

*THE AUSTRIAN SUBJECTIVIST THEORY OF INTEREST:
AN INVESTIGATION INTO THE HISTORY OF THOUGHT.*
BY INGO PELLENGAHR. LONDON: PETER LANG, 1996

Many of the disputes in economic theory are the result, not of genuine disagreement on fundamental issues, but of the contradictory uses of terminology. This deplorable phenomenon is perhaps nowhere better exemplified than in the complex controversies that have historically raged in capital and interest theory.

Ingo Pelligahr's doctoral dissertation, *The Austrian Subjectivist Theory of Interest*, focuses on one small aspect of these ongoing debates. He traces the development and evolution of what is generally referred to as the (pure) time preference theory (PTPT) of interest. The PTPT is historically associated with the Austrian School, whose characteristically subjectivist members stress the primacy of individual valuations—versus objective facts concerning the productivity of capital—in any discussion of interest. Pelligahr offers a largely critical review of the major Austrian contributions to the evolving PTPT and then presents an original, “essentialist” synthesis which he hopes will be acceptable to the various factions in the debate.

It must be stated at the outset that Pelligahr's book assumes a thoroughgoing familiarity with all of the relevant literature; the reader who finds Mises's treatment of Böhm-Bawerk in *Human Action* to be obscure will gain little from Pelligahr's discussion. This review will likewise assume such a familiarity and thus cater only to the book's relevant audience.

Pelligahr's greatest contribution is his attempt at terminological and conceptual clarification. As noted above, the Austrian treatment of capital and interest theories has been plagued by systematic confusion in this regard. It is precisely for this reason that Pelligahr devotes his entire chapter three to an “Excursus: On the Definition of Time Preference.”

There are two related, but distinct, meanings attached to the term *time preference*. One meaning, generally employed by the Austrians, refers to the higher subjective value placed on a marginal unit of a good available *now* rather than the “same” unit not available until *later*. A neoclassical would refer to this concept, not as positive time preference, but rather as the marginal rate of substitution of present for future goods being lower than one.

The second meaning, employed by all current neoclassicals, refers to the “exogenous” (ex ante) preference for present goods. Thus, a person exhibits time preference, not if he actually prefers present to future goods, but rather if, *hypothetically speaking*, he would prefer a present-oriented consumption stream to the “same” stream distributed uniformly throughout time. If certain assumptions about the agent’s ordinal preferences are made, the neoclassical can reduce his concept of time preference to a numerical discount on future utility. Thus, if a good consumed next year will *at that time* yield 50 “utils,” then the agent, anticipating this future consumption, will evaluate its marginal utility as only, say, 25 utils, because future utility is discounted.

Under this latter interpretation, it should be noted, time preference is neither necessary nor sufficient for a higher valuation of present over future goods. For example, it might very well be the case that an individual discounts future enjoyments (that is, possesses time preference in the second sense), but due to a relative abundance of wealth in the present, the individual would nonetheless prefer consumption of a marginal future to a marginal present unit of a good.

It must also be kept in mind that this distinction between the two meanings of the term is not important merely for dialogue with outsiders. Even if the Austrians care not a whit for neoclassical treatments of interest, such a distinction must be recognized to maintain the coherence of their own discussions. Throughout his book, Pellengahr tirelessly documents countless examples—even in the works of such giants as Mises and Rothbard—where the absence of such recognition leads to unsatisfactory argumentation.

Having praised Pellengahr’s unrivaled care in untangling the various contradictory uses of the term *time preference*, it must sadly be concluded that Pellengahr misunderstood Böhm-Bawerk’s seminal contribution. An interpretation of Böhm-Bawerk’s theory follows here in order to clarify the shortcomings of Pellengahr’s analysis.

Piercing the web of confused discussion concerning capital and interest, Böhm-Bawerk made the simple yet elegant claim that interest is nothing but an intertemporal exchange. As such, if a premium is placed on present versus future goods, this can only be due to a higher subjective valuation of present goods. As Böhm-Bawerk himself thought, this insight is “the nub and kernel of the theory of interest” that he presented (*Capital and Interest*, vol. 2, *Positive Theory of Capital*, George D. Huncke and Hans F. Sennholz, trans., South Holland, Ill.: Libertarian Press, 1959, p. 259).

Had Böhm-Bawerk simply stated *this*, his contribution would have been noteworthy, for the marginal and subjectivist revolution had not yet worked its way through the prevailing interest theories of Böhm-Bawerk’s day. But, as Fetter pointed out, this “nub and kernel” really is no *explanation*; it is rather a reformulation of the problem. If one wants to know why a capitalist receives

interest, it will not do to simply state that this is “due” to the fact that people value present dollars more highly than future ones. It is this more fundamental “undervaluation” of future goods which must be explained.

Böhm-Bawerk attempts to provide just such an explanation. Present goods as a rule are more valuable than future goods for three main reasons. First, people generally expect to be more richly endowed in the future, and thus present consumption (on the margin) appears more urgent. The second reason is that future wants tend to be systematically undervalued; what will yield a utility of 50 next year is only *now* perceived as yielding a utility, say, of 25. (Thus, if all else is equal, one unit now will exchange for two units next year.) The final reason is that, as an empirical technological fact, more “round-about” production processes are more *physically* productive than less round-about ones. It is the combination of all three reasons (the second of which is broken down into subsidiary causes) that yields the general rule that present goods are more valuable than future goods, which implies a positive interest rate.

The first reason is innocuous enough. The second—the discount of future utility—is, of course, what neoclassicals mean by “time preference.” It is an exogenous fact, not influenced by considerations of relative supply, which is handled under the first cause. The third cause—the one responsible for inordinate controversy—simply refers to the fact that one can often obtain more of a given end by first achieving an intermediate, and not directly useful, end. Thus, if one wants to eat apples, one method is to climb trees and directly pick them. But another, more “roundabout” approach, is to first construct a long pole (which in itself is useless) and then use it to knock down many more apples than could be had by the more direct method. Perhaps a different way of expressing Böhm-Bawerk’s third cause would be to say that, as a general technological fact, capital goods can be constructed whose physical productivities exceed the sum of the physical productivities of their inputs.

In a discussion of a different book, it certainly would be inappropriate to dwell further on the reviewer’s idiosyncratic views. Having said that, I want to stress that the above understanding completely exonerates Böhm-Bawerk from the frequent charge that he unwittingly reverted to the productivity fallacies that he had so brilliantly demolished in volume one of his great work, *Capital and Interest*. Irving Fisher’s charge—that the third cause is superfluous and entirely subordinate to the first two—is more tenable, and indeed Böhm-Bawerk himself did not adequately address this concern. This was due to the unfortunate tendency for *all* interest theorists—even the Austrians—to focus on “steady-state” situations. If we allow for unexpected, one-shot changes, it would seem possible to assign the third cause a genuinely independent role.

In light of the above discussion, an objection must be made to Pellengahr’s apparent endorsement of the unanimous PTPT rejection of Böhm-Bawerk’s

third cause (p. 21). Further, I must strongly object to Pellengahr's claim of Böhm-Bawerk's inconsistency on the use of the term "time preference" (p. 23) –a claim made all the more dubious by Pellengahr's own admission that Böhm-Bawerk does not even employ the term. Thus, Böhm-Bawerk's apparent inconsistency is in reality a reflection of the (rare) failure of Pellengahr himself to keep distinct the two notions of "time preference." These quibbles aside, chapter three alone makes Pellengahr's book indispensable to the Austrian theorist. Our author documents the surprising lack among the Austrians (with the exception of Rothbard) of a formal definition of time preference, and the myriad difficulties inherent in the various definitions which are implicit in their discussions.

Pellengahr devotes a chapter each to Fetter, Mises, and Rothbard. Except for those arguments tainted by his confusion regarding Böhm-Bawerk's theory, Pellengahr's analysis in these chapters is simply impeccable. In particular, the brief yet incisive analysis of Mises's attempts to prove the *a priori* necessity of time preference was enjoyable. The proponent of Mises's treatment in *Human Action* must deal with Pellengahr's informed critique.

(Commenting on Mises's second "case of capitalist saving," Pellengahr says, in characteristic understatement, "Assuming a positive rate of interest in a setting designed to shed light on the reasons for a positive rate of interest is, moreover, clearly of particularly dubious value" [p. 42]. This critique, though powerful, is exceptionally polite.)

This standard of excellence is maintained throughout Pellengahr's treatment of the more recent Austrian contributions. However, I disagree with his handling of Roger Garrison, who is treated unfairly, and of Charles Baird, who is let off the hook too easily. Pellengahr characterizes Garrison's interpretation as "vague and ambiguous" (p. 53), whereas I found Garrison's (as well as Walter Block's) writings on the PTPT to be very clear.

Pellengahr rightly criticizes Baird's discussion of time preference, particularly in his section, "The Primacy of Time Preference" (p. 56). However, as noted above, Pellengahr is far too lenient. In this section, Baird "proves" the primacy of time preference by imagining a man who owns two sheep, which will multiply into three sheep in one year. Baird supposes the man has no time preference and argues that if the "future market value" of the three sheep next year is higher than the market value of the two sheep this year, then the man, since he has no time preference, will postpone consumption of his capital stock to "reap the gain." By such action, the market value of the future sheep will decline (due to increased savings) until the market value of two sheep *now* equals the "future market value" of three sheep next year. Thus, the man's capital goods will not appreciate in value over time, despite their postulated net physical productivity. Baird concludes that time preference is "necessary and sufficient" for a positive rate of interest.

The problem is that Baird assumes what he is trying to demonstrate. If “zero time preference” is *the same thing* as equal valuation of a present dollar of revenue and a future dollar, then *obviously* time preference is “necessary and sufficient” for positive interest rates. But if this is really Baird’s argument (and it is), he could simplify it greatly. He needn’t refer to sheep. All he need do is suppose a man places \$100 in a savings account. If the man has “zero time preference,” then he doesn’t care *at what date* he withdraws his money; therefore, if the “future market value” of his account—i.e., his balance—exceeds \$100, he’ll postpone his withdrawal. In such a setting, equilibrium can only be achieved if the interest rate is zero percent. Thus, time preference is necessary for a positive rate of interest.

Needless to say, *this* sort of argumentation has no bearing on the dispute with the (modern) “productivity theorists.” Nobody is so thickheaded as to deny the fact that a higher subjective valuation of a marginal present dollar is necessary and sufficient for a positive rate of interest. What the “productivity theorists” (as well as Böhm-Bawerk) try to explain is *why* this higher valuation of the present dollar exists in the first place, and in this explanation they feel, rightly or wrongly, that technological facts are just as relevant as exogenous features of preferences.

Next is Pellengahr’s attempted synthesis, and unfortunately the conclusion is unsatisfactory (pp. 59-61). Indeed, one might read *it* without realizing that it had even been presented. It seems Pellengahr rehabilitates the PTPT by reformulating it merely as the insight that considerations of time are what interest is “essentially” about. Although this is certainly true, the point has already been made by others, particularly Kirzner, and it renders the PTPT largely vacuous.

In closing, Ingo Pellengahr’s *The Austrian Subjectivist Theory of Interest* is by far the most lucid account on the subject. In addition to thoroughly clarifying the subtle distinctions in the exposition of the PTPT by various authors, Pellengahr raises some interesting issues. A personal favorite (p. 12) is the tantalizing suggestion that Menger’s infamous dismissal of Böhm-Bawerk’s *Positive Theory*, as “one of the greatest errors ever committed,” was perhaps not due merely to his focus on productivity, but *also* to his notion of discounting future utility—a procedure which at first smacks of cardinality, particularly in the manner used by Böhm-Bawerk. Current advocates of the PTPT would do well to convince themselves of the considerations behind Menger’s statement before citing it as proof of the PTPT’s superior claim to subjectivism.

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