HISTORY OF ECONOMIC THOUGHT

Lecture Notes for Week 5

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Austrian School and its Neighborhood

From the Marginalist revolution, three branches of neoclassical economic thought began to develop: the Austrian School, initiated by Carl Menger; British economics, influenced by William Stanley Jevons at University College London and the pivotal work of Alfred Marshall at Cambridge; and the development of the Theory of General Equilibrium, pioneered by Léon Walras at the University of Lausanne in Switzerland.

Let us highlight once more some differences between classical and neoclassical thinking:

- **Classical thinking:**
    - Focuses on the continuous functioning of an economic system based on the division of labor,
    - Seeks equilibrium that equalizes sector profit rates,
    - Views prices as indicators of an objective value,
    - Believes that income distribution reflects the power relations among classes.
- **Neoclassical thinking:**
    - Concentrates on the optimal utilization of scarce resources to meet the desires of economic agents,
    - Seeks equilibrium between demand and supply in markets,
    - Views prices as indicators of a subjective value,
    - Attributes income distribution to the pricing of factors of production.

This chapter summarizes the development of the Austrian school, and the next chapter discusses the development of neoclassical thought in the Anglo Saxonian world.

General background: The Belle Époque, which translates to "Beautiful Era," refers to a period in European history that began in the late 19th century and lasted until the outbreak of World War I in 1914. This era was characterized by significant cultural, economic, and technological progress, particularly in Western Europe. It was a time of relative peace, prosperity, and optimism, marked by advancements in the arts, sciences, and industry. Economically, the era was defined by prosperity and industrial growth, which led to improved standards of living for many, though not for all. Technological advancements, such as the expansion of railways, the invention of the telephone, and the popularization of electricity, contributed to the modernization of society. Austria also benefited from the positives of this era.

The Belle Epoque was interrupted by World War I, known as the Great War, that lasted from 1914 to 1918 and involved major world powers divided into the Allies and the Central Powers. Triggered by the assassination of the Austrian Archduke Franz Ferdinand, the war featured brutal trench warfare and new military technologies, leading to massive casualties. The conflict resulted in the collapse of several empires, including the Austro-Hungarian, Ottoman, Russian, and German empires. It concluded with the Treaty of Versailles in 1919, which imposed severe penalties on Germany, left Germany resentful and set the stage for future tensions.

The interwar period (1918-1939) was marked by political and economic turmoil. After World War I, Europe struggled with reconstruction. The "Roaring Twenties" brought temporary economic recovery, but the Great Depression in 1929 caused global hardship and unemployment. This instability led to the rise of totalitarian regimes like Nazi Germany and Fascist Italy. Efforts to maintain peace failed, with escalating tensions such as Japan's invasion of Manchuria and the Spanish Civil War, ultimately paving the way for World War II.

World War II (1939-1945) was a global conflict involving the Allies and the Axis powers. It began with Germany's invasion of Poland and expanded worldwide after Japan attacked Pearl Harbor, prompting U.S. entry. Key events include the Holocaust, major battles like Stalingrad and D-Day, and the use of atomic bombs on Hiroshima and Nagasaki.

The war ended in 1945 with the surrender of Germany and Japan. It caused an estimated 70-85 million deaths.

The period after World War II, beginning in 1945, was characterized by significant geopolitical, economic, and social changes. The United States of America and the Soviet Union emerged as superpowers, leading to the Cold War, a period of political tension and arms race but without direct military conflict. This era saw the division of Europe by the Iron Curtain and conflicts such as the Korean and Vietnam wars. Economically, the post-war period saw rapid recovery and growth, especially in Western Europe and Japan, aided by U.S. initiatives like the Marshall Plan. This era also witnessed decolonization, with many African and Asian countries gaining independence from European powers. Socially, there were significant movements for civil rights and social justice, particularly in the United States. The establishment of the United Nations aimed to foster international cooperation and prevent future conflicts, while the world gradually shifted towards globalization and technological advancement over the following decades.

Until the World War I, Austria had been a big multicultural empire. After the war, the empire divided into many national states.

During the Belle Époque, Austria generated a lot of economists, philosophers, and social scientists, who were typically linked by personal ties and who contributed significantly to their respective fields. Notable figures included:

- Sigmund Freud: The father of psychoanalysis, born in Pribor, Bohemia. Freud's revolutionary ideas on the unconscious mind and human psychology were developed during his time in Vienna.
- Ludwig Wittgenstein: A prominent philosopher who influenced the fields of logic, language, and the philosophy of mind, Wittgenstein was born in Vienna and developed much of his early thought in the city.
- Edmund Husserl: born in Prostejov, Bohemia. A prominent philosopher, widely regarded as the founder of phenomenology.
- Karl Popper: Although his most productive years came later, Popper, originally from Vienna, was beginning to form his critical rationalist philosophy during this period.

Austrian School

The Austrian School of Economics originated in Vienna in the 19th century with the work of Carl Menger, particularly his 1871 book *Principles of Economics.* His students, Friedrich von Wieser and Eugen von Boehm-Bawerk, comprised the first generation of this school. Key later figures are Ludwig von Mises and Friedrich von Hayek. After World War I, it seemed that the ideas of this school were being absorbed into mainstream neoclassical thinking, leading to the perception that the school was disappearing. Despite this, after World War II, the school experienced a revival in the Neo-Austrian School, represented by Israel Kirzner and Murray Rothbard.

Summary of the principles on which the Austrian School is based:

- Methodological Individualism: Explanations are based on the behavior of individuals.
- Political Liberalism: Advocates for free markets and laissez-faire economic policies.
- Market as a Process: Emphasizes the dynamic nature of markets, viewing the search for market equilibrium as unproductive.

- Decision-Making under Uncertainty: Recognizes that people make decisions under conditions of true uncertainty; even the risk cannot be calculated in the most of decisions.
- Unintended Consequences of Human Actions: Acknowledges that human actions often have unexpected outcomes.
- Subjective Value Theory: Values are subjective and vary from person to person.
- Criticism of Scientism (Positivism, Empiricism): Challenges the belief that the methods of the natural sciences are the most authoritative or the only valid ways to understand the world, advocating for the recognition of other methodologies in philosophy, religion, social sciences, and the humanities.
- Criticism of Mathematical Methods: Questions the application of mathematical methods to economic analysis.

Carl Menger (1840 – 1921) was presented already as one of the key figures of the Marginalist Revolution.

Friedrich von Wieser (1851 – 1926) was member of the first generation of the Austrian School of Economics. As a student of Carl Menger, he became his direct follower and collaborator. In 1903, he succeeded Menger to the economic chair at the university of Vienna. His basic book is *Origins and Fundamental Laws of Economic Value* (1884).

- He was the first economist which used the term “marginal utility“ (Grenznutzen).
- He coined the term "opportunity cost”, which describes the value of the next best alternative foregone in making a choice.
- Costs of production are sacrifice of the utility that could have been obtained through a different use of factors of production. In other words: costs of production are subjective opportunity costs, derived from entrepreneurs’ evaluation of different uses of the factors of production.
- He made substantial contribution to the theory of imputation, which deals with the distribution of value among the factors of production. Let us take his example:
  - We have three commodities with prices 300, 900, 1700.
  - We have three factors of production with yet unknown prices X, Y, Z.

- Amounts of factors of production for one unit of:
    - Commodity 1: $X + Y = 300$,
    - Commodity 2: $6X + Z = 900$,
    - Commodity 3: $4Y + 3Z = 1700$.
- We have three equations with three unknowns, so we can calculate the imputed value of factors of production as: $X = 100$, $Y = 200$, $Z = 300$.

Eugen von Boehm-Bawerk (1851–1914) was member of the first generation of the Austrian School of Economics. Friedrich von Wieser was his fellow student and later became his brother-in-law. Boehm-Bawerk studied in Germany under economists of the Old German Historical School. He served as a professor of political economy in Innsbruck from 1880 to 1889 and was thrice Minister of Finance in the Austro-Hungarian Monarchy. Since 1904, he was professor of political economy at the University of Vienna.

His basic book is *Positive Theory of Capital* (1914), where he presented his theory of capital and interest rate. He used the concept of the "average period of production" He viewed capital as an intermediary input that enables more productive and extensive production processes over time.

The average period of production refers to the time span between the initial investment in production and the final output being available for consumption. According to Boehm-Bawerk, more roundabout (i.e., capital-intensive and time-consuming) production methods tend to result in greater productivity and higher output. This increased productivity is possible because capital allows for more sophisticated production techniques, which can yield higher returns over time. Let us cite:

„It is that a greater result is obtained by producing goods in roundabout ways than by producing them directly. Where a good can be produced in either way, we have the fact that, by the indirect way, a greater product can be got with equal labor, or the same product with less labor . . . That roundabout methods lead to greater results than direct methods is one of the most important and fundamental propositions in the whole theory of production. "

Boehm-Bawerk's theory emphasizes the importance of the time element in capital investments, arguing that interest rates emerge as a natural compensation for the deferment of consumption. Essentially, an investor will require compensation for postponing the use of resources, which they could otherwise consume immediately, and this compensation is reflected in the interest received from lending those resources.

Boehm-Bawerkˇs theory was later used and elaborated by the Swedish economist Knut Wicksell and Friedrich von Hayek. Carl Menger considered it to be erroneous. Further critics of the theory have pointed out challenges in measuring the actual "average period of production" and have debated its applicability in complex, modern economies. Criticism led finally to the abandonment of this research program.

Ludwig von Mises (1881 – 1973) was member of the second generation of Austrian economists. He was born in n Lemberg, which was then part of the Austro-Hungarian Empire. Today, the city is known as Lviv and is in Ukraine. He studied at the University of Vienna and stayed in Vienna until 1934. From 1934 to 1940, he was professor at the Graduate Institute of International Studies in Geneva, Switzerland. Since 1940, he lived in the USA. From 1945 to 1969, he was a visiting professor at the New York University.

He was one of the co-founders of the Mont Pelerin Society in 1947, together with Friedrich von Hayek, Karl Popper, Milton Friedman, and others. Mont Pelerin Society is an international organization of economists, philosophers, historians, and other intellectuals. The society was established to promote classical liberalism and to provide a forum for discussing ideas related to free markets, individual liberty, and limited government. It takes its name from Mont Pèlerin, near Vevey, Switzerland, where the first meeting was held. The society played a crucial role in reviving liberal economic thought in the mid-20th century and has been influential in shaping economic policies favoring market-oriented reforms around the world. Its members include several Nobel laureates in economics: Hayek (1974), Friedman (1976), George Stigler (1982), James M. Buchanan (1986) and Ronald Coase (1991).

Mises´s article *Economic Calculation in the Socialist Commonwealth* (1920) started a years long debate with the economists of socialist inclination. His book *Liberalism*, first published in 1927, is a defense of classical liberal ideals, emphasizing the principles of individual liberty, private property, free markets, and limited government. In this work, Mises argues that these principles are essential for achieving peace, prosperity, and social harmony. He criticizes both socialism and interventionist policies, asserting that government interference in the economy leads to inefficiencies and undermines individual freedom. Through logical reasoning and analysis, Mises makes the case that a liberal economic order not only fosters economic growth but also supports a just and peaceful society. Let us present some of his ideas, topics and positions from chapter 2 – "On Liberal Economic Policy":

- Liberalism is derived from the pure sciences of economics and sociology.
- Mises analyzes Capitalism, Socialism, Interventionism, Syndicalism.
- Socialism, Interventionism and Syndicalism bring periodic confiscation of all wealth and its subsequent redistribution.
- Private property sets limits to the operation of the authoritarian will.
- In a capitalist society, means of production are owned by those best fitted for it.
- A liberal government is a "contradictio in adjecto" (a contradiction in terms).
- Governments consider opposition to private property to be correct in principle.
- It is easy for the government to incite the masses against the owners of land and capital.
- Governments must be forced into liberalism by the power of the opinion of the people.
- He is against government interventionism – e.g. price controls, fixing of minimum wages and protectionist trade policy.
- He is against trade unions.
- He mentions that Johan Wolfgang Goethe pronounced the system of double-entry bookkeeping "one of the finest inventions of the human mind".
- Economic calculation must be based on monetary calculation.
- Monetary calculation suffices if the monetary system is sound.
- Monetary calculation constitutes an important tool of the capitalist entrepreneur.
- State enterprises can flourish side by side with private ownership of the means of production.
- Genuine monopolies can be established only by control of land or mineral resources.
- National monopolies are the product of antiliberal economic policies.
- Bureaucratization of big business is the necessary consequence of interventionism.
- The judgment of the activity of public officials is a matter of subjective opinion.

His *Human Action: A Treatise on Economics*, first published in 1949, is a comprehensive work in which Mises presents economics as a deductive science based on the axiom that humans engage in purposeful behavior to achieve desired ends. He argues against empirical and mathematical approaches in economics, emphasizing the importance of understanding the logic of human choices and actions. *Human Action* encompasses a wide range of topics, including the role of entrepreneurship, the functioning of markets, and the consequences of government intervention. The book is considered a cornerstone of the Austrian School of Economics and remains influential in the study and promotion of free-market economics.

Ludwig von Mises outlines in this book the principles of praxeology, or the study of human action. Human actions are oriented toward the future. All social sciences analyze human actions and, as such, are part of praxeology. Research oriented to the past is covered by history. In fact, instead of the standard classification of social sciences, he suggests a different classification into praxeology and history. He proposes calling that part of praxeology that analyzes human economic actions "Catallactics" (from the Greek for "to exchange") instead of "Economics" (from the Greek for "household management").

Ludwig von Mises's theory of business cycles, also known as the Austrian Business Cycle Theory, is centered around the effects of artificially low interest rates, or "cheap money," created by central banks. According to Mises, when central banks lower interest rates below their natural equilibrium level, it leads to an excessive expansion of credit. This easy access to cheap money encourages businesses to invest in capital-intensive projects that would not have been undertaken at higher, market-determined interest rates.

These malinvestments create an artificial boom, characterized by unsustainable economic expansion and asset bubbles. Eventually, as reality sets in and resources become scarce, the boom leads to a bust. The necessary reallocation of resources causes a recession or depression, as the economy adjusts to the actual preferences and resources available.

Mises argued that such cycles of boom and bust are inevitable under a system of monetary intervention, and the only way to prevent them is to maintain sound monetary policies that do not artificially manipulate interest rates. This theory highlights the dangers of central banking practices that distort the natural signals and functions of the market.

Friedrich August von Hayek (1899 – 1992) was member of the second generation of Austrian economists. He studied at the University of Vienna, where von Wieser and von Mises were among his teachers. In 1927, he became the director of the newly established "Austrian Institute for Business Cycle Research". In 1931, he moved to the London School of Economics (LSE). From 1950 to 1962 he was professor at the University of Chicago's Committee on Social Thought. During his time there he focused more on philosophical and interdisciplinary work, reflecting the Committee's broad approach to social sciences and humanities. From 1962, he was affiliated with both Freiburg in Germany and Salzburg in Austria. Hayek shared the 1974 Nobel Prize in Economic Sciences with the Swedish economist Gunnar Myrdal for his "pioneering work in the theory of money and economic fluctuations and ... penetrating analysis of the interdependence of economic, social, and institutional phenomena".

His main economic writing is *Prices and Production* (1931). It contains the lectures he gave at the LSE in 1931. In this book, Hayek elaborates the Austrian Business Cycle Theory. His approach was criticized by Cambridge economists which were developing another explanation of fluctuation in that time.

His important later works are:

- *Collectivist Economic Planning* (1935) is a book edited by Friedrich von Hayek. It is a collection of essays that criticizes the economic feasibility and efficiency of central planning under socialism. The book brings together contributions from prominent economists of the Austrian School and other critics of socialist planning, including essays by Hayek himself. The central argument of the book is that central planning is inherently inefficient because it lacks the essential information conveyed by price signals in a market economy. Without market-determined prices, planners cannot efficiently allocate resources, leading to misallocation and waste. The contributors argue that decentralized decision-making, informed by individual knowledge and price signals, is crucial for an efficient economy. The book engages with the socialist calculation debate initiated by Ludwig von Mises.
- *The Road to Serfdom* (1944) is a seminal work that warns against the dangers of government overreach and centralized economic planning. In this book, Hayek argues that

efforts to control economic life through central planning inevitably lead to the erosion of individual freedom and the rise of totalitarianism.

- *The Use of Knowledge in Society* (1945) is a pivotal essay exploring how knowledge is distributed in an economy and how it is utilized in decision-making processes. In this work, Hayek argues that knowledge is decentralized, dispersed across countless individuals, each possessing unique information about local conditions and specific circumstances. Hayek underscores the importance of the price system as a mechanism for communicating this dispersed knowledge. Prices reflect the supply and demand for goods and services, allowing individuals to make informed decisions without needing complete information about the entire economy. Through price signals, consumers and producers can adjust their behaviors, leading to efficient resource allocation. The equilibrium in this system is dynamic and is understood as the harmony among individual actions.
- *Law, Legislation and Liberty* (1973 – 1979). is a three-volume work by Hayek that explores the philosophical and legal foundations of a free society. Hayek distinguishes between spontaneous orders, like social rules, which arise naturally from social practices, and constructed orders, like legislation, which are deliberately designed. He argues that rules should evolve organically to facilitate coordination without dictating outcomes. In criticizing "social justice", Hayek contends that its subjective nature undermines a free society, as attempts at enforced distributive justice through legislation lead to centralization of power and loss of freedoms. He also addresses the limitations of democracy, cautioning against the excesses of majority rule, and suggests constitutional safeguards to protect individual liberty from government overreach.

Methodological differences with Ludwig von Mises:

- Ludwig von Mises used Apriorism, which means:
    - Theories are developed from a priori assumptions,
    - Stress on reason in formulating assumptions,
    - Assumptions formulated in this way cannot be in principle falsified by experiences.

- Friedrich von Hayek used Falsificationism, the philosophy of science developed by his friend from the LSE Karl Popper. This philosophy stresses the importance of experiences for the falsification of theories.

Neighborhood of the Austrian School

Max Weber (1864 – 1920) can be assigned to the German Historical School. He was professor of political economy in Freiburg and Heidelberg (Germany). He is widely regarded as one of the founding figures of sociology.

One of his most influential works is *The Protestant Ethic and the Spirit of Capitalism* (1905), in which he explores the relationship between the rise of capitalism and Protestant ethics, particularly Calvinism, arguing that religious values played a vital role in developing the modern capitalist mindset. Moreover, the doctrine of predestination in Calvinism, which posited that one's salvation was predetermined, led believers to seek signs of their "elect" status. Economic success was interpreted as a sign of divine favor, encouraging individuals to engage in disciplined and rational economic activity.

In 1919 he gave a lecture *Politics as Vocation* that was later published as an essay. This lecture remains significant in political science for its insights into the ethical and practical dimensions of political leadership. Weber defines here the state as an entity with the monopoly on the legitimate use of force and examines the nature of political leadership. He distinguishes between politicians who live for politics, serving it as a calling, and those who live off politics, using it for personal gain. He highlights the need for politicians to balance the "ethic of conviction" with the "ethic of responsibility".

Economy and Society, published posthumously in 1922, is his fundamental work that significantly shaped sociology. The book examines social structures and institutions, introducing Weber's typology of authority: traditional, charismatic, and rational-legal. It explores how these forms of authority influence social organization. Weber analyzes various institutions—religious, economic, legal, and political—and their interactions within societies. He is particularly noted for his study of bureaucracy, highlighting its efficiency and potential drawbacks. The work also addresses themes like rationalization and the influence of values on social science.

Weber´s methodology was based on “ideal types”, analytical constructs used in social science to understand and compare social phenomena. They are not meant to represent reality directly but serve as a conceptual tool to highlight essential characteristics of a certain phenomenon by presenting a simplified, exaggerated, and clear-cut version of it. By comparing real-world examples to these idealized models, researchers can better understand variations and deviations in social structures and behaviors. E.g., Weber employed ideal types to understand different economic systems (capitalism, socialism).

Weber´s interpretation of the evolution of capitalism starts with institutions and culture that influence the material conditions of economic reproduction. Market capitalism transits to regulated capitalism and the rise of bureaucracy. The rise of bureaucracy weakens the dynamics of capitalism, that originally comes with entrepreneurs. Socialism implies a drastic increase in bureaucratization, economic stagnation and limits to individual liberty.

Joseph Alois Schumpeter (1883 – 1950) was born in Triesch, which was then part of the Austro-Hungarian Empire. Today, Triesch is known as Třešť and is located in the Czech Republic. He is considered one of the best economists and political scientists of the 20ies century. We will cover him in detail later.

Neo-Austrian School is a label that covers some libertarian economists and political scientists. Let us name **Izrael Kirzner (1930-)** and **Murray Rothbard (1926 – 1995).**

Israel Kirzner is an American economist born in 1930 in London, Kirzner is best known for his work on the theory of entrepreneurship and market processes. He studied under Ludwig von Mises at New York University, where he later became professor of economics. Kirzner's most influential work emphasizes the role of the entrepreneur as a central figure in driving market coordination and discovery. He introduced the concept of "entrepreneurial alertness", describing how entrepreneurs identify and exploit opportunities for profit by recognizing discrepancies in the market. His insights highlight the dynamic nature of markets and the importance of individual action in fostering economic development.

Murray Rothbard was an American economist, historian, and political theorist known for his contributions to the libertarian philosophy. A student of Ludwig von Mises, Rothbard led the Austrian principles ad absurdum and became a leading advocate for anarcho-capitalism, a political philosophy that argues for the elimination of the state in favor of private property and free markets.

Murray Rothbard was involved with both the **Cato Institute** and the **Mises Institute**, two prominent organizations within the libertarian movement, albeit in different ways and with varying levels of influence: Rothbard was co-founder of the Cato Institute in 1974. The Cato Institute was founded with the vision of promoting libertarian ideas in public policy. However, differing views on the direction of the organization, its approach to working within mainstream political processes, and internal conflicts ultimately led to Rothbard's departure by the early 1980s. Rothbard had a more sustained and influential relationship with the Ludwig von Mises Institute. Founded in 1982, the Mises Institute is dedicated to promoting the philosophical legacy of Ludwig von Mises. Rothbard played a crucial role in shaping the institute’s direction and output, contributing extensively through his writings, lectures, and mentorship of students and scholars. The Mises Institute became a central platform for New Austrian Economics and for Rothbard's work on libertarian philosophy and anarcho-capitalism, the latter surely not being part of the philosophical legacy of von Mises.

Summary

The Belle Époque, spanning the late 19th century until World War I in 1914, was a period of cultural, economic, and technological progress in Europe, notably in Western regions, including Austria. This era saw prosperity, industrial growth, and innovations like railways and electricity, though it came to an abrupt end with the outbreak of World War I. Triggered by the assassination of the Austrian Archduke Franz Ferdinand, the war led to the collapse of several empires, including Austro-Hungarian, and concluded with the Treaty of Versailles in 1919.

The interwar period (1918-1939) was marked by economic turmoil, highlighted by the Great Depression and the rise of totalitarian regimes. World War II (1939-1945) followed, involving global conflict, immense casualties, and ending with the Axis defeat. Post-war, the USA and the Soviet Union emerged as superpowers and the Cold War, characterized by geopolitical tension, lasted until the collapse of the Soviet Union in the 90ies.

During the Belle Époque, Austria was home to many influential thinkers in economics, philosophy, and social science, such as Sigmund Freud, Ludwig Wittgenstein, Edmund Husserl, and Karl Popper, who made significant contributions to their fields. Austria, once a multicultural empire, disintegrated into multiple nation-states post-World War I.

The Austrian School of Economics originated in Vienna in the 19th century with Carl Menger and was later developed by figures like Friedrich von Wieser and Eugen von Boehm-Bawerk. Key principles of the school include methodological individualism, political liberalism, the dynamic nature of markets, subjective value theory, and criticism of scientism and mathematical methods in economics. Although the school's ideas appeared to integrate into mainstream neoclassical thinking post-World War I, a revival occurred post-World War II with proponents like Israel Kirzner and Murray Rothbard.

Ludwig von Mises and Friedrich von Hayek were prominent figures from the second generation of Austrian economists. Mises contributed with works like *Human Action*, introducing praxeology and stressing the importance of a healthy monetary policy. Hayek is known for *The Road to Serfdom*, warning against central planning and totalitarianism, and *The Use of Knowledge in Society*, highlighting decentralized information.

Methodologically, Mises favored apriorism, advocating theory development from basic assumptions that can't be falsified, whereas Hayek, influenced by Karl Popper, adopted Falsificationism, emphasizing empirical testing of theories.

Max Weber (1864–1920), associated with the German Historical School, was a crucial figure in sociology and political economy, teaching in Freiburg and Heidelberg. His work *The Protestant Ethic and the Spirit of Capitalism* (1905) links Protestant values to the emergence of capitalism, arguing that religious ethics encouraged disciplined economic activity. *Economy and Society* (1922) was his major work, presenting a typology of authority—traditional, charismatic, rational-legal—and analyzing bureaucracy's role in society.

Joseph Schumpeter (1883–1950), a renowned 20th-century economist and political scientist, is not covered in detail here.

The Neo-Austrian School includes libertarian economists like Israel Kirzner and Murray Rothbard. Kirzner is known for his work on entrepreneurship. Rothbard, a student of Mises, became a proponent of anarcho-capitalism. He co-founded the Cato Institute but left due to disagreements and was later influential at the Mises Institute.

Roots of Current Ideas on International Trade

Basic Currently Used Concepts

Balance of Payment is the account of foreign countries in the System of National Accounts. It summarizes the transactions made between residents of a country and the rest of the world over a specific period, typically a year or a quarter. It provides a detailed account of all economic transactions, including trade in goods and services, investment flows, and financial transfers. It consists of three main components:

- **Current Account:** This includes the trade balance (exports minus imports of goods and services), net income from abroad, and net current transfers such as foreign aid and remittances.
- **Capital Account:** This records minor transactions like the transfer of non-produced, non-financial assets (e.g., patents) and capital transfers, which involve ownership changes of fixed assets or debt forgiveness.
- **Financial Account:** This details changes in international ownership of assets, including direct and portfolio investments and other financial flows like loans and bank deposits.

Ideally, without discrepancies due to statistical errors, the balance of payments should balance, meaning the sum of the current, capital, and financial accounts equals zero. Balance of payments is crucial for understanding a country's economic standing and influences exchange rates and macroeconomic policies.

Absolute and Comparative Advantage:

We have 2 countries, X and Y and two products, A and B. Following table is about how many days each country needs for production of 1 unit of product A or B:

	Product A	**Product B**
Country X	**1 day**	**1 day**
Country Y	**2 days**	**4 days**

Following table is about monthly productivities, we assume 24 days per month. Country X has higher productivity for both products, we say it has **absolute advantage**.

	Product A	**Product B**
Country X	**24 units**	**24 units**
Country Y	**12 units**	**6 units**

Opportunity costs: value of the second-best option we cannot do to be able to do the best option.

Country X: Opportunity costs for production of 1 unit of A are 1 unit of B. Opportunity costs for production of 1 unit of B are 1 unit of A.

Country Y: Opportunity costs for production of 1 unit of A is 1/2 unit of B. Opportunity costs for production of 1 unit of B are 2 units of A.

	Product A	**Product B**
Country X	**1 unit B**	**1 unit A**
Country Y	**½ unit B**	**2 units A**

Country Y has lower opportunity costs for product A, we say that it has **comparative advantage** in production of product A. Country X has lower opportunity costs for product B, we say that it has **comparative advantage** in production of product B.

If countries open to foreign trade and specialize in products where they have comparative advantage, the system of two countries as a whole can gain.

Following table shows monthly consumption before opening to foreign trade. Both countries are on their Production Possibilities Frontier. The Production Possibility Frontier (PPF) depicts the maximum feasible combinations of two goods or services that an economy can produce, given its available resources and technology.

	Product A	**Product B**
Country X	**4 units**	**20 units**
Country Y	**6 units**	**3 units**

Following table shows potential monthly production after opening to foreign trade and specialization:

	Product A	**Product B**
Country X	**3 units**	**21 units**
Country Y	**8 units**	**2 units**

Country X exports 1 unit of B to country Y, country Y exports 1 unit of A to country X. Consumption will be on the same level but 1 more unit of A can be produced.

History: Adam Smith described absolute advantage. He wrote:
"Agriculture is the proper business of all new colonies; a business which the cheapness of land renders more advantageous than any other."

Comparative advantage was described by David Ricardo. He used Portugal and England and Wine and Cloth. Ricardo specified simplifying assumptions with which it works:

- Labor is the only relevant factor of production,
- In both countries and both industries is perfect competition,

- Factors of production can freely move domestically but cannot move between the two countries,
- There are no barriers to trade, such as tariffs or quotas.

Ricardo could not have used opportunity costs for his explanation; Ludwig von Wieser defined opportunity costs much later.

Political Economy of Foreign Trade: Theoretical analysis shows that opening to trade maximizes social welfare. Empirical analysis shows the same, both on the level of global economy and on the level of single countries. Nevertheless, domestic population is very often for protectionism and governments very often create barriers for trade. Political Economy of Foreign Trade explains why.

Assume situation on some domestic market as in Figure 5-1, before opening to trade:

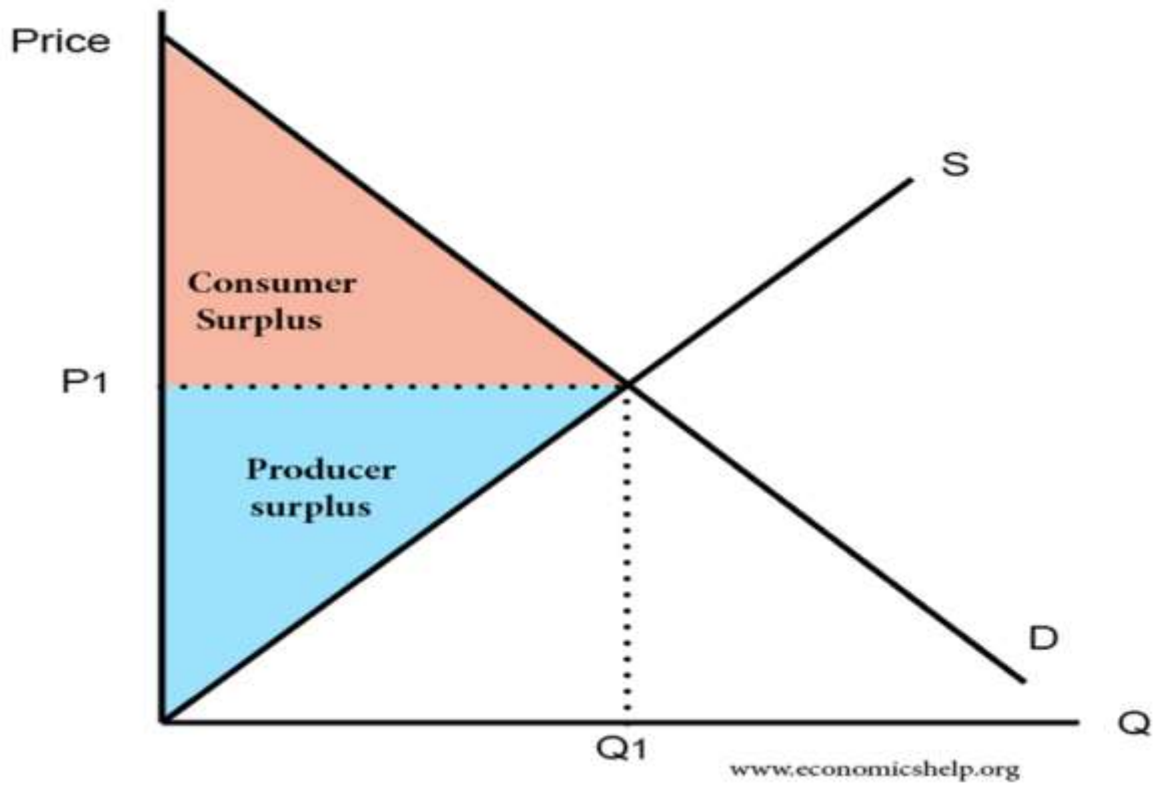

Figure 5-1: Surpluses on a closed market.

Assume that after opening to trade, import is possible in any amount for a lower price (red line in Figure 5-2). Consumer surplus and Total surplus increase but Producer surplus decreases.

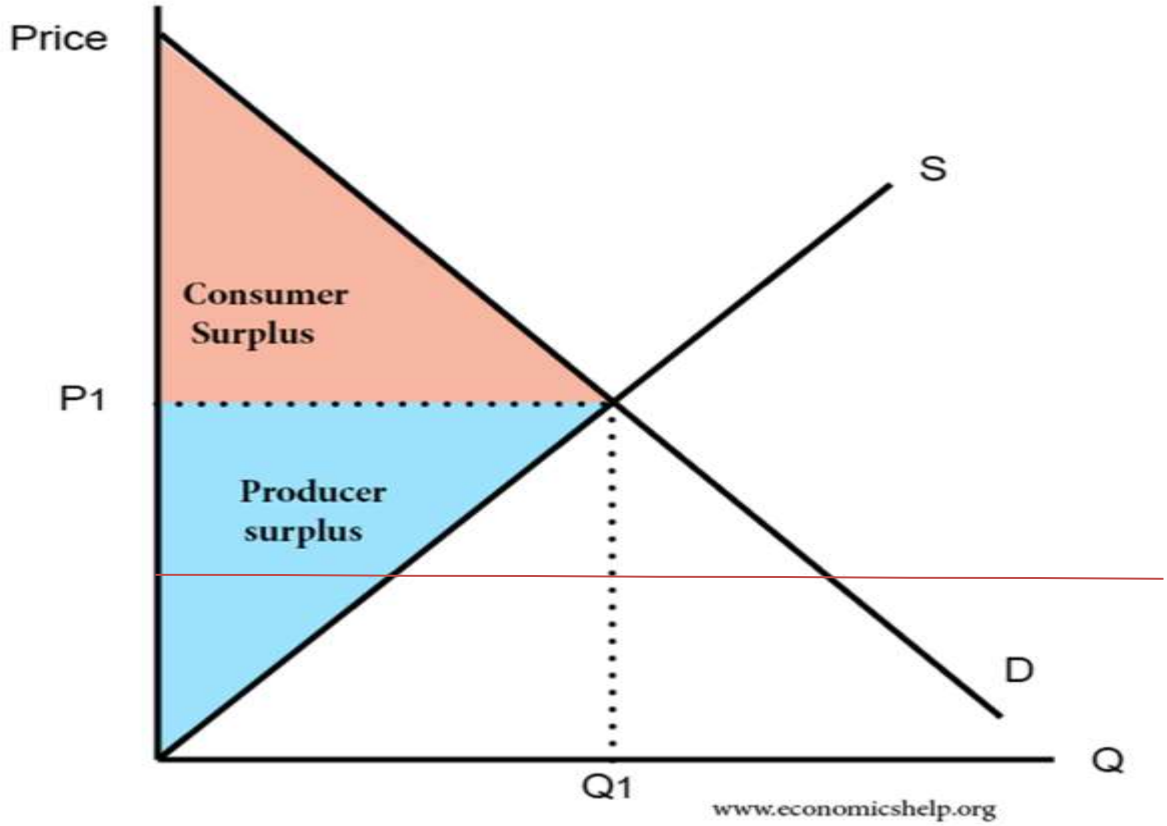

Figure 5-2: Red line shows the World price.

Producers try to persuade government to implement an import tariff (Figure 5-3). It increases Producer surplus, decreases Consumer surplus, government has an income from tariff and Total surplus decreases by triangles a and b, in comparison with the situation without tariff (we assume that taxes are used for the well-being of private agents). Triangles a and b are the deadweight loss from tariff.

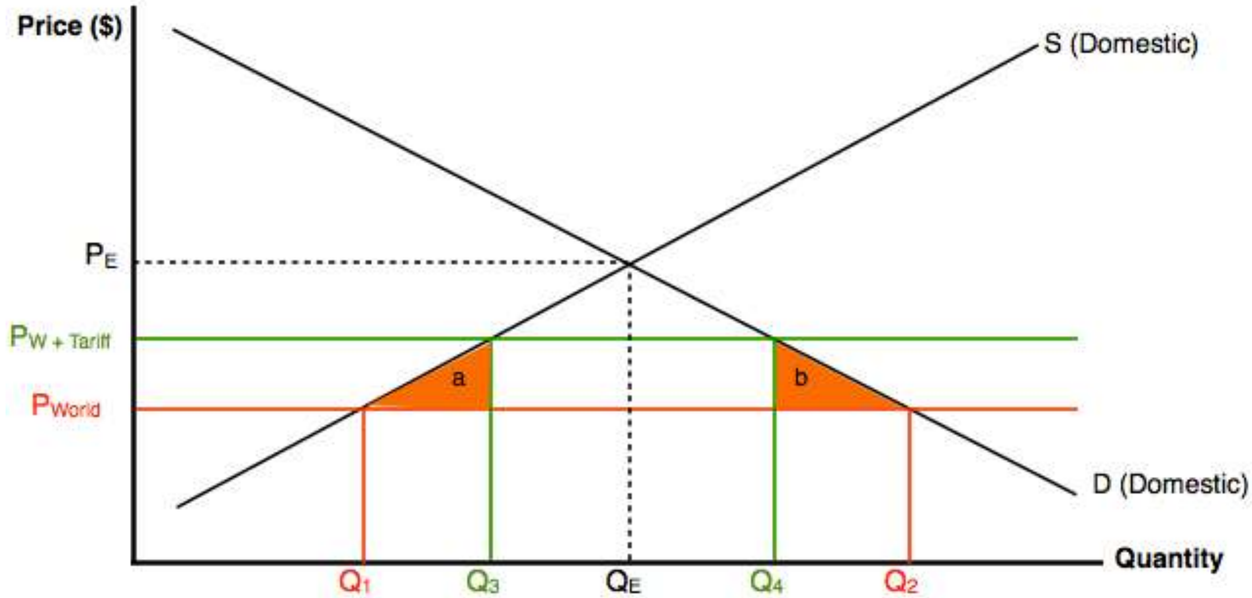

Figure 5-3: After the tariff.

History: Jules Dupuis in 1844 was the first one who described Consumer Surplus. After a long break, neoclassical economists Alfred Marshall and Artur Cecil Pigou made working with surpluses a standard tool in economic analysis.

The World Trade Organization (WTO), established on January 1, 1995, is an international body that oversees and facilitates global trade. It aims to ensure that trade flows smoothly and freely across borders. The WTO serves as a platform for negotiating trade agreements, settling conflicts, monitoring trade policies, and providing support to developing nations. With 164 member countries, the WTO is essential for promoting free trade and fostering international economic cooperation.

- Trade wars are conflicts that arise when countries impose tariffs or trade barriers on each other in retaliation for similar actions. These conflicts can lead to higher consumer prices, as tariffs increase costs for importers who often pass them onto consumers, resulting in inflation. Trade wars can strain international relations, escalate geopolitical tensions, and create market uncertainty, affecting business investments and global economic growth. They can also impact job markets, with some industries facing job losses due to reduced exports. Additionally, trade wars can hinder technological progress by restricting access to foreign innovations. Overall, while aimed at protecting domestic industries or addressing trade imbalances, trade wars generally have negative economic and welfare effects, underscoring the value of cooperative trade agreements.

Economic Integration often starts with the creation of a Free Trade Area (FTA) or a Customs Union. A FTA is a region where a group of countries agrees to reduce or eliminate trade barriers, such as tariffs and quotas, among themselves. However, each country maintains its own trade policies and tariffs for non-member countries. A Customs Union is an agreement between a group of countries to eliminate trade barriers among themselves and adopt common external tariffs on trade with non-member countries. A Free Trade Area is less difficult to establish but more difficult to run than a Customs Union.

Historical Development of Ideas

Plato: City state is not entirely self-sufficient. The needs of both the body and the soul could be satisfied by international exchange

Confucius: „Wise kings inspected travelers at custom-houses but did not levy duty upon commodities. “

European Middle Ages – “Providentialist Theory of Trade“: By scattering resources to different parts of the world, God created incentives for people to interact with each other.

Francisco de Vitoria (Salamanca school): International trade is based on natural law.

Hugo Grotius born in 1583 in the Netherlands, was a renowned philosopher and diplomat, often considered the "father of international law". In his work *On the Law of War and Peace* (1625) he wrote that no state should deny any other state the opportunity to trade.

Mercantilists mostly viewed international trade as a zero-sum game, where one nation's gain was another's loss. They believed the wealth of nations depended on accumulating precious metals like gold and silver. As a result, they advocated for maximizing exports and minimizing imports to achieve a favorable trade balance.

David Hume described in *Essays, Moral, Political, and Literaly* (1742) the Price-Specie Flow Mechanism to describe how gold and silver (specie) flows would automatically correct trade imbalances between nations. This concept is based on the Quantity Theory of Money. It is central to classical economics and was a key component of the international gold standard. **Balancing the trade imbalances nowadays** involves several processes and strategies aimed at achieving equilibrium. E.g.: Trade surplus -> Increase of supply of foreign currencies on the foreign exchange market -> Appreciation of domestic currency -> Export becomes more expensive -> Trade balance balances. This process is basically the Hume´s process in the world without gold and silver money.

Adam Smith:

- Believed that trade is beneficial in general, because it supports the division of labor,
- Was a fierce supporter of free international trade,
- Described the Absolute Advantage,
- Stressed the importance of transportation costs in determining both the volume and composition of trade,
- Specified the gains from trade as:
  - Having more abundant goods and greater variety of goods,
  - Using lower costs abroad,
  - Allowing further specialization and gains in productivity.

David Ricardo:

- Described the Comparative Advantage,
- Was a prominent opponent of the Corn Laws in the United Kingdom. The debate over the Corn Laws spanned several decades. These laws were originally enacted in 1815, following the end of the Napoleonic Wars, and consisted of tariffs and trade restrictions on imported grain designed to protect domestic agriculture by keeping grain prices high. Ricardo argued that promoting free trade would decrease grain prices, allowing for greater accumulation of capital. His arguments were influential in the eventual repeal of the Corn Laws in 1846.

John Stuart Mill:

- Specifies the gains from trade as:
    - Direct effects: Possibility to get products with lower costs,
    - Indirect effects: Larger markets increase productivity,
    - Exposition to different cultures has intellectual and moral effects.
- In *Essays on some unsettled questions of political economy* (1844) formulates following question: "For which prices will countries trade?" With the help of a simple model of two countries and two commodities, with the assumption that countries realize all their surpluses, he answers: "The produce of a country exchanges for the produce of the other country at such values as are required in order that the whole of her exports may exactly pay for the whole of her imports." With this he comes very close to the currently used concept „Terms of Trade ", that is defined as Export Price Index divided by the Import Price Index.

The Heckscher-Ohlin model was first introduced by the Swedish economist Eli Heckscher (1879 – 1952) in the article *The Effect of Foreign Trade on the Distribution of income* (1919). It was later expanded and formalized by his student, Bertil Ohlin (1899 – 1979), in his 1933 book titled *Interregional and International Trade.* This model builds on the earlier work by David Ricardo on comparative advantage. Ricardo took productivity differences as given. This model derives productivity differences from differences in factor endowments. A country will specialize in producing and exporting goods that require the factors of production it has in abundance. Bertil Ohlin's contributions to the model earned him the Nobel Prize in Economic Sciences in 1977, which he shared with the British economist James Meade (1907 – 1995) for their pathbreaking contributions to the theory of international trade and international capital movements.

The Stolper-Samuelson theorem, was introduced in a paper titled *Protection and Real Wages,* authored by American economists Wolfgang Stolper (1912 – 2002) and Paul Samuelson (1915 – 2009, Nobel prize in economics in 1970). It is a key concept in international trade theory that explores the relationship between trade and income distribution. Rooted in the Heckscher-Ohlin model, it states that an increase in the price of a good benefits the factor of production used intensively in its production, while harming the other factor. For instance, in a capital-abundant country, trade can boost capital owners' income relative to laborers, while the opposite occurs in a labor-abundant nation. The theorem illustrates how trade can create winners and losers within an economy, influencing support for or opposition to trade policies. Despite its theoretical clarity, real-world applications are complex due to factors like technology and labor mobility. Nonetheless, the Stolper-Samuelson theorem remains crucial for understanding how trade affects wage inequality and economic policy.

New Trade Theory, which emerged in the late 1970s and early 1980s, provides insights into the patterns and benefits of international trade that previous theories could not fully explain. Unlike previous models that focus on comparative advantage due to factor endowments, New Trade Theory suggests that countries can benefit from trade even when they have similar resources and technologies. This theory has helped explain the prevalence of international intra-industry trade with similar products. In contrast with previous models that used the assumption of prefect competition, this theory assumes monopolistic competition and stresses the importance of increasing returns to scale. It was pioneered by the American economist Paul Krugman (1953 - , Nobel prize in economics in 2008).