Comment on Tullock's "Why Austrians Are Wrong About Depressions"

Joseph T. Salerno

Let me preface my comment with the following caveat: I am skeptical of the value of a scholarly journal article that attempts to critically evaluate the "canonical version" of an economic theory, particularly when the theory in question deals with a phenomenon as complex as the business cycle. Added to this is my uneasiness over the fact that the version that is chosen for criticism (Rothbard [1969]) was intended as a popular exposition of the theory. This hardly does justice to the profundity of the Austrian theory of the business cycle or to the scholarship of Murray N. Rothbard. If one wishes to pen a brief critique of the general thrust of Austrian cycle theory, it is more appropriately done as an explicit book review, say, of an anthology such as Mises et al. (1983). Having expressed these reservations, I proceed with my comment.

The three nits that Tullock picks at the beginning of his article in *The Review of Austrian Economics*, volume 2 (pp. 73–74), deserve comment because they bear out the concerns I mentioned in the preceding paragraph. First, the author correctly notes that, in the particular pamphlet under review, "Rothbard never explains why the inflation which is part of his theory cannot simply be continued or even accelerated." But, of course, this question is dealt with in many advanced expositions of Austrian cycle theory. As one of numerous examples, Rothbard (1970, volume 2, pp. 875–77), himself, addresses the issue under the heading of "The Ultimate Limit: The Runaway Boom." Moreover, Tullock's personal testimony that hyperinflation "is undeniably unpleasant, but not really a disaster" (p. 73), while certainly provocative, is irrelevant with respect to this issue. It is sufficient that the political and monetary authorities who orchestrate the inflationary boom fear the eventuality of hyperinflation and act to prevent it. Thus, for instance, the proximate cause of the 1980–82 U.S. depression was the well-publicized decision of the Volcker Fed to "disinflate" the economy from highly unpopular double-digit inflation levels by reining in the growth of money and bank credit.

The author's second nit (p. 73) concerns Rothbard's alleged failure to come to grips with the question of why entrepreneurs do not eventually learn about,

correctly forecast, and adjust their investment activities to the business cycle. In current jargon, the author is questioning why Austrian cycle theorists do not assume that market participants are capable of formulating "rational expectations," which incorporate a correct theory of economic relationships and preclude systematic forecasting errors. Without attempting to provide an answer to this question here, suffice it to say that the issue has been discussed by a number of Austrian cycle theorists, including Mises (1943), O'Driscoll (1977, pp. 106–08; 1979, pp. 166–68), and Garrison (1986, pp. 445–47). Once again, the author's decision to avoid grappling with the extensive literature on the theory has led him to suggest a lacuna in the theory that simply does not exist.

The final nit Tullock picked out (p. 74) stems from his apparent misunderstanding of the methodological context of the Austrian business-cycle theory. Thus the author faults Rothbard for ignoring the results of statistical tests that suggest that depressions and booms do not follow a cycle but, instead, follow a so-called "random walk." This is beside the point, however, since Austrians do not construe the term *business cycle* as a mechanistic or statistical regularity that openly manifests itself in history, but as a recurring qualitative sequence of abstract economic phenomena that can only be detected in the historical data by the application of theory. In an early contribution, Mises (1978, p. 117) wrote: "Neither the connection between boom and bust nor the cyclical change of business conditions is a fact that can be established independent of theory. Only theory, business cycle theory, permits us to detect the wavy outline of a cycle in the tangled confusion of events." The author could have found a concise and lucid discussion of the methodological foundations of Austrian cycle theory in Rothbard (1975, pp. 1–7).

With regard to Tullock's "major objection" to the theory, his argument (pp. 3–10) is likewise marred by an apparent unfamiliarity with advanced expositions of the theory. I shall not attempt here to give a point-by-point critique of the author's main argument that, during a typical Austrian business cycle, "there would be only minor transitional unemployment [and] measured GNP would be higher as a result" (p. 74). It is enough to point out that the author's conclusion rests on basic misconceptions about Austrian capital theory and structure-of-production analysis.

First, the author appears to ignore the important notion of intertemporal complementarity in the structure of production. Thus, even if the higher-stage investment projects and production processes induced by the artificially depressed interest rate are eventually completed in the technological sense, they still may be underutilized or wholly abandoned during the depression-adjustment phase. The reason is that the products yielded by these higher-order processes confront greatly contracted market demands, resulting from the suddenly revealed increased scarcity (and hence money costs) of the temporally "nonspecific" inputs with which they must be combined in lower-order production processes.

For example, a newly completed iron ore mine may be abandoned because, at any technically feasible rate of output, the price of the ore has fallen below the "marginal costs" of the mine's operation, including wage rates, prices of fuels, and the rents of power generators and hauling vehicles. Higher prices for the services of labor and of the other relatively nonspecific inputs or "convertible" capital goods are due, in turn, to the fact that too great a proportion of the available stock of these resources was erroneously invested in the production of "inconvertible" or "specific" higher-order goods, such as the iron mine shaft and related "fixed" investments. The higher monetary costs of nonspecific resources, which make their continued employment in certain higher-stage processes uneconomic, simply reflect the fact that such resources have higher marginal revenue products in the lower-stage processes from which they were originally diverted during the inflationary boom. The bankruptcies and resource unemployment occurring in the mining and mining-equipment industries during the depression-adjustment phase are thus part and parcel of the process by which labor and other nonspecific factor inputs are reallocated to finished-goods production and to the wholesale and retail industries. It is the metaphorical "structure of production" itself—not necessarily particular factories or other construction—that cannot be completed, due to the unanticipated scarcity of capital that is suddenly revealed during the depression-adjustment phase.

A second basic confusion of the author involves his apparent belief that Austrian cycle theory indicates that an interest rate temporarily lowered by monetary inflation will lead to general overinvestment in capital *and* consumer-goods industries (Tullock, pp. 5–7). But the main insight of Austrian cycle theory is that the inflationary boom induces "malinvestment," which denotes a diversion of scarce factors and money capital away from consumer-goods industries into capital-goods or, more generally, "higher-stage" industries, including, for example, investments in specially designed computers and software for specific R&D projects, expanding facilities supplying wildcat oil drillers, site planning for new hydroelectric plants, and so on. With scarce resources thus reallocated higher up the ladder of the structure of production, there necessarily occurs at least a temporary reduction in the quantities of final consumer goods produced.

Moreover, the uneconomic commitment of labor services and other nonspecific resources to the expansion of the production of relatively inconvertible higher-stage goods such as industrial construction and equipment will ultimately be revealed in an unforeseen bidding up of wage rates initiated in the lower stages, when it is discovered that available stocks of labor inputs are insufficient to complement the full array of products beginning to flow forth from the overbuilt higher stages. Such intertemporal price variations result in a shifting of labor as well as convertible capital goods into the relatively undermanned and underequipped lower-stage industries and account for the corresponding

bankruptcies and retrenchments of overcapitalized higher-stage firms, thus bringing about the abandonment of many of the investments—whether technologically completed or not—in inconvertible higher-order capital goods. Even where the latter constitute completely sunk costs, they still may be entirely abandoned, because their continued utilization at any level of output does not generate an income sufficient to cover the "opportunity costs" of their complementary nonspecific factors, such as labor.

It is precisely the abandoned or underutilized factories, equipment, power-generating sites, mines, and R&D projects that represent the "malinvested" capital of the boom period characterized by artificially lowered interest rates. In view of this wasted capital investment, the aggregate capital/labor ratio for the economy and, therefore, marginal productivity of labor and real wage rates can be expected to be lower than if investment of scarce productive resources and the "length" of the production structure had been determined by genuine market time preferences, which are reflected in the unmanipulated or "natural" interest rate. Thus, contrary to Tullock's contentions (pp. 3, 10), Austrian cycle theory *does* explain the observed drop in "measured GNP" and in laborers' living standards during the depression.

At the end of his article (pp. 8–9), Tullock rehearses his earlier objection regarding the explanatory power of the Austrian theory when confronted with rational expectations. This is an important and timely issue and the author could have provided a valuable service by formulating his objection in a manner that speaks to what Austrian theorists have already written on this subject. (The relevant contributions are cited in the third paragraph of this comment.) Having chosen not to do this, however, the author's discussion fails to provoke any new or interesting thoughts on the matter.

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