Ewald Nowotny: The Austrian school of economics and Austrian economic policy

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Accompanying slides can be found on the Central Bank of the Republic of Austria's website.

The tensions of a ceasing empire – the founder generations

Unlike the natural sciences economics is not progressing incrementally. As in any social science economic schools of thought rather reflect the character of the societies in which they are created. Therefore the Austrian school of economics cannot be understood without having a thorough comprehension of the institutional environment in which it was created.

The beginning of the school and its core determinants lay in the Austria of the second half of the 19th century. This period served as the formative environment for the founders of the Austrian school of economics: Carl Menger, Eugen von Böhm-Bawerk and Friedrich Wieser. It was a period that was characterised by a massive underlying tension. On the one side there was a state that progressively lost legitimacy yet continued to claim a massive grasp on the life of his subordinates. On the other side there was an increasingly professional elite that witnessed the accumulating dysfunctionalities of the empire yet owed its entire reputation to it. The internal conflicts arising out of this contradiction turned out to be a huge inspiration for the intellectuals of the time. Of course these internal conflicts also were decisive in the making of the Austrian school of economics. Let me therefore explore these two major influences in more detail.

The first two generations of the Austrian school of economics lived their early life during the first decades of the second half of the 19th century. They thus formed what might be called the first post-1848 generation. As a result, the first important political development they experienced was the immediate reactionary backlash against the bourgeois revolution of 1848. Metternich – the powerful former chancellor who had returned from his temporary exile taken in 1848 – continued to strongly influence Austrian politics until his death in 1860. However, also after Metternich's death, the empire continued to rigorously regulate daily life, most ostentatiously through censorship.

The events of 1848 also had brought Franz Josef I to power, who continued to govern the country until 1916. His rule was most strikingly characterized by an obsession with a strict Spanish-type court ceremonial that appeared vastly anachronistic even to his contemporaries. More relevant in daily life, however, was that one's social status was strongly determined by the personal ties that one could establish with court members and representatives. Carl Menger, for instance, was a teacher of the unfortunate Crown Prince Rudolf for two years.

The importance of the court created an environment in which protectionism and interventionism were endemic and affected all parts of public life. Mundane aspects of daily life such as verdicts, the granting of trade licenses or at times even the playing schedule of theatres were subject to interventions. The huge bureaucracy offered a more than fertile ground for protectionism. In other words: The empire was omnipresent, omnipotent and determined career paths. What is more, the interventionism and protectionism made the activities of the empire quite often very arbitrary.

This might not have been as fatal for the empire as it turned out to be, had it still been able to deliver successes. However, the Austro-Hungarian Empire – as it became to be called after

1867 – lost a succession of wars and, as a direct consequence, provinces like Lombardy or Venetia. As a further consequence of these defeats it lost much of its importance in the German-speaking world to the rising young Prussia and after the Austro-Prussian war in 1866 it finally was expelled from the German confederation – an event substantially reducing its significance in international politics. Simultaneously, the intellectual evolution of the 19th century and the growing importance of the middle classes brought an alternative concept of the sovereign into play. The concept of the emperor as sovereign that was the basis of the rule of Franz Josef I was increasingly contrasted with a view that put the nation as the sovereign. The empire thus was increasingly challenged by the concept of the nation state. This development was wide-spread in the 19th century and not a phenomenon that was limited to Austria. However in the multi-ethnic society the Austro-Hungarian Empire that hosted so many nations under its common roof it turned out to be particularly devastating. The rising tensions amongst the "peoples of Austria" led to an escalating dysfunctionality of the parliamentary process that had been introduced only reluctantly anyhow. Eventually the ageing Franz Josef I found himself forced to rule by emergency decrees for almost a decade around the fin de siècle (1897-1906). On top of this ever more obvious systemic political crisis there was a systemic economic crisis. Austria had been a late starter in the industrial revolution as post-feudalistic elements and repressive commercial policies had inhibited faster capital accumulation and the rise of a confident bourgeoisie at an earlier stage. The belated industrialization now culminated in the so-called *Gründerkrach* of 1873. The result of this major banking crisis was an ensuing period of economic stagnation and deflation that Austrian economists like Joseph Schumpeter later came to refer to as great depression. The deep irritation triggered by the experience of Austria's first major economic crisis further fuelled the rise of alternative concepts to capitalism. In this regard, socialist ideas were most prevalent at the fin de siècle – note that Karl Marx was a contemporary of the first generations of the Austrian school of economics. An omnipotent, often arbitrary and, on top of this, increasingly dysfunctional state thus triggered a deep and systemic crisis of confidence. This was the first part of the intellectual framework that should govern early Austrian economic thinking.

However, there was a deep insoluble ambivalence to this crisis of confidence for the first proponents of Austrian economics. It should not be forgotten that the main pillar of the empire was its bureaucracy. A major basis for the formation of this bureaucracy was the educational system, which, as early as in 1850, had been subject to fundamental reforms. These reforms did not only extend the curriculum from six to eight years but shifted the emphasis of education from religion and obedience to an education in preparation of academic research duties. It was a school system that – at least compared to its predecessor – rather encouraged than suppressed critique and opposition. It cannot be overestimated how much this added to the vastly fruitful intellectual soil of fin de siècle Vienna. However, at the same time the school system created a very elitist breed, with graduates of certain schools often forming lifelong ties. It is no coincidence that the most important proponents of the second generation of Austrian economists – Friedrich Wieser and Eugen von Böhm-Bawerk – for many years had been class mates in the well-known Viennese *Schottengymnasium*. This educational system formed the basis for a highly trained bureaucracy, with a bourgeois class consciousness and a strong, technocratic work ethos. Menger, Wieser and Böhm-Bawerk were members of these bureaucratic cadres not only as academics but also through occasional employment within ministries such as the finance ministry or even – as in the case of Böhm-Bawerk – as ministers. The crux was that they derived their status and reputation from being representatives of a regime whose dysfunctionalities and anachronisms lay blatantly open to everyone who was willing to see. The second part of the Austrian intellectual framework thus was the extremely ambivalent association with the elite of a crumbling regime.

The massive tension that arose out of these two – in principle irreconcilable – factors created an extremely fertile ground for the intellectuals of those days. Two different reactions prevailed: obsession with the individual and therapeutic nihilism. Already during the

Biedermeier of the Metternich period the rising class-consciousness and social presence of the middle classes had been channelled into the epidemic cultivation of domestic aestheticism amid a repressive and contractionary state. The fin de siècle somewhat echoed this escapism – now in a more public form. The arts turned toward an unprecedented aestheticism as represented for instance in the works of Makart, Klimt and Schiele or in the music of Johann Strauss. It is not by sheer coincidence that Maurice Ravel later should refer to the waltz as a "fantastic whirl of destiny". Amongst more analytical minds this obsession with one's destiny amid an omnipresent and arbitrary state turned into a twist toward inwardness and an occupation with the individual. Think for instance of the hugely influential Sigmund Freud and his psychoanalysis. Another very telling example is the work of Arthur Schnitzler – not by chance one of the first masters of the inner monologue – and his explorations of the depths of the human mind.

However, at the extreme edge this individualistic twist was taken ad absurdum. This more extreme approach amongst intellectuals was the so-called therapeutic nihilism. Originally this term had been coined in the medical science at the beginning of the 19th century to describe an approach that gave the diagnosis absolute primacy – even if at the cost of dissection – over the therapy. At the turn of the century this attitude was widely adopted amongst philosophers (e.g. Weininger, Wittgenstein), social scientists and other intellectuals (Kraus). With these intellectuals therapeutic nihilism turned into a more generalized view that "diseases" of society or language could not be healed or corrected in any sensible way and efforts to do so would be in vain.

It is fair to say that the Austrian school of economics within its own development covered the distance between these two intellectual extremes. In the end, both the obsession with the individual and therapeutic nihilism found shelter under the theoretical roof of Austrian economic analysis. At the beginning, however, the focus on the individual was the prevalent force in the making of Austrian economics. Carl Menger introduced methodological individualism and methodological subjectivism into the analysis and thereby became one of the fathers of the so called marginalist revolution in economics. From that point on, efforts to base a theory of value on any objective criterion – like for instance labor as in the Marxist labor theory of value – were outside the realm of mainstream economics. The concept of marginal utility – first labelled as such by Friedrich Wieser – quickly became the main theory of value used around the world. However, these innovations today are widely accepted elements of mainstream economic analysis and if it were only for these innovations we would find no necessity to discuss a separate Austrian school of economics.

Yet, there were already important concepts in the early Austrian economic discourse that would later put this school outside the emerging mainstream debate. Already Menger stressed the importance of uncertainty, which, according to him, increases along with the accumulating stock of a society's knowledge. The concept of time and path dependency became central to the Austrian theory of capital as put forth by Böhm-Bawerk. The relative importance of these aspects continued to increase steadily within Austrian economic thinking. Further, in defining freedom and one's own responsibility as the basis of the general development of a state Carl Menger already sketched what became the *leitmotif* of the Austrian school of economics. However, contrary to more recent definitions that would define freedom as the free availability of opportunities, the definition of the Austrian school of economics always remained a negative one that exclusively defined freedom as the absence of constraints. This should become decisive for the spin that later Austrian economists took toward analytical nihilism.

Collapse and exile – the later generations

Despite all the dysfunctionalities and anomalies a core property of the Austro-Hungarian Empire was the remarkable stability of its society. In the institutional sphere things only changed at glacial speed. The great stagnationist phase at the end of the century further helped to accentuate this political stagnation in the economic and social sphere. Against this background, the shock that was triggered by World War I and the dissolution of the Austro-Hungarian Empire was even larger. As anachronistic as the empire may have been it had been omnipresent and had hardly changed. Now, the man who had governed the empire for more than sixty years was gone and with him not only the empire's grandeur but also its existence was a thing of the past. The intellectuals of Vienna had been used to seeing themselves as the elite of the capital of an empire with fifty million inhabitants. Suddenly they were situated at the fringe of a six-million people carcass. Long-standing truths were invalid and the structure of the society fundamentally changed. An illustrative example is the abolishment of the gentry and its nomenclature. Austrian economists of the third and fourth generation like Mises continued to use the noble version of their names until the end of their days but this nomenclature already had been abolished in 1919 thereby eliminating the "von" in the names of Hayek and Mises. More decisive for the Austrian school of economics however was that the socialist challenges of capitalism now had become a very serious and a very real threat. Russia had become a communist country and the financial wealth of many Austrians was lost during the period of hyperinflation of 1920-1922, which fuelled the further erosion of trust into capitalism. The endemic rivalry between bourgeois and socialist politicians in Austrian politics had turned into a subcutaneous civil war now that real power was at stake. Occasionally this conflict turned into open confrontations that eventually were to culminate in a brief civil war.

Finally, the world economic crisis added to the ongoing conflicts. The Austrian economists strongly pushed for a clear laissez faire approach entailing balanced budgets, the absence of exchange restrictions and free trade. They later were to receive much of the blame for the above-average severity of the crisis in Austria for their role in the design of economic policies during the crisis. Nonetheless with the beginning of Austro-Fascism in 1933 the most important students of the founders of the Austrian school of economics – Joseph Schumpeter, Ludwig Mises and August Hayek – already had left Austria for universities abroad. From now on the Austrian school of economics and the economic development in Austria would be increasingly separated.

It will hardly come as a surprise that the turbulent times of the inter-war period were strongly reflected in the mind-set of the third and fourth generations of Austrian economists. While the first two generations had contented themselves with the analysis of a largely static economy this now radically changed. Austrian economists pioneered the analysis of the business cycle in the inter-war years. Innovation and the role of entrepreneurship became a central theme in the works of Joseph Schumpeter. Mises too insisted on the importance of entrepreneurs amid an uncertain environment. However, while the occupation with a critique of Marxist ideas already had been endemic among the first generations it turned into an obsession starting with Mises. Mises spent a considerable part of his career with the effort to prove the theoretical inconsistency of the concept of a planned economy and objected to public interventions into the economy.

Mises contrasted with the more reflected Schumpeter. However, with their successor Hayek, the Austrian school had completed its transformation toward the libertarian fringe in which it is situated today. Hayek developed the economic concept of knowledge that already had been present in Menger's thought into a full-blown attack against any public interventions. In the evolutionary concept of an economy that Hayek had in mind no public authority would ever be able to outperform the allocative efficiency of markets due to its incomplete knowledge. The Austrian theory of the business cycle in his hands turned into a theory that regarded credit creation by public authorities as the main source of economic fluctuations. Completely ignoring that problems of this kind might also arise in the private sector, Hayek thus fervently argued for an absolute minimum state. He also was one of the most prominent Austrian economists that actively tried to influence the economic policies during the world economic crisis. As early as in 1930 Hayek's prime policy recommendation to fight the crisis – published in his book "Prices and Production" – was to refrain from any interventions and wait for markets to stabilise themselves. This was a recommendation whose devastating effect only becomes clear when it is contrasted with the beneficial effects of the successful New Deal in the USA that did exactly the opposite. The more mature Hayek's career became the more focus he put on propagating these libertarian ideas in the policy arena which ultimately led him to found the Mont Pelerin society in 1947.

Recalling the two extreme positions taken by the intellectuals of fin de siècle Vienna – individualism and therapeutic nihilism – it thus is fair to say that the Austrian school of economics had made a long journey from the more individualistic positions of Menger to eventually reach the climax of therapeutic nihilism with Hayek. Austrian economists like Wieser had been deeply concerned with problems arising out of inequality and the law of declining marginal utility in the hands of Böhm-Bawerk turned into an intellectual tool for promoting progressive taxation. Hayek – a Fabian socialist in his youth – with a zeal often found among converts now gave the Austrian school of economics its final extremist spin. This extremism somehow helps to understand why later representatives of Austrian economics – as for instance represented by Fritz Machlup or Israel Kirzner – never came close to reaching the academic impact of its founders. Somewhat mimicking Hayek's career path from now on the most important influence of the Austrian school of economics was in the political sphere. The influence of the political agenda of the later generations on political circles around the world, and especially in the United States, should not be underestimated, though. However, as far as the economic policy of the name-giving country – Austria – is concerned the influence of the Austrian school of economics remained very limited after World War II. To some extent this was one of the major reasons for the remarkable success of the Austrian post-war economy.

Austrian economic policies – a lesson in non-Austrian economics

The period after the horrors of World War II and the Holocaust marked the ultimate radicalization of the Austrian school of economics. However, this time also brought a structural shift in Austrian economic policies. The emigrating generations of Austrian economists had left a country that was characterized by a destructive and violent conflict between conservatives and socialists and was headed for disaster. However, the terrors of World War II and the necessities of the ensuing occupation and reconstruction fundamentally altered these dynamics. In lieu of the hostility and distrust, the new style of Austrian politics was one of cooperation and compromise. This helped to pave the way for the revitalization of the Austrian economy.

The most important manifestation of this development was the cooperation of the social partners. It started in an effort to stabilize price growth in the economy of scarcity of the immediate post-war years. While these efforts only turned out to be successful at the beginning they planted the seeds of the neo-corporatist approach to economic policy that was to form the backbone of Austrian post-war economic policy. The basis of this approach was a high degree of voluntary cooperation between many of the key players of the social partnership such as chambers representing employer and employee interests and trade unions. The cooperation was built around a simple but effective settlement of the concurring claims whose incompatibility had caused so many troubles in the inter-war years. Institutions representing employee interests acceded to moderate their wage claims in exchange for a steady and high degree of investment and the moderation of social hardship by a generous social state. Bi- and tripartite bodies became the rule and had strong influence on the legislative procedure thus decisively shaping the design of post-war Austria. At the same time the high level of coordination of collective bargaining made it easier to internalize positive externalities. This helped to build Austria's much acclaimed system of vocational training that was to become a basis for Austria's remarkable productivity growth in the post-war years.

Most importantly, the atmosphere of mutual trust significantly reduced uncertainty and thereby supported the high rates of investment that were so crucial for rebuilding Austria. This was decisively supported by the substantial international help that Austria received in the years after the war. First of all – but not exclusively – the funds granted under the Marshall Plan Fund helped Austria to finance its initially persistent current account deficit. This made it possible to start the reindustrialization of the devastated industry. Nationalized industries took the key role in this process and the social partnership was crucial, with social partners being represented on the boards of the nationalized industry. At the beginning, the output of these industries grew much faster than that of the private industries. What is more, they were at the cutting edge of innovation and leading in the export sector.

Eventually this system of moderate wage policies and a high share of nationalized industries fused into what came to be labelled as Austro-Keynesianism. An additional ingredient of Austro-Keynesianism was a strong anticyclical focus of the fiscal system combined with the effort to make the tax system more redistributive. Another key ingredient was the currency policy. The Austrian central bank pursued a hard currency policy and steadily reduced fluctuations in the exchange rate vis-à-vis the German mark. The major motivation was mistrust against the instrument of currency depreciations, which, in other countries, repeatedly had proven as a merely temporary means of relief. Indeed the central bank's hard currency policy put the Austrian export industry on projectable foundations and helped to contain the uncertainty that had been vastly increased by the breakdown of the world currency order under the system of Bretton Woods. These initially quite painful policies – in a period before the introduction of central bank independence – could only be pursued thanks to the backing and support of the social partners.

This was especially important as with a growing distance to the era of reconstruction the heavy industry increasingly gave way to the production of consumer goods; a development that was further fuelled by the take-off of globalisation and the associated shifts of production abroad. This process implied a decrease in the relative importance of the nationalized industries. On top of this structural change, the nationalized industries were increasingly aching from a structural set-up that was sorely in need of reform. The fact that they increasingly had to obey to the necessities of regional policies often came at the expense of economic efficiency. Thus, in retrospect, the adjustments imposed on Austria's economy by the hard currency policy turned out to be a blessing for Austria. The private sector industry was forced to adjust its international competitiveness at a very early stage. This helped the private sector to step in and replace the importance of the nationalized industries as the latter went through a fundamental crisis. This structural change made Austria's economy fit to sustain the periods of harsh consolidation that later came in preparation for the accession to the EU. What is even more important: The increased price competiveness of the Austrian economy made the integration into the European economy far easier. The regained profitability of the Austrian industry also supported the successful expansion into Eastern Europe after the fall of the iron curtain that significantly added to Austria's economic growth of the last decades. Ultimately, the combination of a competitive industry with a skilled workforce and a low degree of labor disputes has also helped Austria to emerge from the recent crisis in a relatively strong condition.

Certainly, any approach to economic policy comes with its specific downsides. The approach taken in Austria is no exception to this rule. To some extend the current state of the Austrian economy echoes the famous bon mot of the Austria's former chancellor Bruno Kreisky who stated that: "a few additional billions of debt cause me fewer sleepless nights than a few additional hundred thousands of people being unemployed" The nationalized industry and the active fiscal policy and large social state have left a large debt burden. This cannot be disputed, yet Austria's national debt is still at a manageable level. The strong role of the social partners led to some idiosyncrasies, and limiting room for manoeuvre not only reduces uncertainty but also reduces some innovative capacity. The educational system – despite its successes in the past – requires a structural overhaul to adapt skill-formation and knowledge dispersion to the requirements of a modern computerized society. Finally, the financial sector is on its way to undertake some structural adjustments. However, compared with its peers, Austria has performed very well, producing decent growth, a skilled population and very low unemployment rates at the cost of some problems that still are quite manageable. At the bottom line, the non-Austrian economic policy of Austria has been very successful.

To sum up: The Austrian school of economics developed an approach based on methodological individualism and a subjective theory of value. It put knowledge in the centre of the analysis and deduced that increasing knowledge would lead to increasing uncertainty. As a result – according to Austrian economists only the free interplay of market forces and entrepreneurship can reveal the underlying knowledge by an undisturbed determination of prices and profits. A minimum state and strict non-interventionism thus would be the policy ideal.

Economic policy in Austria indeed has tackled key aspects raised by the Austrian school of economics such as uncertainty, the dispersion of knowledge and entrepreneurship. It is a strange irony however that the success of Austrian economic policy was brought about by tackling these problems with policy tools that ran completely counter those recommended by the Austrian school of economics. Uncertainty was handled by stabilizing expectations through corporatist institutions and by a generous social state. Knowledge dispersion was promoted by centralized collective bargaining institutions. While the Austrian school of economics thus regarded uncertainty as the main argument why entrepreneurship outperforms any public intervention, in post-war Austria it was only *through* public interventions that uncertainty was brought to sufficiently low levels and entrepreneurship could unfold. Thus, where the Austrian school of economics was obsessed with fighting constraints to ensure freedom, economic policymakers in Austria tried to ensure freedom by equalizing opportunities. Indeed, it was actions *contrary* to the libertarian recommendations by late proponents of Austrian economics that made Austria economically successful.

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