Ludwig Von Mises explained the world's adoption of faulty economics

By Richard Ebeling, The Heartland Institute, 8 September 2019

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September 2019 marks 70 years since the appearance of Ludwig von Mises's *Human Action: A Treatise on Economics,* one of the truly great "classics" of modern economics. Too often a "classic" means a famous book considered to have made important contributions to some field of study and that is reverentially referred to but is unfortunately rarely ever read any-more.

In economics, Adam Smith's *Wealth of Nations* is a typical example of such a work. Every economist and a good number of people in the general public have heard of the "invisible hand" and the notion that self-interest furthers the public interest through the incentive mechanism of free-market competition; but in fact few economists nowadays have actually read more than a handful of snippets and brief passages from Smith's profound treatise. Among the general public, the number of people who even know the snippets dwindles to almost nothing.

A still-read and still-relevant classic

However, Ludwig von Mises's *Human Action* uniquely stands out as a classic in the literature of economics. Not only among "Austrian" economists but also for a growing number of other people, Mises's brilliant treatise continues to be read and taken seriously as a cornerstone for understanding the nature of the free society and the workings of the market economy.

It has taken on even more relevance and significance in these first decades of the 21st century because of the economic crisis of 2008-2009, the full effects from which the American economy has still not fully recovered, and in the wake of a dangerous revival of a call for a "democratic socialism" that demands the implementation of various forms and degrees of government central planning. They have made the economic reasoning and public-policy analysis that runs through most of *Human Action* as timely today as when its first edition appeared in bookstores on September 14, 1949.

A few days after its publication, the famous free-market journalist Henry Hazlitt reviewed *Human Action* in his column in *Newsweek* magazine. He emphasized its importance by telling his readers,

[The] book is destined to become a landmark in the progress of economics.… *Human Action* is, in short, the most uncompromising and the most rigorously reasoned statement of the case for capitalism that has yet appeared.… It should become the leading text of everyone who believes in freedom, in individualism, and the ability of a free-market economy not only to outdistance any government-planned system in the production of goods and services for the masses, but to promote and safeguard, as no collectivist tyranny can ever do, those intellectual, cultural, and moral values upon which all civilization ultimately rests.

Keys to human progress

If the field of sociology did not have such a controversial history and so many conflicting notions about what its subject matter and approach are supposed to be about, it would not be misplaced to say that in *Human Action,* Mises demonstrated himself to be not only one of the greatest economists of the last century, but one of its leading sociologists as well.

In the most appropriate meaning of the term, Mises formulated a "science of society" in the tradition of Scottish philosophers such as Adam Smith. All that happens in the social world begins in the thinking and actions of individual human beings. They are the starting point for understanding society: man, as a purposefully acting being, gives assigned meanings to the world around him, selects desired ends, decides upon possibly useful means to their attainment, and undertakes courses of action through time in attempts to bring his desired plans to fruition.

Humans rose above animal existence through their developed capacity to reason, conceptualize, imagine possible futures, and conceive of ways of bringing them into reality. But on his own, man's mental and physical powers are too limited for achieving much above bare subsistence. The profound key to the betterment of the human condition, Mises insisted, was man's discovery of the benefits that could come from a division of labor through which men could specialize in their tasks and mutually gain through cooperative association that slowly but surely improved the standards of living, the quality of life, and the cultural elements that mark off "civilization."

But how shall human beings collaborate — through plundering conquest or peaceful trade? It took thousands of years for people to stumble upon the superiority of market-based cooperation over politically based power and privilege. As production and trade become ever more complex owing to the extension of the system of division of labor, there had to arise a method by which the participants in the emerging relationships of supply and demand could know how and what to do.

Economic calculation

A central theme through much of the *Human Action* is Mises's insistence on the essential importance of economic calculation. In the early decades of the 20th century, socialists of almost all stripes were certain that the institutions of the market economy could be done away with — either through peaceful means or violent revolution — and replaced with direct government ownership or control of the means of production with no loss in economic productivity or efficiency.

Mises's landmark contribution 100 years ago in 1920 was to demonstrate that only with market-based prices expressed through a medium of exchange could rational decision-making be undertaken for the use and application of the myriad means of production to ensure the effective satisfaction of the multitudes of competing consumer demands in society.

"Monetary calculation is the guiding star of action under the system of division of labor," Mises declared in *Human Action.* "It is the compass of the man embarking on production." The significance of the competitive process, as Mises had expressed it in his earlier volume *Liberalism* (1927), is that it facilitates "the intellectual division of labor that consists in the cooperation of all entrepreneurs, landowners, and workers as producers and consumers in the formation of market prices. But without it, rationality, i.e., the possibility of economic calculation, is unthinkable."

Such rationality in the use of means to satisfy ends is impossible in a comprehensive system of socialist central planning. How, Mises asked, will the socialist planners know the best uses for which the factors of production under their central control should be applied without such market-generated money prices? Without private ownership of the means of production, there would be nothing (legally) to buy and sell. Without the ability to buy and sell, there would be no bids and offers, and therefore no haggling over terms of trade among competing buyers and sellers. Without the haggling of market competition there would, of course, be no agreed-upon terms of exchange. Without agreed-upon terms of exchange, there are no actual market prices. And without such market prices, how will the central planners know the opportunity costs and therefore the most highly valued uses for which those resources could or should be applied to satisfy the consumer demands of "the people"?

With the abolition of private property, and therefore market exchange and prices, the central planners would lack the necessary institutional and informational tools to determine what to produce and how, in order to minimize waste and inefficiency.

Therefore, Mises declared in 1931,

From the standpoint of both politics and history, this proof [of the impossibility of socialist planning] is certainly the most important discovery by economic theory.… It alone will enable future historians to understand how it came about that the victory of the socialist movement did not lead to the creation of the socialist order of society.

Government intervention and monetary manipulation

At the same time, Mises demonstrated the inherent inconsistencies in any system of piecemeal political intervention in the market economy. Price controls and production restrictions on entrepreneurial decision-making bring about distortions and imbalances in the relationships of supply and demand, as well as constraints on the most efficient use of resources in the service of consumers. The political intervenor is left with the choice of either introducing new controls and regulations in an attempt to compensate for the distortions and imbalances the prior interventions have caused or repealing the interventionist controls and regulations already in place and allowing the market once again to be free and competitive. The path of one set of piecemeal interventions followed by another entails a logic in the growth of government that eventually results in the entire economy's coming under state management. Hence, interventionism consistently applied could lead to socialism on an incremental basis through an unintended back door.

The most pernicious form of government intervention, in Mises's view, was political control and manipulation of the monetary system. Contrary to both the Marxists and the Keynesians, Mises did not consider the fluctuations experienced over the business cycle to be an inherent and inescapable part of the free-market economy. Waves of inflations and depressions were the product of political intervention in money and banking. And that included the Great Depression of the 1930s, Mises argued.

Under various political and ideological pressures, governments had monopolized control over the monetary system. They used the ability to create money out of thin air through the printing press or on the ledger books of the banks to finance government deficits and to artificially lower interest rates to stimulate unsustainable investment booms. Such monetary expansions always tended to distort market prices resulting in misdirections of resources, including labor, and malinvestments of capital. The inflationary upswing that is caused by an artificial expansion of money and bank credit sets the stage for an eventual economic downturn. By distorting the rate of interest — the market price for borrowing and lending — the monetary authority throws savings and investment out of balance, with the need for an inevitable correction.

The “depression” or “recession” phase of the business cycle occurs when the monetary authority either slows downs or stops any further increases in the money supply. The imbalances and distortions become visible, with some investment projects having to be written down or written off as losses, with reallocations of labor and other resources to alternative, more profitable employments, and sometimes significant adjustments and declines in wages and prices to bring supply and demand back into proper order.

The errors of Keynesianism

The Keynesian revolution of the 1930s, which then dominated economic-policy discussions for decades following the Second World War, was based on a fundamental misconception of how the market economy worked. What Keynes called “aggregate demand failures” (to explain the reason for high and prolonged unemployment) distracted attention from the real source of less-than-full employment: the failure of producers and workers on the supply side of the market to price their products and labor services at levels that potential demanders would be willing to pay. Unemployment and idle resources were a pricing problem, not a demand-management problem. Mises considered Keynesian economics basically to be nothing more than a rationale for special-interest groups, such as trade unions, who didn’t want to adapt to the reality of supply and demand, and of what the market viewed as their real worth.

Thus Mises’s conclusion from his analysis of socialism and interventionism, including monetary manipulation, was that there is no alternative to a thoroughgoing, unhampered, free-market economy — and one that included a market-based monetary system such as the gold standard. Both socialism and interventionism are, respectively, unworkable and unstable substitutes for open, competitive capitalism.

The classical liberal defends private property and the free-market economy, Mises insisted, precisely because it is the only system of social cooperation that provides wide latitude for freedom and personal choice to all members of society, while generating the institutional means for coordinating the actions of billions of people in the most economically rational manner.

The apparent triumph of capitalism over collectivism, following the demise of the Soviet bloc in the 1990s, has, unfortunately, turned out to be mostly an illusion. Governments in the Western world did not reduce their size or intrusiveness in the economic affairs of their citizens. The interventionist-welfare state has remained alive and well, and continued to grow along with the government debts to pay for the entire redistributive largess.

Central banking and free banking

But the heart of the interventionist system is government control of the monetary system — indeed, it has remained an untouched element of monetary central planning through the institution of central banking.

Fortunately, over the last forty years, Mises's analysis and defense of gold-backed, private competitive banking in place of government-monopoly central banking has finally begun to win over a growing number of Austrian and other advocates. (See my ebook *Monetary Central Planning and the State.*)

Monetary manipulation by central banks inserts one of the most disruptive distortions into the process of economic calculation. Interest rates — which are meant to inform market participants about the availability of savings relative to the demands for investment expenditures, and which facilitate the coordination of resource use over periods of time relative to the demands of income earners for consumption in the present versus the future — send out misinformation to both producers and consumers under the pressure of monetary expansion.

The financial crisis and its interventionist aftermath

In the wake of Federal Reserve monetary mischief during the early years of the 21st century, imbalances and distortions were once again generated by monetary policies that resulted in the financial and economic crisis of 2008-2009.

There soon occurred the return of the "ghost of Keynes past." In the face of the inescapable need for the rebalancing and re-coordination of misdirected resources and malinvested capital for a full return to normal and sustainable, market-based growth, government spending and budget deficits to "stimulate" the economy out of a recession were once again insisted upon.

The focus remained on "aggregate" output and employment, which always hides from view the underlying microeconomic relations that are at the core of the market process. How can the multitudes of market participants discern where and to what extent market errors have been made under the pressure of past monetary and interest-rate manipulations if the price system is not permitted to perform its job of telling the truth about the reality of supply and demand? That is, the degree to which resources were misallocated and wrongly priced during the preceding boom. Or the extent to which men, material, and savings-backed financial funds need to realign themselves to restore a properly understood full-employment market-driven economy.

The recovery period was drawn out for almost ten years, longer than most other periods of post-boom readjustments since the end of the Second World War. How could people know what to do and where to do it in the social system of division of labor, when the crucial tool of economic calculation was undermined by government bailouts, subsidies, price floors, capital-market interventions, and continuing monetary manipulation and near-zero interest-rate policies that threatened new misdirections of capital and labor, with the risk of another boom-bust cycle to come?

In the immediate aftermath of the 2008-2009 downturn, the argument was constantly made that many banks were too big to fail, that depositors needed to have their various bank accounts protected and guaranteed, and that the repercussions of allowing the financial markets to adjust on their own to the post-boom reality would have been too harsh. In fact, Mises had responded to such arguments in his 1928 monograph, *Monetary Stabilization and Cyclical Policy,* even before the Great Depression began, by warning of what today is understood as "moral hazard," that is, the danger of reinforcing the repetition of bad decisions by the government's bailing out mistakes made in the market:

In any event, the practice of intervening for the benefit of banks, rendered insolvent by the crisis, and of the customers of these banks, resulted in suspending the market forces that otherwise would have served to prevent a return of the expansion, in the form of a new boom, and the crisis which inevitably follows. If the banks emerge from the crisis unscathed, or only slightly weakened, what remains to restrain them from embarking once more on an attempt to reduce artificially the interest rate on loans and expand circulation credit? If the crisis were ruthlessly permitted to run its course, bringing about the destruction of enterprises which were unable to meet their obligations, then all entrepreneurs — not only banks but also other businessmen — would exhibit more caution in granting and using credit in the future. Instead, public opinion approves of giving assistance in the crisis. Then, no sooner is the worst over, than the banks are spurred on to a new expansion of circulation credit.

Mises's warning

Just as there was a huge shift toward more and bigger government in the years leading up to the publication of *Human Action,* so today we are seeing an expansion of governmental presence and domination of social life, especially in health care, education, and the energy sector — as well as the financial and capital markets.

But where will all the money come from to fund this new gargantuan largess for expanded political paternalism? In the Austria of the interwar period of the 1920s and 1930s, Mises had witnessed and explained the consequences from unrestrained government spending that finally resulted in the "eating of the seed corn" — capital consumption. Mises warned of this danger, too, in the pages of *Human Action,* and the fact that there must be a point at which the interventionist welfare state will have exhausted "the reserve fund" of accumulated wealth, after which the consumption of capital becomes the only basis upon which to continue to feed the fiscal demands of the redistributive state. Those currently in political power in Washington seem hell-bent on bringing that about in the decades ahead.

The enduring value and importance of *Human Action*

A "predecessor" of *Human Action* had appeared in German in 1940. Shortly after it appeared, Friedrich A. Hayek reviewed it, emphasizing its astonishingly unique qualities:

There appears to be a width of view and an intellectual spaciousness about the whole book that are much more like that of an eighteenth-century philosopher than that of a modern specialist. And yet, or perhaps because of this, one feels throughout much nearer reality, and is constantly recalled from the discussion of the technicalities to the consideration of the great problems of our time…. It ranges from the most general philosophical problems raised by all scientific study of human action to the major problems of economic policy of our time….

[The] result is a really imposing unified system of a liberal social philosophy. It is here also, more than elsewhere, that the author's astounding knowledge of history as well as of the contemporary world helps most to illustrate his argument.

The years since the original appearance of *Human Action* in 1949 have done nothing to diminish the validity of Hayek's interpretation. Indeed, the social, political, and economic conditions of our world today give Ludwig von Mises's treatise a refreshing relevance matched by few other works written over the last century.

That is what has resulted in its being read by more and more people today, rather than simply being one of those many "classics" collecting dust on a shelf. If enough people discover and rediscover the timeless truths in the pages of *Human Action*, the ideas of Ludwig von Mises may well assist us in stemming the growing tide toward an even larger leviathan state that dangerously looms in front of us.

[Originally Published at the Future of Freedom Foundation]