

Why Austrian Economics Matters

By Llewellyn H. Rockwell, Jr.

In 1954 Joseph Schumpeter wrote, "Economics is a big omnibus which contains many passengers of incommensurable interests and abilities."¹ To put the matter in plainer terms, economists are an incoherent and ineffectual bunch, and their reputation reflects it. Yet it need not be so, for the economist attempts to answer the most profound question regarding the material world.

Pretend you know nothing about the market, and ask yourself the economic question: how can all of society's scarce resources be assembled so as to 1) minimize cost, 2) make use of the talents of every individual, 3) provide for the needs and tastes of every consumer, 4) encourage technical innovation, creativity, and social development, and 5) do all this in a way that can be sustained?

Economics was not invented by Adam Smith, as popular mythology has it. The central questions of economics have concerned the greatest thinkers from Old Testament times to the present.² Today, economic thinking is broken into many diverse schools of thought: the Keynesians, the Post-Keynesians, the Neo-Keynesians, the Classicists, the New Classicists (or Rational Expectations School), the Monetarists, the Chicago Public Choicers, the Virginia Public Choicers, and the ever-expanding subtleties between varying branches of Supply Sideism.

Also part of this mix is the Austrian School. Whereas the mainstream in all its guises is based largely on idealized mathematical models of the economy, to which the government is supposed to make the world conform, Austrian theory attempts to be more realistic. It sees economics as a way to understand the way in which real people cooperate and compete in the process of allocating resources and discovering new and better ways to go about the task of building a prosperous social order. Austrians see entrepreneurship as a critical force in economic development, private property as essential to an efficient use of economic resources, and government intervention as always and everywhere destructive of peaceful cooperation and prosperity.

High Points in the Austrian Tradition. In its 120 year history, the Austrian School has experienced different levels of prominence. It was central to the debate over price theory at the turn of the century, and to the debates over the feasibility of socialism and the cause of the business cycle in the 1920s and 1930s. It fell into obscurity from the 1950s to the mid-1970s, when it was regarded as worthy of mention only in history of thought texts. But since the collapse of socialism and widespread confusion about the current recession, the Austrian School has found itself in another upswing.³

The School dates from the publication, in 1871, of Carl Menger's *Principles of Economics*,⁴ which revolutionized economics by rethinking the source of economic value and price; by creating a new theory of the origin of money as a market institution; and by grounding economics in deductive laws discoverable through the methods of the social sciences.

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He spoke at The Heritage Foundation on December 10, 1991, in the Resource Bank series of lectures featuring leaders of conservative education and public policy organizations.

ISSN 0272-1155. © 1992 by The Heritage Foundation.

Eugen von Boehm-Bawerk was the next important figure in the Austrian School. He developed a sophisticated model of interest rates and capital, showing that the interest rate is determined by the time horizons of the public and that the rate of return on investment tends to equal the rate of time preference. He also dealt a deadly blow to Marx's theory of capital and exploitation.⁵

Boehm-Bawerk's greatest student was Ludwig von Mises, whose first major project was the development of a new theory of money. In *The Theory of Money and Credit*, published in 1912, he elaborated on Menger's theory of the origin of money, showing not only that money had its origin in the market, but there was no other way it could come about. He provided a rigorous argument that money and banking ought to be left to the market and that government intervention can only cause harm.

In that book, he also sowed the seeds of his business cycle theory by arguing that when the central bank artificially lowers interest rates, it causes distortions in the capital-goods sector of the structure of production. He argued that when malinvestments do occur, the inevitable recession is necessary to wash out these bad investments—about which more later.⁶

Along with his great student F.A. Hayek, Mises established the Austrian Institute for Business Cycle Research in Vienna, and he and Hayek generated an enormous number of articles elaborating and defending the idea that the central bank is the source of the business cycles. Their work was the basis for the only effective challenge to Keynes and the Keynesians.⁷

The Mises-Hayek theory became dominant in Europe until Keynes won the day in the late thirties by arguing that the market itself is responsible for the business cycle. In part, Keynes won because his theory—that more government spending, inflation, and deficits were needed—was already being practiced by governments around the world.⁸

At the time of the business cycle debate, Mises and Hayek were also involved in a controversy over socialism. In 1921, Mises had written one of the most important economic articles of the century: "Economic Calculation in the Socialist Commonwealth." Until that essay, there had been many conventional critiques of socialism, but none that challenged the socialists to explain how their economy would actually work without free prices and private property.⁹

Mises argued that rational economic calculation requires a profit and loss test. If a firm makes a profit, it is using resources efficiently, and if it makes losses, it is not. Without such signals, the economic actor has no way to test the appropriateness of his decisions. He cannot assess the opportunity costs of this or that production decision. Prices, and the profit-and-loss corollary, are essential. Mises also showed that private property in the means of production is necessary for these prices to be generated.

Socialism holds that the means of production should be in collective hands. This means no buying or selling of capital goods and thus prices for them. Without prices, there is no profit and loss test, which is necessary for rational accounting methods. Without accounting for profit and loss, there can be no real economy. Should a new factory be built? Under socialism, there is no way to tell. Everything becomes guesswork.¹⁰

Mises's essay ignited a debate all over Europe and America. One top socialist, Oskar Lange, conceded that prices are necessary for economic calculation, but he said that central planners could generate prices out of their own heads, watch the length of lines in stores to determine consumer demand, and provide the signals of production themselves. Mises answered that "playing market" wouldn't work either; socialism would have to fail.

Hayek used the occasion of the calculation debate to broaden the Misesian argument into his own theory of the uses of knowledge in society. He argued that the knowledge generated by the

market process was inaccessible to any single human mind, especially that of the central planner. The millions of decisions required for a prosperous economy are too complex for any one person to comprehend. This became the basis of a fuller theory of the social order that occupied Hayek for the rest of his academic life.¹¹

Mises came to the U.S. after fleeing the Nazis and was taken in by a handful of free-market businessmen. Here he helped build a movement around his ideas, and non-Austrian economists such as Milton Friedman and James Buchanan have acknowledged their debt to him. No one, as Friedman has said, did as much as Mises to promote free markets in this country. But those were dark times. Not only was he unable to get a paid university post, but he could not get a wider audience for his views.

Until the 1970s, it was difficult to find an economist who did not share the Keynesian tenets: that the price system was perverse, that the free market was irrational, that the stock market was frequently overtaken by animal spirits, that the private sector could not be trusted, that government was capable of centrally planning an economy to keep it from falling into recession, that inflation and unemployment were inversely related.

One exception was Murray N. Rothbard, another great student of Mises's, who wrote a massive economic treatise in the early 1960s called *Man, Economy, and State*, an elucidation of Mises's *Human Action*.¹² In his book, Rothbard added his own contributions to Austrian thought, which will be discussed later. Similarly, the work in the theory of capital and entrepreneurship of Israel Kirzner, another influential student of Mises's, helped carry on the tradition, and Henry Hazlitt, then writing a weekly column for *Newsweek* did as much as anybody to promote the School, as well as making contributions himself.¹³

The stagflation of the 1970s undermined Keynesianism by showing that it was indeed possible to have both high inflation and high unemployment at the same time, and the Nobel Prize that Hayek received in 1974 for his business cycle research with Mises caused an explosion of academic interest in the Austrian School. A new generation of graduate students began studying the work of Mises and Hayek, and that research program continues today.

The Relevance of Austrian Theory. Austrian theory, as was pointed out earlier, takes a realistic view of the world. It says that man is constantly faced with a wide array of choices. Every action implies forgone alternatives or costs. And every action, by definition, is designed to improve the actor's lot from his point of view. Moreover, every actor in the economy has a different set of values and preferences, different needs and desires, and different time schedules for the goals he intends to reach.

The needs, tastes, desires, and time schedules of different people cannot be added to or subtracted from other people's. It is not possible to collapse tastes or time schedules onto one curve and call it consumer preference. Why? Because economic value is subjective to the individual.

Similarly, it is not possible to assume that the economy's capital stock is one big blob summarized by the letter "K," to be put into an equation. The capital stock is heterogeneous. Some capital may be intended to create goods for sale tomorrow and others for sale in ten years. The time schedules for capital use are as varied as the capital stock itself.

Austrian theory sees competition as a process of discovering new and better ways to organize resources, one that is fraught with errors but that is also constantly being improved. This way of looking at the market is radically different from every other school of thought. Since Keynes, economists have developed the habit of constructing parallel universes that have nothing to do with the real world. Capital is represented by a single letter. Competition is a static end state with the "right" number of sellers, prices reflecting the costs of production, and no "excess" profits.

Economic welfare is determined by adding up the utilities of all individuals in society. The passing of time is rarely accounted for, except in changing from one static state to another. Varying time schedules of producers and consumers are nonexistent. Instead, we have the useless concepts of aggregate demand and aggregate supply.

A mainstream economist is quick to point out that these models are indeed unrealistic, ideal types to be used as mere tools of analysis. But this is disingenuous, since these same economists use these models for policy recommendations.

One obvious example of policy based on contrived models takes place at the Justice Department's antitrust division. There the bureaucrats pretend to know the proper structure of industry, what kind of mergers and acquisitions harm the economy, who has too much market share or too little, and what the relevant market is. This represents what Hayek called the pretense of knowledge. The correct relations between competitors can only be worked out through buying and selling, not bureaucratic fiat.

Austrian economists, in particular Rothbard, argue that the only real monopolies are created by government. Markets are too competitive to allow real monopolies to be sustained.¹⁴

Another example is the idea that economic growth can be manufactured by manipulating aggregate demand curves through more and faster government spending—considered to be a demand booster instead of a supply reducer—or government bullying of the consuming public. The classic case occurred just the other day, with President Bush and his \$28 worth of socks.

If the hallmark of mainstream economics is unrealistic models, the hallmark of Austrian economics is its profound appreciation of the price system. Prices provide economic actors with critical information about the relative scarcity of goods and services. It is not necessary that a consumer know, for example, that a disease has swept the chicken population to know that he should economize on eggs. The price system, by making eggs more expensive, informs us of the appropriate behavior. The price system tells producers when to enter and leave markets, by relaying information about consumer preferences. And it tells producers the most efficient—that is, the least costly—way to assemble other resources to create goods. Apart from the price system, there is no way to know these things.

But prices must be generated by the free market. They cannot be made up the way the Government Printing Office makes up the prices for its publications. They cannot be based on the costs of production in the manner of the Post Office. Those practices create distortions and inefficiencies. Rather, prices must grow out of the free actions of individuals, and only free-market prices, unconstrained by government, can properly coordinate the actions of individuals.

Mainstream price theory, as found in most graduate level texts, covers much of this territory. But typically, it takes for granted the accuracy of prices apart from their foundation in private property. As a result, virtually every op-ed on reforming the ex-Communist economies talks about the need for better management, loans from the West, new and different forms of regulation, and the removal of price controls. But not private property. Yet free-floating prices cannot do their work apart from private property and the concomitant freedom to contract.

Austrian theory sees private property as the first principle of a sound economy. Most mainstream economists neglect the subject, and the few times they mention it, it's in the context of philosophically justifying its violation.

The issue of market failure, and its public goods corollary, is universally accepted by non-Austrian schools of thought. The notion of public goods is that they cannot be supplied by the market, and instead must be provided by government and funded through its taxing power. The

classic case is the lighthouse, except that, as the new Nobel laureate Ronald Coase has shown, private lighthouses have existed for centuries.

Austrians point out that it is impossible to know whether or not the market is failing without an independent test, and there is none. The market is the only available criterion for determining how resources ought to be used.

Let's say I deem it necessary that there be one free-market think tank per 1,000 Americans, and as I look around, I notice this is not the case. So the National Endowment for Free-Market Think Tanks should be created to subsidize such institutions.

In fact, the only way I can know how many free-market think tanks ought to exist is through the market. If more don't exist, and there are no government barriers, I can assume that they should not exist in present circumstances. It is not economically proper to develop a wish list of goods that stands apart from the market.

Externalities. The area of negative and positive externalities is fraught with danger as well. Conventional economics argues that if the benefits or costs of one person's economic decisions spill over onto others, an externality exists, and it ought to be corrected by the government through redistribution. But broadly defined, externalities are inherent in every economic transaction because costs and benefits are subjective. I may be delighted to see factories emitting smoke because I love industry. But that does not mean I should be taxed for the privilege of viewing them. Similarly, I may be offended that most men don't have beards, but that doesn't mean that the clean-shaven ought to be taxed to compensate me for my displeasure.

The Austrian School redefines externalities as occurring only with physical invasions of property, as when my neighbor dumps trash in my yard, and then it is simple crime. There can be no value-free adding up of utilities to determine subjective costs or benefits. Instead, the relevant criterion should be whether economic action occurs in a peaceful manner.¹⁵

Another area Austrians differ from the mainstream is over how exactly the government is supposed to correct "market failures." Grant that the government can spot a market failure. The burden of proof is still on the government to demonstrate that it can perform the task more efficiently than the market. Instead of worrying about non-existent "market failure," Austrians are concerned with the broad and growing area of government failures.

But the failure of government to do what mainstream theory says it can is not a popular subject. Outside of the Public Choice schools, it is usually assumed that the government is capable of doing anything it wants to do, and doing it well. Forgotten is the nature of the state as an institution with its own pernicious designs on society. One of the many contributions of Rothbard was to focus Austrian thought on the nature of the state and the likely patterns its interventions will take. He developed a typology of interventionism and provided detailed critiques of many kinds of interventions and their consequences.

The question is often asked, in Buchanan's famous phrase, "What Should Economists Do?"¹⁶ Mainstreamers answer, in part, "forecast the economic future." Forecasting has in fact become the religion of modern economics, witness the motto of econometricians, "Science Is Prediction." This is true in the natural sciences, because rocks and sound waves do not make choices. But economics is a social science, which deals with people who make choices, respond to incentives, change their minds, and even act irrationally.

Austrian economists realize that the future is always uncertain, not radically so, but largely so. Human action in an uncertain world with pervasive scarcity poses the economic problem in the first place. We need entrepreneurs and prices to help overcome uncertainty, although it can never be done completely.

Forecasting the future is the job of entrepreneurs, not economists. This is not to say that Austrian economists cannot expect certain consequences from particular government policies. For example, we know that price ceilings set below the market always and everywhere create shortages, and we know that expansions of the money supply through the central bank lead to general price increases and the business cycle. But we cannot know the time and exact nature of these expected events.¹⁷

One final area of theoretical concern that distinguishes Austrians from the mainstream is economic statistics. Austrian economists are critical of most existing statistical measures of the economy. They are also critical of the uses to which they are put. Take, for example, the question of price elasticities, which allegedly measure consumer responsiveness to price changes. If the price goes up and consumers continue to buy at the same rate, it is said that the elasticity of the demand curve is vertical. If they stop buying, it is said that the elasticity of the demand curve is horizontal. All this suggests that elasticities exist independent of human action, that they are moving parts of a large machine. But such measures of historical consumer behavior do not constitute economic theory.

Another example of a questionable statistical technique is the use made of the index number, the prime means by which the government calculates inflation. The problem is that index numbers obscure relative price changes between goods and industries, and relative price changes are of prime importance. This is not to say the Consumer Price Index is irrelevant, only that it is not the solid indicator we are supposed to think it is, and that it can be subject to abuse.

The Gross National Product is riddled with the fallacies inherent in the Keynesian model on which it is based. Government spending is considered part of aggregate demand, and no effort is made to account for the destructive costs of taxation, regulation, and redistribution.

If Austrians had their way, the government would never collect another economic statistic. Such data is used to attempt to plan the economy.



Austrian Economics and Public Policy. It would be impossible to cover all the distinctive Austrian critiques of modern economic policy in this talk, but I would like to attempt an overview.

Economic regulation is a huge category, encompassing hundreds of government agencies. It is always destructive of prosperity because it misallocates resources and subverts entrepreneurship.

Environmental regulation has been among the worst offenders in recent years. Nobody can calculate the extraordinary losses that will be associated with the Clean Air Act, and the absurdities associated with wetlands policy, by which private property is indiscriminately taken for public use, are well known. Austrians would support the recent efforts to force the government to abide by the takings clause of the Constitution.

Environmental policy can do what it is explicitly intended to do: lower standards of living. But antitrust policy, in contrast to its stated purpose, does not generate competitiveness. Such bogeymen as predatory pricing still scare the bureaucrats at Justice, whereas simple economic analysis can refute the idea that a competitor can sell below his cost of production to take over the market, and then sell at monopoly prices later. Any firm that attempts to sell below its costs of production will have to indefinitely suffer losses. The moment it attempts to raise prices, it invites competitors back into the market. In the meantime, consumers benefit from the low prices.¹⁸

Civil rights legislation is the worst present regulatory intervention in labor markets. Business is spending more time worrying about lawsuits from disgruntled victim groups than in making a profit. When employers are not able to hire and fire, promote and demote, on their own criterion of merit, dislocations occur within the firm. Moreover, civil rights legislation, which creates legal preferences for some groups over others, undermines the sense of fairness that the market creates.

Kirzner points out another cost of economic regulation: it impedes the entrepreneurial discovery process.¹⁹ This process is based on having a wide array of alternatives open to the use of capital. It is most effective when artificial barriers to entry do not exist. Yet government regulation limits the options of entrepreneurs and erects barriers to the exercise of entrepreneurial talent. Price ceilings and floors are the most obvious example, but the same is true of safety, health, and labor regulations. Not only do these regulations inhibit existing production, they impede the development of better production methods in the future.

Austrians have developed impressive critiques of redistributionism. Conventional welfare theory argues that if the law of diminishing marginal utility is true, then total utility can be easily increased. If you take a dollar from a rich man, his welfare is slightly diminished. But that dollar is worth less to him than it would be to a poor man. Thus redistributing a dollar from a rich man to a poor man increases the total utility between the two. The implication is that welfare can be maximized through greater income equality. The problem with this, say Austrians, is that utilities cannot be added and subtracted from each other since utility is subjective.

Redistribution takes from property-owners and producers and gives, by definition, to non-property owners and non-producers. This diminishes the value of the property that has been redistributed. Far from increasing total welfare, redistributionism diminishes it. By making property and its value less secure, income transfers take away the advantage of ownership and production, and thus create disincentives to both.

Austrians reject the use of fiscal policy to stimulate the economy or otherwise manipulate economic activity. Increasing taxes, for example, can do nothing but harm an economy. A shorthand for taxes is wealth destruction. They confiscate property that could otherwise be saved or invested, thus diminishing the number of consumer options available. Moreover, there is no such thing as a consumer tax. All taxes are ultimately taxes on production.

Austrians do not go along with the notion that deficits don't matter. In fact, the requirement that deficits be financed by the public or foreign bond holders drives up interest rates and thus crowds out potential private investment. Deficits also create the danger that they will be financed through central bank inflation. The answer to deficits is not increased taxation, which is more destructive than deficits, but balancing the budget through spending cuts. Where to cut? At this stage in history, anywhere and everywhere.

The ideal situation, however, is not simply a balanced budget. Government spending itself, regardless of deficit or surplus, should be as small as possible. Why? Because such spending has distortionary effects on private production. It diverts resources from better uses in private markets.

In Washington, we hear lots of talk about this or that "government investment." Austrians reject this term as an oxymoron. Real investment takes place when capitalists risk their own money in hopes of satisfying future consumer demands. Government limits the satisfaction of consumer demands by hampering production in the private sector. Besides, government investments are notorious wastes of money, and are in fact consumption spending by politicians and bureaucrats. The government cannot know what future technologies are needed by consumers. Often we hear that this or that project must be funded by government since it is too costly to be funded in the

private sphere. But the fact that private investors aren't likely to fund something is pretty good evidence that it need not be funded.

Money and Banking. Now we come to the question of monetary policy and the structure of the banking industry. Mainstream economists hold that the government must control both, through central banking, banking cartels, deposit insurance, and a flexible fiat currency. Austrians reject this entire paradigm and argue that all are better controlled through private markets. In fact, to the extent that we have serious, radical proposals for making the market play a greater role in banking and monetary policy, it is due to the Austrian School.

Deposit insurance has been on the public mind with the collapse of the S&L industry and the ongoing fall of the banking industry. But why should the cause of these things be a mystery? The government guarantees deposits and loans with taxpayers' money, making financial institutions careless. The government effectively does to the financial institution what a permissive parent does to a child: encourage poor behavior by eliminating the threat of punishment.

Austrians would eliminate government deposit insurance, forcing banks to be more careful with the money deposited with them. Austrians would not only allow bank runs to occur, they would see their potential as a necessary check on the banking industry. The threat of angry depositors lining up for their money discourages profligacy. There would be no lender of last resort in an Austrian monetary regime to bail out bankrupt, illiquid institutions.

Much of the Austrian critique of central banking centers around the Mises-Hayek business cycle theory. The central bank, and not the market itself, is responsible for the cyclical behavior of business activity. And to demonstrate the theory, Austrians have undertaken extensive studies of many historical periods of recession and recovery to show that each was preceded by central banking machinations.

The theory argues that central bank efforts to lower interest rates below their natural level causes borrowers in the capital goods industry to overinvest. A lower interest rate is normally a signal that consumers have new savings to back up new production. That is, if a producer borrows to build a new building, there is enough savings for consumers to buy the goods and services made in the building. Thus, projects undertaken can be sustained. But artificially lowered interest rates fool businesses into undertaking unnecessary projects. This creates an artificial boom that is always followed by a bust once it becomes clear that savings weren't high enough to justify the higher degree of expansion.

The Austrian critique of the monetarist growth rule points to the so-called injection effects of even the smallest artificial increase in money and credit. Such injections will always create this business cycle, even if they work to maintain a relatively stable price level as during the 1920s and 1980s.

What then should policy makers do when the economy enters a recession? Mostly, nothing. It takes time to wipe out the malinvestment created by the credit boom so the market can re-equilibrate. Projects that were mistakenly undertaken have to go bankrupt, employees mistakenly hired must lose their jobs, and the wage level must shift downward. After the economy is cleansed of the bad investment induced by the central bank, then growth can begin anew on a solid foundation of a realistic assessment of the future behavior of consumers.

If the government wants to make the recovery process work at a faster rate—say there is an election coming up—it can dramatically cut taxes, putting more wealth into private hands to fuel the recovery. It can weaken or eliminate regulations that inhibit private sector growth. It can lower spending and reduce the demand on credit markets. It can slash tariffs and quotas to allow consumers to buy new goods at cheaper prices.

Central banking also creates incentives toward inflationary monetary policies. It is not a coincidence that since the creation of the Federal Reserve the value of the dollar has declined so much. The market is not responsible. The culprit is a central bank whose institutional logic drives it toward an inflationary policy just as a counterfeiter is driven to keep his printing machines running.²⁰

Austrians would reform all this in two ways. Broadly speaking, Misesians advocate a 100% gold standard without a central bank, and Hayekians support a free banking system where consumers choose their preferred currency. My own preference is the gold standard, but either would represent a vast improvement, removing monetary policy as a tool of government management, insuring a sound currency, and subjecting now-privileged banks to the discipline of the market.²¹

Future of the Austrian School. I said earlier that Austrian economics is on the upswing. Mises's and Hayek's work is being distributed all over Eastern Europe and the Soviet Union. There is new interest in the United States as well, where the insights of the Austrian School are just as needed, and I believe that the work of the Ludwig von Mises Institute, now ten years old, can testify to this new interest.

It was the founding purpose of the Mises Institute to ensure that the Austrian School be a major force in economic debate. To this end, we have cultivated professional economists and provided scholarly and popular outlets for their work, educated hundreds of graduate students in Austrian theory, and sought to teach the general public as well.

Every year we hold scholarly conferences and a week-long instructional seminar, at which we offer courses on all levels and in all fields within the Austrian tradition, taught by a large faculty. The quality of students—undergraduates and graduate alike—continues to improve every year. Kluwer Academic Publishers publishes our scholarly journal, *The Review of Austrian Economics*, the major outlet for new scholarship in the Austrian tradition, as well as our book series, "Studies in Austrian School Economics." We publish books and monographs ourselves and distribute other Austrian publications. We provide scholarships for graduate students who want to teach, and our *Free Market* and *Austrian Economics Newsletter* reach the public and students.

Many of our former students are now teaching and influencing a new generation. New books on the Austrian School are appearing at a break-neck speed, and such younger stars as Walter Block at Holy Cross College, Roy Cordato at IRET, Richard Ebeling at Hillsdale College, Roger Garrison at Auburn University, Jeffrey Herbener at Washington and Jefferson College, Hans-Hermann Hoppe at the University of Nevada, Las Vegas, Yuri N. Maltsev at Carthage College, Joseph T. Salerno at Pace University, George Selgin at the University of Georgia, and Mark Thornton of Auburn University to name just a few—are doing important work on business cycles, interest rates, capital, utility, banking, financial markets, history, and much more.

The future of the Austrian School appears bright. If we are to reverse the statist trend in this country, and reestablish a free market, new scholars and new scholarship are critically important. We are helping provide them. Ideas, after all, are history's driving force. *That* is why the economics of the Austrian School matters.

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Endnotes

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