Hazlitt For Our Time

Economics for Real People: An Introduction to the Austrian School

Gene Callahan
Ludwig von Mises Institute, 2002
349 pgs.

Gene Callahan superbly executes a very difficult task. Wittgenstein famously said, "whatever can be said, can be said clearly"; but does this apply to economics? Callahan, like his great predecessor Henry Hazlitt, shows that it does. If the theme of Hazlitt's *Economics in One Lesson* is the indirect effects of intervention in the economy, Callahan's dominant thread is the role of monetary calculation in making possible cooperative activity on a vast scale. Using this organizing principle, he explains a remarkable amount of Austrian economics in a simple and straightforward way.

Along the way, he makes illuminating remarks that will be of great benefit to more advanced readers. Every reader of *The Mises Review*, I am sure, knows that an economic exchange takes place only if each party values what he gains more than what he gives up. Exchange involves not an equality of value, as the classical school thought, but a double inequality. But what happens if one denies this?

Callahan draws attention to an important but neglected argument advanced by Carl Menger. Suppose one thinks that the double inequality is not required: why is it not enough to say, for example, that you will trade apples for oranges if you are indifferent between the two goods? If I am not mistaken, the standard neoclassical model of Paul Samuelson and others incorporates exactly this view.

As Menger pointed out, "to regard an exchange as occurring at a point of equal valuation leads to absurdities. If two people exchange when they consider the value they are getting to be equal to the value of what they are giving up, there is no reason they shouldn't simply reverse the trade a moment later. . . . In fact, if the exchange took place at a point of equal valuation, there is no reason you and the other party shouldn't swap [the item exchanged] . . . any number of times" (p. 71). A supporter of the neoclassical view could, I suppose, "bite the bullet." He might say that only transactions costs explain why such repeated exchanges do not take place; but this seems implausible. If transactions costs suffice to bar repeated

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exchanges under conditions of indifference, why do they not rule out even the first such exchange?

Callahan has rightly seized upon a vital theme in Mises that often receives inadequate attention. David Ricardo long ago demolished an objection to free international trade. A country can profit from trade if another country can produce more efficiently a good that it wants. In return, it can offer in exchange a good that it makes more efficiently. "But what of the case where one country . . . is worse at producing everything than some other country is? . . . How can it possibly offer the more advanced nation anything in trade?" (p. 64).

Ricardo arrived at a remarkable result. He showed that, in the case just indicated, the advanced nation would still find it advantageous to trade. The poorer nation should produce the commodity in which its inefficiency, compared to the advanced country, is least—this is its comparative advantage.

More than any other economist, Mises extended Ricardo's principle of comparative advantage into a general law of association. Ricardo's demonstration applies to individuals as well as nations. "The law of association demonstrates that . . . it is to everyone's material advantage to cooperate through the division of labor and voluntary exchange. It is the basis of the extended social order" (p. 66).

The more the social order is extended, the better; but to extend it involves an essential prerequisite. Production at anything above the level of subsistence for a small group demands the use of capital goods—goods not directly consumed but used to produce other goods. But once capital goods are present on a large scale, a problem arises: how can the users of such goods decide where to allocate them?

Only through calculation using a common unit can this question be answered. Given a common unit, entrepreneurs can calculate where capital goods will net them the greatest profit possible, and allocate them accordingly. In so doing, they best satisfy the wishes of consumers. The common unit in question is, of course, money.

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Callahan ably shows how money arises as a commodity on the free market. Once the use of money becomes widespread in an economy, capital goods have room to expand indefinitely. We not only get goods used to produce consumer goods, but "higher-order" capital goods to produce these capital goods. The process obviously can be extended further; the structure of production may require many stages until consumer goods eventually emerge.

Monetary calculation is then essential to a developed economy; and from this a further important result follows. Only in a capitalist economy can monetary calculation take place. A centrally planned economy has no means to calculate economically and thus cannot function. "Mises showed the impossibility of all socialist schemes, because they leave the economic planners with no means by which to perform economic calculation. . . . A central planning bureau has no mechanism that can fill the role that prices play in the market" (p. 164).

A developed economy, then, depends on a complex structure of capital; and Callahan explains a point about this structure that has, since Böhm-Bawerk, become a leitmotif of the Austrian School. Suppose that you are a capitalist faced with a choice between two equally productive processes, one of which takes longer than the other. You will naturally favor the shorter process, since that will get you the goods you want faster.

If so, why are long processes of production ever adopted? Given the universal fact of time preference, this can only happen because the longer processes are more productive. "The economy generally advances through increasing the 'roundaboutness' of production because the shorter methods have been tried already" (p. 135).

Here Callahan once more displays his ability to bring to bear a little-known fact on his discussion. He notes that the philosopher Ernst Cassirer recognized the importance of long structures of production: "All cultural work, be it technical or purely intellectual, proceeds by the shift from the direct relation between man and his environment to an indirect relation" (p. 136, quoting Cassirer). Incidentally, Cassirer's influence on Mises merits investigation. Mises cites him favorably in

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Human Action for his discussion of polylogism, and his neo-Kantian theory of knowledge has some affinity with Mises's views (see *Human Action*, Scholar's Edition, p. 38).

Unfortunately, governments have proved unwilling to learn the lesson that only the free market works, and Callahan devotes considerable attention to various governmental schemes that aim to "improve" the market but lead only to disaster. I found especially valuable his treatment of the business cycle, which in the Austrian view stems from an overexpansion of bank credit.

Callahan analyzes an objection brought against the theory by the Cambridge economist Piero Sraffa. He "objected to ABCT [Austrian Business Cycle Theory] as stated by Hayek: Why, he asked, couldn't relative wealth changes from the [interest] rate cut drive marginal time preferences down to where the central bank had set the rate?" (p. 216). In other words, the Austrian theory claims that increased bank credit drives the market rate of interest below the natural rate, determined by the extent to which people prefer present goods to future goods. Sraffa suggests that the expansion may lower people's rates of time preference; if so, there would be no gap between the natural and market rates.

Callahan's response is simple and effective: Suppose relative changes in wealth do drive down the rate of time preference. "So could the wealth changes from price-fixing in the egg market just happen to set supply and demand equal. But it would be pure chance and happen very rarely" (p. 216).

This answer parallels Mises's reaction to the inverse objection, raised by Ludwig Lachmann. Sraffa supposes that people's time preferences adjust to the monetary expansion: Lachmann, by contrast, asks, what happens if businessmen fail to use the new money to increase production? Mises's reply was that in this case no cycle would occur. In like fashion, no cycle would be present under Sraffa's hypothesis. Mises's aim was to explain the cycles that did happen; in these instances, no countervailing process blocks the process he sets forward in his theory.[1]

Callahan, following his great predecessors Mises and Rothbard, shows that free-enterprise capitalism meets the demands of consumers better than any competing system. Does this settle matters in favor of capitalism? One might think the answer obvious, but this is to underestimate the extremes to which opponents of the market will go. John Gray, a British political theorist, is a case in point.

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Gray asks, why should satisfaction of consumer preferences matter? The pressure of the market drives people to continual changes in behavior. These changes ignore the values of custom and tradition. Does not the government have the obligation to slow down the mad pace of change?

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[1]Callahan's own excellent discussion of the expectations objection does not mention Mises's reply to Lachmann.

As ever, Callahan stands ready with an effective retort: "And just what will Gray do about those people who might move around willy-nilly if left to their own devices?[2] Why, he must stop them, of course! . . . Gray cannot eliminate the fact that life involves trade-offs and that better opportunities might be available only far from home. He cannot eliminate tough decisions, but he would be happy to make them for you" (p. 296).

Much to my dismay, I found very little in this book to which I could take exception. It seems to me not quite correct to say, "If we are completely satisfied with the way things are at this moment, we have no motivation to act—any action could only make matters worse!" (p. 22). Not dissatisfaction with the present, but discontent with what would be the case if one did not act, is necessary for action. (His uncharacteristic failure to make this distinction lands Mises into theological difficulties at one place in *Human Action*.)

Again, in objecting to the use of experiments in economics, Callahan claims: "Humans, as experimental subjects, do attempt to learn about the experiment, and they modify their behavior based on what they learn" (p. 35). No doubt exactly this happens in many cases, but I cannot see any necessity in this. What rules out a hypothesis that operates regardless of whether people, knowing of it, attempt to thwart it?

I shall close with a more controversial issue, one where to my regret I find myself at odds with most of my fellow Austrians. Callahan adopts the standard Austrian view of this issue: "The uncertainty of the future is implied by the very existence of action. In a world where the future is known with exacting certainty, action is not possible. If I know what is coming and there is no possibility of altering it, there is no point in attempting to do so. If I can act to alter the future, then the future was not certain after all!" (p. 45).

Not only do I know what I shall have for breakfast tomorrow: I also know that Callahan has written an excellent and vitally needed book.

But what if just what I know is coming is that I will act in a certain way? Why cannot I be sure that I will do something, and then do it? Callahan's analysis does not distinguish the case where I know something is coming, regardless of what I do, from a situation in which I know what my own action will be. The fact that I am sure I shall have toast tomorrow for breakfast does not stop me from eating it tomorrow.

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[2] I shall not resist pointing out that "willy-nilly" is misused here.

Democracy's False Prophet

How Democratic is the American Constitution?

Robert A. Dahl
Yale University Press, 2001
x + 198 pgs.

The fame of this book's author baffles me. Professor Robert Dahl, now retired, was long ensconced in the Political Science Department of Yale University. He has somehow acquired a reputation as one of the world's leading theorists of democracy. I am at a loss to know why. True enough, he published in the far-distant past a well-regarded analysis of James Madison's theory of government. But he has done little since except endlessly repeat his belief in unlimited democracy. Even if you agree with his views, what is supposed to be so great about him?

I had hoped to find an answer in the present book. Professor Fred Greenstein of Princeton informs us, "This book is vintage Dahl at the highest possible level. It is lucid . . . [and] acutely analytic." Professor G. John Ikenberry calls Dahl "this country's leading student of democratic theory and practice." (Both are quoted from the dust jacket.) Here if anywhere, I thought, I might find the key to the mystery: the depth of analysis present in the book would at last demonstrate Dahl's transcendent stature.

To my regret, my quest has ended unfulfilled: after reading the book, I still wonder what all the fuss is about. But as always, I am completely fair; the book contains a few good things.

Unlike most of his leftist colleagues, Dahl recognizes the excesses of the U.S. Supreme Court. He thinks that the Court should have the power

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to declare unconstitutional federal laws that violate "fundamental democratic rights." But it must not go beyond this. "For then it becomes an unelected legislative body. In the guise of interpreting the Constitution—or, even more questionable, divining the obscure and often unknowable intentions of the Framers—the high court enacts important laws and policies that are the proper province of elected officials" (pp. 153–54). This is well said,