Austrian Economics vs. the Mainstream
Guest: Randall Holcombe
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Randall Holcombe is a professor of economics at Florida State University.

WOODS: You are quite a prolific guy. You seem to have a new book coming out on a fairly regular basis. And now you've had Edward Elgar—did they commission you to write this book?

HOLCOMBE: They did indeed.

WOODS: It's called *Advanced Introduction to the Austrian School of Economics,* so my audience will have a natural interest in this. You have been a professor of economics for—I don't mean to date you, but I am just curious—how many years now?

HOLCOMBE: Let's see. If I count them up—30.

WOODS: Oh, my goodness gracious. Well, we should have some kind of celebration for you here on this show. (laughs) That's quite something. Now, have you observed over those 30 years an ebb and flow in terms of interest in the Austrian School, or can you clearly see there's more interest than there used to be? What's been your experience?

HOLCOMBE: Oh, there clearly is. When you talk about ebb and flow, I really got interested in the Austrian School as it was flowing. I think the ebb came before I came along. Some of your listeners may be familiar with the South Royalton, Vermont conference in 1974, which there was a kind of a resurgence of the Austrian School that often dates back to that 1974 conference, and I was a graduate student at the time and fortunate to be able to attend that conference, and the Austrian School has just been building since then.

WOODS: I didn't realize you were at the South Royalton conference. That really is—I'm sure some of my listeners do know about it, but it is a little bit inside baseball. This was an event at which pretty much all the Austrian people who could still be found came together. Was this shortly after Hayek won the Nobel Prize?

HOLCOMBE: No, it was before.

WOODS: It was before?

HOLCOMBE: Yes, and there was another conference the next year in Hartford, Connecticut, and that was shortly after Hayek won the Nobel Prize, and Hayek was at that conference, the second conference.

WOODS: So you had the privilege of being at that great South Royalton event. Of course, at the time you couldn't have known we would look back at as a landmark event. It's been 40 years since Hayek won the prize. We all hoped that maybe Israel Kirzner might win it this year because of some rumors we heard, but yet, without having a more recent prize under our belts, we still have more and more interest being generated in it, and I think there are a variety of circumstances. I think of Ron Paul, the economic downturn, the available of alternative points of view on the Internet, and so on.

Now you've written a short, little book as an introduction. If you had to, let's say, talk to somebody for just a minute, you get one minute to persuade this person that the Austrian School has a unique perspective that's worth listening to, what aspects would you highlight?

HOLCOMBE: Boy, that is a tough question. I have been asked that before, and I really don't have a good answer, and I think that's one thing that might keep the Austrian School from being more popular and more visible. Maybe somebody else will have a good answer to that question, but I think it's really hard to summarize the great ideas of the Austrian School in a few sentences. It's a little more subtle than that.

WOODS: Well, then let's talk about some big concepts that somebody will encounter when delving into Austrian economics. You talk at the beginning of your book about something you call the market process, and you contrast that with the equilibrium framework of more mainstream economics. Can you explain what both of these mean and what the value is of thinking in terms of market process?

HOLCOMBE: Sure. Let me talk about that a little bit, and I'll preface my remarks here by going back to your earlier question and saying if I was going to try to summarize the ideas of the Austrian School to somebody who didn't know very much about it and wanted a short answer, that's probably not where I would start. But the book starts there because I think that's one of the key elements of the Austrian School, that if you look at mainstream economics, and I think my comments here are more aimed at people who know a little bit of economics, maybe have taken some introductory economics classes, and economics today is heavily focused on equilibrium concepts. So it's after all the economic forces have played out, here's what we might expect the economy to look like. But we know those economic forces never completely play out. So what's going on all the time in the economy isn't an economy at equilibrium, but rather it's the process that leads an economy toward equilibrium. And one of the key ideas there is the notion of a spontaneous order, the idea that you can have an orderly result, to use the phrase that Hayek popularized, as a result of human action, but not of human design. That's one of my favorite phrases. But Hayek emphasized the decentralized nature of knowledge and the fact that knowledge is a lot of times tacit knowledge, which means you can't readily communicate it to someone else. So the real challenge of a market economy isn't to find an equilibrium, which is what we find in mainstream economics, which focuses on that equilibrium idea, but it's rather: how do we take advantage of the continually changing, decentralized and often inarticulate knowledge that every individual has? How do we coordinate all of that knowledge to get a productive economic result?

WOODS: What do you think an analysis that focuses so much on equilibrium is missing out on that you as an Austrian economist can see?

HOLCOMBE: Well, one of the big things I really see is that if you look at the remarkable prosperity that we have in our market today, it really doesn't have too much to do with equilibrium. It has to do with economic progress, and that economic progress is the result of entrepreneurship in an economy that's continually changing, not an economy at equilibrium. I think the focus on equilibrium takes our eye off of the entrepreneurial nature of an economy that creates economic progress.

And if I can just throw in a little bit of economic jargon, and this will mainly be for people who know a little bit of economics, but modern welfare economics talks about maximizing welfare by arriving at, well, the term is a Pareto optimum, but the idea is that there is some outcome that is welfare maximizing. Now, if you think about our actual welfare, and why we are so well off, it's because of the economic progress that we have, and that's completely foreign to a static notion of equilibrium that we find in mainstream economics. So I really think one of the big things that's missing from the mainstream in economics is this notion of a spontaneous order that leads to economic progress. Even in economic growth theory there are equilibrium models of growth, but those don't capture the actual process by which economic progress takes place.

WOODS: Do you think—this is, I suppose, a loaded question—part of the reason for the focus on equilibrium in what we might call mainstream economics has to do with the fact that equilibrium, this one point, is more mathematically tractable than what you are describing? Entrepreneurship, for example, is not mathematically tractable because entrepreneurs are not machines. They are not mechanical. They are not predictable. If they were, we would all be entrepreneurs. The entrepreneur has insights that the rest of us don't have. There's no way to reduce that to functional analysis or mathematical analysis. Do you think that has something to do with it?

HOLCOMBE: I really think it does. I have heard it said—and I wish I could tell you who originated this little thing—that economists, like artists, are often in love with their models. In the last half of the 20th century, economic analysis has developed some pretty sophisticated mathematical techniques, and a lot of times economists think to really be scientific you need to have a mathematical model, and the more elegant the math is, the better the model is. And so academic economists have been led more toward developing sophisticated models than applying them to the economy.

WOODS: You have a chapter on economic calculation, and again, this is another topic that some of my listeners will know inside and out, but I have new people joining all the time, and it's a term that I probably just use just off-handedly without thinking about defining it. This is also another characteristic feature of Austrian economics—the emphasis on economic calculation. What is being calculated in economic calculation?

HOLCOMBE: Yeah, I think this is really one of the hallmarks of Austrian economic analysis, and what's being calculated is the value of goods, services, and resources. And one of the key insights that goes back to Ludwig von Mises, maybe further back than that, but Mises really emphasizes it. One of the key insights is that you really can't know the value of goods, of services, and of resources without market prices. It's market prices that ultimately value our economic resources, and so as a result, you need markets in order to have rational economic calculation, and that's really important for capital markets. It's fairly easy to barter goods and services, maybe—we can never have an advanced economy based on barter—but when you go to capital goods, there's even a bigger problem because it's not that I'm trading for a good that I am going to use now, but rather that I'm setting aside resources to try to put them into a productive process that's going to produce goods and services in the future, and so to really place a value on those capital goods, you have to have a capital market that places a value on them. Otherwise, you can't have rational economic calculation.

WOODS: Of course, Mises applies this to the problem of socialism. How does he do that?

HOLCOMBE: Well, it's pretty straightforward: he says in a socialist economy, you don't have market prices, and so as a result, you can't have rational economic calculation. I think that's really one of the key ideas in the Austrian School, and I think it's one of the ideas that led to the decline of the Austrian School, and then to its resurgence, because Mises made that claim: you can't have rational economic calculation under socialism. A lot of economists disagreed with him, and they really disagreed on two grounds. One is, there are a bunch of theoretical models, mathematical models, that were developed that say, look, here's the process by which you can have rational economic calculation. But the second argument, which maybe is a more powerful argument, you go back to the 1950s and '60s, and people will say, well, Mises says you can't have rational economic calculation under socialism, but look at the Soviet Union. It's working. Mises said socialism can't work, but you can look at the Soviet Union and see it is working. So there was kind of a consensus in the economics profession that Mises had lost that debate.

And then after the collapse of the Berlin Wall, which gosh, was 25 years ago a couple of days ago, the demise of the Soviet Union, people reevaluated Mises' arguments, and so they said, well, maybe there is something to this after all. As a result of the collapse of those centrally planned economies, the ideas of Mises that were just derided a few decades before, in the 1990s people were looking at him and saying, gosh, there is really something to these ideas, and that had a lot to do with the resurgence of the Austrian School.

WOODS: Let's clarify Mises' argument for a minute because I've run into a number of young libertarians who think they understand the socialist calculation problem, and then when it's pointed out to them that there were prices of consumer goods—for example, in Poland you could see a price for a toothbrush or a new hat—and they are stymied. They don't know what to say to this. But the prices that Mises is talking about are prices of factors of production, of the means of production—the raw materials, all the things that go into producing consumer goods. There are no prices of those. So entrepreneurs can't calculate profit and loss because they can't tell what the alternative uses might be of their capital. Where could their capital have earned a better return? They can't calculate that because they have no idea the monetary value of the goods that they are working with. Am I right?

HOLCOMBE: Oh, that's exactly right. Let's say that you have a warehouse, and so you're trying to figure out how should I use my warehouse? Well, if you don't have market prices, you might have a business that you're running and somebody else says, gosh, I could make better use of this warehouse. They could bid it away from you with the capital market. Or somebody else might say, I could take this warehouse and convert it into a factory. So they would bid it away from you. But without a capital market, there's no way for you to know what the relative value is of the capital goods you owe compared to other capital goods.

WOODS: If I were to talk to you about the Austrian School of economics, and you have this new volume on the subject that covers some of the main themes, and I didn't mention money, banking, and business cycles, I think it would be sort of like Hamlet without the prince. So let's bring that in now. This, I think, is more than anything else why the Austrian School suddenly got so much attention: it had a plausible account of what had gone wrong in our own case, in our own day, in 2008 and thereafter. So what is the unique Austrian contribution when thinking about money and/or business cycles?

HOLCOMBE: Well, if I want to distill it down to one thing, and maybe it's a little more complex than that, but if I want to distill it down to one thing, I would say it's heterogeneous capital in the Austrian business cycle model. It's interesting: when you look at the Austrian theory of the business cycle, its rise and fall and rise again pretty much paralleled that socialist calculation debate. Now, you go back to the 1930s, and Hayek's business cycle theory was the main alternative to Keynes, and the Austrian School was a pretty prominent school of economic thought. But then in the mainstream, Keynes won out, and the Austrian business cycle theory was more or less discarded.

But one of the key elements was that in Hayek's business cycle theory he referred to a structure of production where you have heterogeneous capital. So unlike your typical economic model today that just treats all capital the same—we have capital and labor—the idea of heterogeneous capital is a big idea in the Austrian business cycle theory. Now, we know that capital is heterogeneous. We know you can't turn a warehouse into a truck, and you can't turn machine tools into an aircraft or something like that. We know capital is heterogeneous, but the issue is: is that really important for economic analysis?

And the key thing is, if we have heterogeneous capital, that opens up the opportunity. You can see—you can invest in the wrong type of capital. So it's not that there's too much capital or too little capital, but rather you invest in the wrong type of capital. Now, you go back in the 1990s to the dot-com boom, and you can see there was so much investment in computer stuff, Internet stuff—a lot of companies, well, at the end of the 1990s, a lot of companies had invested in Internet infrastructure—fiber optic cable and so forth. It wasn't being used. It was overinvestment. And so-called dark fiber, all this fiber-optic cable that had been laid, but wasn't being used. We invested in the wrong type of capital back then.

Then you go to the housing boom, and it's so obvious there in hindsight. It wasn't that we had too much or too little investment, but rather we invested too much in housing—the wrong type of capital. So one of the key elements in the Austrian business cycle is heterogeneous capital, and it makes a difference not only how much or how little you invest, but what type of capital you invest in, and the Austrian business cycle theory, Hayek's theory, allows that heterogeneous capital. So you can see you can make the wrong types of investment, and it's a very rare mainstream model that would have any type of heterogeneous capital in it.

WOODS: Of course, it's a hideous sounding name, but in a way, Austrian economics is like disaggregated economics. It disaggregates capital. Instead of thinking of it as shmoo, as Peter Klein and others call it, as just being stuff that may as well be interchangeable, it instead looks at it the way it really is in the real world. Likewise, when we look at national income accounting, an Austrian wants to disaggregate that and say that maybe government spending is not analogous to private-sector spending. So we have to separate these things out. There's an interest in looking at these big blobs and reducing them into the component parts that make them what they are.

HOLCOMBE: Well, that's right, and I think—if you look at any type of economic model, one of the virtues of economic modeling is simplification. So you want your model to be as simple as possible, but you don't want it to be too simple. And so we were talking about heterogeneous capital, and are you making a mistake to just assume capital is homogeneous? Well, you want to make every simplifying assumption you can, but in this case, what's happened is we've made a simplifying assumption that simplifies away what we're trying to understand. If your simplifying assumption assumes away what you're trying to understand, the model really does you a disservice. So I think that's where the Austrian School really has an advantage in understanding, for example, the macroeconomic events of the past couple of decades. It looks at that economy as more decentralized, less aggregated, so you can really understand some things that you don't see in other schools of thought.

WOODS: What was your intended audience, or Elgar's intended audience, for this book? Was it laymen who might have an interest in the Austrian School? Was it the rest of the profession, to let them know we're not crazy, and here's what we believe? Or was it both?

HOLCOMBE: Well, I think it was a little bit of both. Now, the book does assume that the reader knows some economics. So I don't start from first principles. It's not a principles of Austrian economics book where we start from first principles and develop from there as, for example, Rothbard's *Man, Economy, and State*, where you pick it up, and you don't know any economics, and so you read through. It's a difficult book to get through, but the idea is it starts from first principles. Now, I don't do that. I assume the reader knows a little bit of economics, maybe has taken an introductory economics course. So the intended audience is somebody who knows a little bit about economics, but doesn't know what's distinctive about the Austrian School. So you might say, well, I know some economics, but what makes the Austrian School different from other schools of thought? That's the audience that I was trying to hit with the book.

WOODS: The book is called *Advanced Introduction to the Austrian School of Economics*. It's available on Amazon. How can people find out more about you online?

HOLCOMBE: Well, I do have a website, which is my name, www.randallholcombe.com, so you can go there, and there is at least some information there.

WOODS: What are you working on these days?

HOLCOMBE: Well, these days I am working on political institutions. I am really interested in the origins of political institutions and the implications of political institutions, and at least some of that has to do with the way people come to get political power and the way they are able to keep political power.

WOODS: Is there a book project in that idea?

HOLCOMBE: There may be a book project coming along down the pike. I do have an article that I expect to be coming out in the *Cato Journal* next year titled "Political Capitalism." So for anybody who is interested, if you keep an eye on the *Cato Journal*, eventually I expect that article to be published, and you can look through that and see what my ideas are on that subject.

WOODS: Well, when that article comes out, I might have you come on and talk about that article. Then we'll talk you into doing a book on it. Any project that I can make somebody else do, I am perfectly happy.