

PRINCIPLES OF ECONOMICS: AN AUSTRIAN CRITIQUE

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The first edition of Gregory Mankiw's *Principles of Economics* (1997) textbook has not only made the book's author rich and famous, but has also gained notoriety for textbook authors in general and for the discipline of economics in particular. The author reportedly received \$1 million in advance, the largest advance ever paid to a textbook author. The press reported that the publisher, no doubt to justify this rich advance, initially targeted 20 percent of the economics textbook market for the first edition. Many experts opined that the publisher had a good chance of success.

For some of us who teach undergraduate economics and who have used Mankiw's text, the media excitement is not surprising. There are several innovations in this book that help set it apart and put it in front of the several dozen other economic principles textbooks on the market, including the most famous of all modern economics textbooks, Professor Paul Samuelson's *Economics* (1998). Most notably, despite their titles, Mankiw's text is one of the few true principles-level economics textbooks that is built squarely around a set of fundamental principles of economics. Mankiw, in the first chapter, introduces "ten principles of economics." Throughout the text, the author refers back to one or more of these principles. It would have been better if the book had only ten chapters or subsections, each dealing primarily with one of these principles. In addition to the ten principles or "theory" chapters, some other chapters could have been added as "application" chapters. However, this approach would be a radical change, given that most other textbooks currently in the

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market include 20 to 30 chapters, with the initial chapters being micro and the latter chapters being devoted to macroeconomic topics.

What is Austrian economics? According to the *Encyclopedia of Economics* (1982, pp. 38-42), two of the founding fathers of the tradition are Carl Menger and Eugen von Böhm-Bawerk. Other important members of the school include Ludwig von Mises, F.A. Hayek, Gottfried Haberler, Fritz Machlup, Oskar Morgenstern, Friedrich von Wieser, and Paul Rosenstein-Rodan. Among contemporary economists, one can count Israel Kirzner, Murray N. Rothbard, Walter Block, and Ludwig Lachmann in this tradition. Although, in the public's eye the Austrian tradition is synonymous with an unfailing support for the free market, the tradition differs from other schools more by the method of analysis than by a specific set of policy ideas.

The Austrian School is certainly one of the most influential schools outside the dominant neoclassical tradition. Many Austrian ideas have been incorporated into the current neoclassical orthodoxy. The basic Austrian point of view about what economics is and how an economist does economics has not, however, been accepted by other economists. Austrians are a priori. The test of a theory is not its predictive power, but rather its assumptions and the logic by which conclusions are drawn from the assumptions. If both are correct, so is the conclusion. It follows that to empirically test a theory is meaningless.

Since economics is the science of choice, the unit of interest is the individual who makes the choice. Aggregation is logically impossible. The idea that there is some social welfare function that can be maximized is incorrect. If something is to be maximized, it is the ability of individuals to coordinate their activities. Virtually all modern Austrians associate this ability with individual freedom (the absence of government interference with the free market).

Economics is viewed as a science, but one inherently different from the physical sciences. The methods of the physical sciences are not appropriate to the social sciences. In particular, mathematics and statistical methods are inappropriate in economics. Some Austrians are, however, more flexible on this than others.

Here we discuss briefly Mankiw's ten principles of economics and offer a critique of these principles à la the Austrian School of economics. A textbook in economics completely based on principles of modern Austrian economics is yet to be written.¹ When such a textbook is written, perhaps this discussion will help the author design the text. We would strongly recommend to the author that the first chapter of the yet-to-be-written textbook be devoted to the ten or so basic principles of economics, with the rest of the book simply enhancing the explanation and application of these principles. This design would well serve students in introductory economics classes by emphasizing

¹A book that comes close to meeting this goal is Roger Garrison's recent intermediate macroeconomics textbook, *Time and Money: The Macroeconomics of Capital Structure* (2001).

the logical consistency and design of economics. Students would carry an understanding of these principles in their intellectual tool kit for the rest of their lives. Unfortunately, too many authors of introductory textbooks in economics take the diametrically opposite approach of cramming topics into their books. In doing so, they lose the important message that economics is a coherent field of inquiry with a worldview that can be extremely useful in our everyday lives.

MANKIW'S TEN PRINCIPLES OF ECONOMICS

The ten principles are divided into three categories in the first edition (1997, p. 14). The first includes four principles governing individual choice. The second includes three principles that are relevant to understanding social interaction among economic agents. The last category includes three principles on how the economy as a whole works.

HOW PEOPLE MAKE DECISIONS 1. People face trade-offs. 2. The cost of something is what you give up to get it. 3. Rational people think at the margin. 4. People respond to incentives.
HOW PEOPLE INTERACT 5. Trade can make everyone better off. 6. Markets are usually a good way to organize economic activity. 7. Government can sometimes improve market outcomes.
HOW THE ECONOMY AS A WHOLE WORKS 8. A country's standard of living depends on its ability to produce goods and services. 9. Prices rise when the government prints too much money. 10. Society faces a short-run trade-off between inflation and unemployment.

THE AUSTRIAN CRITIQUE OF MANKIW'S TEN PRINCIPLES OF ECONOMICS

The *first* principle (people face trade-offs) is standard enough to be considered an “economic law” (2001, p. 4). Mankiw begins with the commonly accepted adage, “there is no such thing as a free lunch.” Economists of all persuasions firmly believe in the principle of scarcity and its implication—the necessity of making choices as individuals and as a society. The Austrian economists would certainly agree that this is an important principle that helps explain individual behavior.

The *second* principle in Mankiw's book (the cost of something is what you give up to get it) is the widely accepted notion of opportunity cost in economics. Mankiw writes, “The opportunity cost of an item is what you give up to get the item” (p. 6). Austrian economists would largely agree that the correct method of measuring costs is to try to measure the value of the foregone opportunities as opposed to measuring only the out-of-pocket expenses (accounting costs). However, Austrians have made innovative contributions to the measurement of the opportunity cost concept that are not fully appreciated in the mainstream literature. According to Alchian (1997),

Clarification of the logical role of the concept of cost in order to explicate clearly the distinction between the two ideas—the value of forsaken alternatives and the so-called undesirable attributes—was begun by the Austrian school of economics in the nineteenth century and was further developed by Frank Knight (1924). (p. 304)

Moss writes, “The cost of a specific action to a decision maker is the next best opportunity he gives up when he chooses that course of action over others” (1976, p. xi). Austrians generally hold that all costs are subjective and, therefore, cannot be measured (Rothbard 1993, pp. 291–94; 1997, pp. 269–71). The opportunity cost of college will never be equal for any two individuals, as the subjective valuation of their time effort would differ. If both individuals happen to be unskilled, the mainstream economist would use the minimum wage to impute the value of their time. However, many Austrians would disagree on the grounds that, being subjective, opportunity costs cannot be measured. The only way to measure the cost of time spent is to ask the individual (subjective evaluation), and even then it may not be possible to accurately measure opportunity costs. According to some Austrians, opportunity cost is an important concept if human behavior is to be understood.²

Regarding the *third* principle, Mankiw writes, “In many situations, people make the best decisions by thinking at the margin” (2001, p. 6). Later in the same section we find, “A rational decision maker takes an action if and only if the marginal benefit of the action exceeds the marginal cost” (p. 7). Virtually

² “[T]he connection between recorded, or accounting, costs and those costs that influence human choice may be so tenuous that statistical laws founded on the former will reveal very little about human action itself” (Moss 1976, p. xi).

identical statements can be found in all the major textbooks in economics. Most modern Austrian economists would accept the principle that rational individuals think at the margin. After all, the original Austrian, Carl Menger, is widely known as one of the founding fathers of what is called the “Marginalist” School in the history of economic ideas. Menger, Walras in Switzerland and Jevons in England independently proposed that people calculate the benefits (positive utility) and costs (negative utility) in small increments. Indeed, the resulting impact of this principle was a revolution in the history of economic ideas. The emphasis of classical economics on objective costs, resources, and factors of production (supply side) was overtaken by the writings of the marginalists, who placed the burden of price determination on subjective factors.

Mankiw’s *fourth* principle is that people respond to incentives. He writes, “Because people make decisions by comparing costs and benefits, their behavior may change when the costs or benefits change” (2001, p. 7). The writings of modern Austrian economists such as Hayek and Mises have had substantial impact on mainstream economics on this point. Human beings make conscious actions toward achieving their goals. Humans respond to both positive and negative incentives, which influence the actions they take. In fact, the equilibrating process in the market, sometimes described as a discovery or a “learning process” by the Austrian economists, is a reflection of individuals responding to changes in incentives. Austrians stress the market process and the role of entrepreneurs in this process. The usual approach to equilibrium takes available choices (resources and ends) as given. Austrians take the market as a process of discovering resources and even ends, rather than as a matter of selecting from a menu of already known possibilities. The market is also a process of learning and forming new expectations as old ones are disappointed.

A *fifth* economic principle espoused in Mankiw’s textbook is that trade can make everyone better off. This is presented as the first principle of social interaction. The term trade is of course used in its broadest sense. It includes all transactions and exchanges that take place between economic agents, whether they are in the same geographical area or across nations. The author writes, “Trade between the United States and Japan is not like a sports contest, where one side wins and the other side loses. In fact the opposite is true: Trade between two countries can make each country better off” (pp. 8–9). Adam Smith and other classical economists argued that free trade is welfare-enhancing, since it improves the allocation of resources and increases specialization that makes the trading partners more productive and efficient. The Austrian author of a textbook would have no problem in accepting this principle. This principle of free trade is an important underpinning of the Austrian School of economic thought. For the Austrians, the main benefit of free trade is that it is mutually advantageous. Restrictions on trade prevent individuals’ purposeful human action to benefit themselves. At least *ex ante* all parties to trade expect to benefit, otherwise why participate in the trade?

The other advantages of free trade consistent with Austrian tradition are that free trade enhances freedom and enlarges the economic pie.

Among the principles of social interaction, the second principle (*sixth* principle overall) is that markets are usually a good way to organize economic activity. Mankiw writes, "Yet, despite decentralized decision making and self-interested decision makers, market economies have proven remarkably successful in organizing economic activity in a way that promotes overall economic well-being" (p. 9). Some Austrians may disagree with the wording in this statement and prefer to state the principle as: Markets are always a superior way to organize economic activity. Right or wrong, over the years the Austrian School has developed a reputation of being a devotee of the free markets. It is widely considered (hard core of the Austrian research agenda) that free and competitive markets are the most efficient known mechanism for allocation of scarce resources and for optimum efficiency. This is not to say that they believe in the notions of equilibrium so dear to modern neoclassical economics. The Austrians believe that, with or without equilibrium, the market process brings about the best outcome for participants and for the society as a whole. Here, too, the basic ethical or value consideration for Austrians is not so much the efficiency of markets as it is their freedom-enhancing nature. So most Austrians would agree that markets are the best way to organize commerce and economic activity.

Mankiw's *seventh* principle is: Government can sometimes improve market outcomes. Most academic economists and textbook authors agree with Mankiw that this principle is important. He writes, "The invisible hand usually leads the markets to allocate resources efficiently. Nonetheless, for various reasons, the invisible hand sometimes does not work" (p. 11). He further writes, "There are two broad reasons for a government to intervene in the economy: to promote efficiency and to promote equity" (p. 11). However, some economists in the Austrian tradition would disagree. For most Austrians, there is need for the government, but only in the political arena—that is, to maintain defense, to define property rights, and to defend these through law and order and the court system.³ There is no role for the government in the economic arena. The public-sector economic activity by definition would be suboptimal. There is a broad set of writings in the Austrian tradition that would emphasize this point. Government action leads to collectivization and usurps the efficient learning process in the market. Collectivization leads to suboptimal economic outcomes. Government by its very nature uses force or the threat of force. State intervention in the form of planning and control necessarily reduces voluntary exchange and redistributes wealth. However, it is impossible even for a giant computer to figure out the market prices, because the data that would have to be fed into the computer simply does not exist outside the market. This results in a net decrease in economic welfare.

³There are some significant exceptions to this rule.

No government entity, no matter how efficient or technologically sophisticated, can mimic the process of learning that goes on in the market. This is a sophisticated argument that needs in-depth reading in the Austrian tradition to be grasped fully.

It can also be said, however, that among Austrians, there is no core agreement on this and a range of opinions exist. A case in point is Wieser, who identified three major reasons for state intervention, depending on the common difficulty of private calculation: first, when the individual is too weak to either defend his country or to maintain a system of courts and police; second, where profits are too small and too uncertain to encourage private action; third, when economies are backward and capitalists are scarce. It becomes the state's duty to fill the gap.⁴

Under the heading of aggregate economic activity, the first principle (*eighth* overall) is that a country's standard of living depends on its ability to produce goods and services. This principle simply states that the concept of gross domestic product—or, more accurately, that of per capita GDP—is the best measure of the wealth of a nation and the living standards of its people. This point does not imply that GDP is a perfect measure of income or that income (even wealth) is the best measure of well-being. “Almost all variations in living standards are attributable to difference in countries' productivity—that is the amount of goods and services produced from each hour of a worker's time” (p. 12). Where would the Austrians stand on this principle? Members of the Austrian School generally tend to be critical of economic aggregates such as GDP. They contend that there are several problems with the use of prices, most of which are not in long-run equilibrium, to measure the value of a diverse collection of goods and services. Even if some collective measure such as GDP is to be used, the Austrians would present the explanation somewhat differently. First, they would decry the implied importance given to the productive side of the economy. Supply is only a response to the market. In other words, the traditional difference between technical efficiency and economic efficiency must be highlighted. The correct measure is not the sheer ability to produce lots of goods and services (based on resources and technology), but the freedom of economic agents to choose and to organize their resources and budgets. A nation well ahead in its productive ability and living standards could stagnate and eventually decline if high taxes or other restrictions were to undermine the market process. The rules of the game and the institutions are exceedingly important in the dynamic process of capitalist growth. Mankiw notes in this section that factors other than labor productivity, such as labor unions and minimum wage laws, cannot explain gains in workers' real incomes over the last quarter century (p. 11). The real hero is the rising productivity of American labor. However, this begs the question of what

⁴Lekachman writes “Wieser was far removed from the orthodox laissez faire and still further removed from the apologetics of which his school was frequently accused. Wieser was a good example of the political neutrality of the marginalist tools” (1959, p. 282-83).

is behind this increase in productivity (and technological improvements) and why productivity growth seems to have stalled in recent decades. According to Austrians, we need to look at the institutions and at the laws to see if markets are being increasingly constrained. Consider the following statements: "It is not the physical existence of capital on the which prosperity of society's members depends but rather the position these goods play in the plans of acting individuals." And also, that "the meaning of such [statistical] measurements must be constantly checked against the underlying human plans and purposes that they allegedly represent" (Moss 1976, p. xii).

The *ninth* principle is squarely in the macroeconomic tradition: Prices rise when governments print too much money. This monetary explanation of inflation is now widely accepted in mainstream economics. Mankiw writes, "In almost all cases of large and persistent inflation, the culprit turns out to be the same—growth in the quantity of money" (2001, p. 14). He reinforces the argument by discussing the episodes of hyperinflation in Germany and the 1970s inflation in the U.S. The Austrian theory of the business cycle is considered to be one of the Austrians' most important contributions to modern economic science. According to this theory, most booms are caused by the central banks producing too much liquidity. This excess liquidity causes a wedge between the nominal and the real interest rates. This sends incorrect messages to the investors, who are led to overinvest, causing an artificial boom that eventually collapses as the error is corrected. To the extent that price rises are part of the boom, the explanation is consistent with the limited idea expressed in the short-term negatively sloped Philips curve: as inflation occurs, production usually increases, causing unemployment to fall temporarily. However, this is eventually corrected, and in the bust that inevitably follows a boom, falling output or rising unemployment will accompany the disinflation (or deflation).

Austrians often define inflation as an increase in the money supply rather than as an increase in the price level. Indeed, the very concept of the price level has overtones of aggregation. Sometimes, however, a distinction is made between price inflation and money inflation. A critical point in Austrian theory is that inflation of the money supply results in malinvestment and distortions in relative prices even if price inflation does not result. This differs markedly from the usual textbook presentation.

Mankiw's *tenth* and last principle is also in the modern macroeconomic tradition that, in the short run, society faces a trade-off between price inflation and unemployment. Mankiw states that the Philips curve is a controversial concept, but most economists agree that a trade-off between inflation and unemployment is a reality in the short run because some prices are slow to adjust. The average Austrian likely would not agree to this principle. In the Austrian paradigm, there is no distinction between the short and long term. As far as Hayek and Mises and contemporary Austrian economists are concerned, such a distinction is artificial and unwarranted.

Moreover, if increases in the money supply do result in reduced unemployment, this is merely because the central bank has distorted relative prices

and some people do not yet realize it. When they realize that their expectations are not being fulfilled, this sets the stage for the contractionary phase of the business cycle. Some Austrians insist that only gold (or the gold standard) constitutes money. On that basis, they argue that monetary policy, by its very nature, is fraudulent.

THE (AUSTRIAN SCHOOL) PRINCIPLES OF ECONOMICS

A possible reformulation of the principles based on the Austrian critique of neoclassical economics is presented in the table below.

HOW PEOPLE MAKE DECISIONS 1. People face trade-offs. 2. The cost of something is what you give up to get it. 3. Rational people think at the margin. 4. People respond to incentives. NEW PRINCIPLES: → The entrepreneur is the most important force in the free market. → Value is subjective.
HOW PEOPLE INTERACT NEW PRINCIPLE: → All economic phenomena are the result of human action. 5. Free trade can make everyone better off. 6. Markets are always a superior way to organize economic activity. 7. Government can never improve on market outcomes.
HOW THE ECONOMY AS A WHOLE WORKS 8. A country's standard of living depends on its ability to produce goods and services, which is closely dependent on economic freedom and institutions. 9. Inflation of the money supply often leads to price inflation and always leads to distortions in relative prices. 10. Government control of the money supply is inherently fraudulent leading to a boom-bust cycle.

CONCLUDING REMARKS

The list of the ten most important principles of economics as supported by the textbook author of Austrian persuasion would have much in common with Mankiw's list of the principles of economics. However, there would be some differences. One difference would be that the Austrian author would likely include the paramount role of the entrepreneur in the market economic process. The Austrian belief is that the entrepreneur is an important catalyst or force in the market. This is true for both the consumer and the production sides. Second, in discussing trade and exchange, the Austrian author would likely add details on the discovery and learning processes in the market. This principle would fill an important gap in contemporary mainstream economics as taught to introductory college students. Third, the Austrian author would restate the principle on the role of the market to read that the markets are always a superior mechanism for resource allocation over planning and government regulations. Fourth, there would also be greater emphasis on the role of the institutions and the laws that impinge on commercial activities. Fifth, in explaining inflation and the short-run trade-off between inflation and unemployment, the Austrian instructor would discuss the business cycle theory, which emphasizes that such cycles are generated when the central bank loses control over the money supply, possibly due to the influence of political forces. Finally, two of the most important insights credited to the Austrians are not on Mankiw's list. These two insights, according to the Austrians, are fundamental to properly understanding economics. These are the principle of human action (all economic phenomena are the result of human action) and value (value is subjective).⁵

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⁵"[T]he subject matter of economics is human action, and a concern with abstract character of action is what defines the economic point of view" (Moss 1976, p. ix).

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