future is uncertain. We may have a good idea or a good feeling about it, but it is still fundamentally unknown. Therefore, we cannot make certain assumptions about future market conditions given a present action the way that Game Theory does. Additionally, Game Theory makes strict assumptions about what outcomes are preferable for the individuals involved. The value scales of individuals can only be revealed through their actions. We can never know a priori if someone values X over Y, or Y over X. Additionally, Game Theory assumes that once individuals reach equilibrium, referred to as a “Nash Equilibrium”, that they will stay there and repeatedly make this choice because it optimizes their outcomes. However, this assumption is totally unwarranted. Individuals’ value judgments can always change. Just because they prefer X over Y today, does not mean that they will prefer X over Y tomorrow.

*References: *Austrian Economics and Game Theory: An Evaluation**

What are the differences between the Austrian and Chicago Schools of Economics?

The Austrian School and the Chicago School have a lot of overlap in certain areas. They also have areas where there are large divergences between the two. These are in methodology, competition, money, and capital. We will break each one of these down briefly.

The Chicago School methodology is based on utilizing empirical methods to discover and understand economics. This was defended by Milton Friedman in his famous essay, “The Methodology of Positive Economics”. To understand economics, we must go out into the real world and study the actions of individuals to discover economic laws. The methodology of the Austrian School embraces Praxeology, which is the system of logic deduction that follows from the simple understanding that human beings act. Austrians do not subscribe to empirical methods, but emphasize that economics follows from the praxeological understanding of action. For the Chicago School, economic laws are empirical and falsifiable. For the Austrian School, economic laws are logically deducible and unfalsifiable.

Chicago views of competition on markets are based primarily on different states of the market. If there is only one seller, there is a monopoly. If there are a few, an Oligopoly. There is also Monopolistic Competition and Perfect Competition as well. Depending on the particular state the market is in, it is in one of these competition categories. Austrian conceptions of competition are based primarily on processes. Competition is the action

of entrepreneurs striving to provide the best possible goods on market at the lowest possible price. This process will be constantly evolving over time, as some firms fail, and others succeed. Monopoly only exists where it is granted by the government. All other conceptions of it ultimately fail (See Man, Economy, and State: Chapter 9)

The Chicago School looks at money through the lens of a pure quantity theory. Money is neutral and has no effect on markets in the short-term. If there is a lot of inflation, everyone's incomes will increase and it's all a wash in the end. Nobody is better off and no one is worse off. Instead, inflation and deflation are important as macroeconomic indicators, and we need a central bank to ensure that we do not experience deflation. Austrian views on money are almost the exact opposite. Money is not neutral and does have very real short-term effects. These are through "Cantillon Effects", which occur as new money enters into the economy. When the money supply is inflated, everyone's income does not increase all at once. It starts with one person, or a few people, who have more money. They go out and spend the money, and the people who receive that money go out and spend it as well. As a result of this process, those who receive the new money first will benefit at the expense of those who receive it last. (For more info, see the question on Cantillon Effects above)

The Chicago School subscribes, by and large, to the Clark/Knight view of capital. In this model, Capital is just a homogenous variable, K , which produces goods and services for the consumer. Time is an irrelevant factor, as once we are in general equilibrium, goods will be constantly produced at a steady rate. Austrians differ from this view entirely. Capital is not just a single blob of resources, but made up of heterogeneous tools and producers' goods. Hammers are different from trucks, which are different from ingots of steel, which are different from logs of wood. All of these are capital, but different kinds of it. Capital in an economy is in a structure where goods progress down from the upper stages to the lower stages. As these goods progress, they become more and more finished until they pop out the other end as consumer goods.

Are worker cooperatives a valid form of business organization?

On a free market, individuals are free to act freely given that they are not harming anyone else. If they wished to organize a firm along the lines of a worker cooperative wherein each worker owns a share of the firm, they would be free to do so. However, there are quite a few reasons that this form of business organization is inferior to conventional forms of organization.

First, the function of an entrepreneur in a market economy is not suited to being done by consensus voting. The entrepreneur looks at the present situation, predicts the state of the future market, and then adjusts his action accordingly. This requires large

amounts of information about the state of markets, as well as the inputs for his consumer goods, and how to adjust his actions. Any individual worker is unlikely to possess this knowledge, and as such, the firm would be inherently less efficient.

Secondly, the function of the entrepreneur involves additional work and labor, even when there is no guarantee of profit. All of the functions of the entrepreneur must be carried out even if the firm is taking losses. One of the main reasons that individuals rent out their labor to entrepreneurs is because they desire to have a secure income that will be paid regardless of the firm's success in any particular period. The profit of an entrepreneur has no such certainty.

Third, the fact that worker cooperatives could exist in the market today does not imply that they are not as productive as traditional business organization forms. If worker cooperatives were equally as efficient or more efficient than other forms, they would exist and be successful on markets today. The fact that we do not see such firms implies that this is not the case and that worker cooperatives are not as productive as traditional forms.

*References: *Socialism Chapter 2.4**

What are the differences between the Austrian and Marxist schools of thought?

The Austrian and Marxist schools differ about as much as is possible in the realm of economics. However, much of the difference of these views is reducible down to theories about prices and value. Marx holds a labor theory of value, which is used to prop up much of the rest of the Marxist system. Without the LTV, the view of capitalism as a necessarily exploitative system is wholly untenable.

The labor theory of value states that the exchange value that goods have is an objective feature they possess, and is reducible down to the “socially necessary labor time” that was put into them. For example, if the equivalent of four hours of “socially necessary labor time” was put into baking bread, then the price of the loaf of bread will be equal to four hours of socially necessary baking labor. If these hours are priced at \$5 each, then the price of the bread will be \$20.

Austrians reject this objective analysis in favor of a subjective view of value. The value that goods exchange for is a reflection of the utility individuals place on that good relative to the ends that good can fulfill. The term often used for this view is “marginal utility”. Expressed in more simple terms, value is a result of what people want to use particular goods and services for. I place value on a new car because of all of the

services a new car can provide to me. The prices that these goods will fetch is determined by the intensity of the demand for a product relative to the supply of that product that exists. If people begin to desire a good more highly, the price will increase. If the supply of a good increases, then the price will decrease.

Because of the Austrian rejection of the LTV, Austrians also reject the Marxist view of capitalists as economic parasites. Because all value comes from labor, Marx concludes that the capitalist cannot add any value to production. However, the capitalist still earns an income. This must mean that the capitalist, who hires the laborer, is engaged in exploitation of the labor's value. If the laborer did not engage in exchange with the capitalist, he would receive the full value of his product, but while working under the capitalist he only receives a portion of it.

Rather than viewing the capitalist as an unnecessary leech, Austrians view the capitalist as a necessary force in production. The capitalist is the one who engages in saving his income to purchase capital goods to use in production processes. Additionally, the capitalist is constantly advancing income to land-owners and workers, as he pays out wages and rents to them even while the end product of the production process is not yet complete. It is only when the completed goods or services are sold that the capitalist receives any revenue, while he had been regularly providing revenue to others all along. Without the existence of the capitalist, the capital structure of the economy would quickly fall in disrepair and production processes would halt from a lack of funding. The capitalist, just like the landlord and the worker, are necessary for economic production.

References: Karl Marx and the Close of his System by Eugen von Bohm Bawerk, Marxism Unmasked by Ludwig von Mises

What are the differences between the Austrian and Keynesian schools of economics?

The differences between Austrian and Keynesian thought hinge most importantly on the issue of business cycles, so we will focus exclusively on that issue here. Keynes believed that business cycles are a result of aggregate demand falling below aggregate supply, resulting in goods being unsold, business going under, and the economy entering a depression. The way by which Keynes viewed this to happen was through savings "leaking" out of the economy. This can happen through hoarding, by which Keynes means people taking their money and keeping it in their own possession without depositing it in a bank or financial institution (stuffing it under their mattress, perhaps), and through the behavior of investors. In Keynes' eyes, investors are driven by "animal spirits" and are unreliable and subject to popular trends. Even if an investment is unsound, investors will still be eager to pour liquid capital into it if there is sufficient excitement and hype around the prospect. Inversely, if the economy is doing poorly,

investors are hesitant to fund sound investments because of irrational fear created by the economic situation. If investors get jittery, or hoarding increases, or both, then aggregate demand decreases and the economy is sent into a recession.

As we have seen above, the Austrians have a very different view of the business cycle (see above for question on Austrian Business Cycle Theory), and have explanations for both of Keynes' worries about aggregate demand. First, if it were the case that people were hoarding more money and not depositing it into institutions, this would cause a general deflation throughout the economy. If everyone overnight decided to put 10% of their income in a box under their beds, then we would expect prices to decrease around the economy. While this would cause some degree of economic turbulence, it would not be sufficient to lead to the bust of the business cycle, which involves the revealing of a cluster of entrepreneurial errors and abandoning investment projects. Secondly, the "animal spirits" that Keynes speaks of is not altogether detached from reality. However, the strange behavior he is describing can be very clearly understood through the process of credit creation that Austrians pin as the culprit behind the business cycle. If lots of new credit is created and injected into the economy, investors and banks will be flushed with funds seeking a return. Thus, they will be eager to place these funds into less than reputable investment prospects, simply because they have lots of liquid capital on hand. This explains the stock market bubbles and other similar phenomena that are often associated with the boom of the business cycle and the view Keynes has of investors as a whole.

Austrians and Keynesians also have differing views on interest, with Keynes maintaining a "liquidity preference" theory and the Austrians keeping with a "time-preference" theory. Keynes also views government spending and monetary policy as legitimate and necessary measures to pull the economy out of depression, whereas Austrians reject both of these as solutions.