

Mises's Theory of Economic Growth

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Abstract

Recent interest among neoAustrian economists in economic growth prompts one to seek answers to the question of what the “masters” of Austrian economics regarded as the cause of economic growth. The purpose of this paper is to describe Mises's theory and to defend it with text quotations. The theory begins with a definition of the standard of living that is based on historical consensus. Every reasonable historian knows about the massive increase in standard of living that has occurred under capitalism. Mises's praxeological approach leads him to search for reasons in the actions of individuals. The question, then, is: what are the key characteristics of capitalism that lead individuals to take actions that increase the standard of living? Mises's answer is: the characteristics of a market economy: private property rights, free enterprise, and the absence of manipulation of money.

A complementary question is: *which* actions, given these characteristics, cause economic growth? Mises's most fundamental answer is: specialization (division of labor) and trade, which raise the productivity of labor. The higher labor productivity causes higher saving, which makes it possible to adopt more physically productive but also more time consuming methods of production and it promotes further technological advance through the innovation of promoting entrepreneurs.

Saving may also occur independently of the higher productivity of labor due to three factors: favorable changes in the natural environment, technological advance that is independent of increased saving, and a reduction of “institutional barriers.” Mises does not discuss independent technological advance to any significant degree.

The actions that cause economic growth are contingent on the maintenance of the conditions of the market economy. An excess of intervention is possible and this would reduce the standard of living below what it otherwise would have been. To prevent this, people must be continually educated by economists about the economics of interventionism.

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One of the remarkable developments in neo-Austrian economics is the shift away from the praxeologically-based economics of Mises toward a series of hybrids in which many of the lessons contained in Mises's treatise *Human Action* have been either overlooked, forgotten, or ignored. Although it is difficult to gauge the opinions of the many diverse strands of thought that go by the label Austrian economics today, it seems to be the general opinion that the treatise lacks a theory of economic growth.¹ It is true enough that one cannot find the phrase "economic growth" in *Human Action*. In spite of this, however, the treatise contains a very coherent theory that is fully integrated with the rest of the treatise. That it does not stand out to the modern reader seems to be that the modern reader does not know where to look.

The purpose of this essay is to assist the reader in identifying Mises's theory of economic growth. It achieves this goal by stating the theory as I understand it in part 1 and then, in part 2, trying to justify my interpretation by presenting direct quotations from *Human Action* (1966).

1. A Brief Statement of the Mises Theory of Growth

Mises recognized the difficulty of measuring economic growth. But he also believed that economics – and, more importantly, policy makers and "the masses" – needed to understand the cause of growth if they

¹This is the implied opinion of Joseph Salerno (2001) who, referring to a book by Roger Garrison (2001), asks the question whether Austrian economics needs a theory of secular growth in a capital-based macroeconomics.

were to avoid world wars and a reversion to types of systems in which economic growth would not occur. So he turned to historical consensus for a definition of growth. Taking it for granted that capitalism had led to higher standards of living, he proceed to present a praxeological theory (a theory in which all events could be traced to distinctly human action) in order to explain the higher standards. The theory started with the assumption, again based on experience, that humans first recognize what he called “higher productivity of labor” that can be achieved by specialization and trade. “Labor” here must be take to mean human effort that which includes what modern economists would call human capital.

Given this recognition, the individuals proceed to form contractual bonds, which are based on the mutual recognition of potential gains from interpersonal trade (Mises 1966: 195). As the standard of living rises, increased saving is possible. For a people who then build the institutions that move them in the direction of laissez faire, the higher saving creates opportunities for “promoting entrepreneurs” to profit from their superior foresight, initiative, and eagerness to profit. They proceed to adopt methods of production that are more productive but also that take more time to complete. In addition, they recognize and cause a plethora of new methods of production to be discovered and employed. One result of their activities is the growth of natural science. Even in the absence of additional saving due to the higher productivity of labor, technological advance and a favorable natural environment may enable additional saving to occur.

To maintain the conditions necessary for improving standards of living, people must avoid interventions that would have the opposite effect on the standards of living. These include restrictions on the production and sale of goods and resources, manipulation of money and credit, and a large public debt. The

ability of people to avoid such interventions, in turn, depends on their being educated. The main task of economic theory in this regard is to educate the masses on the effects of market intervention. If this task is not performed effectively, what could be a steady improvement in the standard of living could become a decline.

2. Textual Support for My Interpretation of the Theory

My interpretation of Mises's theory of increases in the standard of living is based on statements that are scattered throughout *Human Action*. To identify the theory, one must skip around in the treatise. Thus the following interpretation of his theory may seem as if it is a presentation of my own theory backed by an extraction of various passages to support that theory. In anticipation of such a criticism, I can only say that I tried to remain conscious of the difficulty one faces in carrying out an exegesis of the type I have done. I may have overlooked some important elements and my mind is open.

Teachings of the Classical Economists Induced a Change in Mentality Which Made Capitalism and Corresponding Economic Growth Possible

What I call Mises's theory of economic growth is a theory of increases in the standard of living. He also uses the terms "wealth" and "welfare." The first relevant statement is in his introduction of his treatise, where he responds to unnamed "grumblers" who claim that because "the social sciences...have not stamped

out misery and starvation...[t]hey are sterile and have contributed nothing to the promotion of happiness and human welfare.” The grumblers are mistaken, Mises says:

These grumblers do not realize that the tremendous progress of technological methods of production and *the resulting increase in wealth and welfare* were feasible only through the pursuit of those liberal policies which were the practical application of the teachings of economics. It was the ideas of the classical economists that removed the checks imposed by age-old laws, customs, and prejudices upon technological improvement and freed the genius of reformers and innovators from the straitjackets of the guilds, government tutelage, and social pressure of various kinds. It was they that reduced the prestige of conquerors and expropriators and demonstrated the social benefits derived from business activity. None of the great modern inventions would have been put to use if the mentality of the precapitalistic era had not been thoroughly demolished by the economists. What is commonly called the "industrial revolution" was an offspring of the ideological revolution brought about by the doctrines of the economists. The economists exploded the old tenets: that it is unfair and unjust to outdo a competitor by producing better and cheaper goods; that it is iniquitous to deviate from the traditional methods of production; that machines are an evil because they bring about unemployment; that it is one of the tasks of civil government to prevent efficient businessmen from getting rich and to protect the less efficient against the competition of the more efficient; that to restrict the freedom of entrepreneurs by government compulsion or by coercion on the part of other social powers is an appropriate means to promote a nation's well-being. British political economy and French Physiocracy were the pacemakers of modern capitalism. It is they that made possible the progress of the applied natural sciences that has heaped benefits upon the masses (*ibid.*: 8-9).

Here he makes the claim that an increase in wealth and welfare was due to the development of the capitalist mentality which enabled the development of the capitalist economic system. The capitalist mentality, in turn, was a result of the teachings of the classical economists.²

Because Wealth and Welfare Cannot Be Measured, the Claim That Economic Growth Has Occurred Is Based on Historical Observation

Much later in the text, he writes about the measurement of “wealth and welfare.” He writes:

In the field of historical experience it is impossible to resort to measurement. As money is no yardstick of value and want-satisfaction, it cannot be applied for comparing the standard of living of people in various periods of time. However, all historians whose judgment is not muddled by romantic prepossessions agree that the evolution of capitalism has multiplied capital equipment on a scale which far exceeded the synchronous increase in population figures. Capital equipment both per capita of the population and per capita of those able to work is immensely larger today than fifty, a hundred, or two hundred years ago (Mises 1966: 616).³

²Mises's discussion of the anti-capitalist mentality is in Mises 1956. See especially section 2, part 2.

³Mises makes the same point about the limitations of money as a measure of wealth at *ibid.*: 216.

In this statement, we find two important clues to his theory. First, we see that he regards the claim that he made earlier as historical. To Mises, this means that the relationship between capitalism and growth is not a praxeological theorem. It cannot be derived logically from the assumption that people act. He goes on to declare that “[t]he ensuing rise in the masses' standard of living is miraculous when compared with the conditions of ages gone by” (*ibid.*). The fact that wealth and welfare or increases in the standard of living cannot be measured does not deter Mises from writing extensively about the causes of such increases.

Capitalism is Accompanied by an increase in Capital Equipment

Second, we see that the increase in wealth and welfare are caused by capitalism which implies an increase in “capital equipment.” This second idea is also present in the following statement:

In the capitalist society there prevails a tendency toward a steady increase in the per capita quota of capital invested. The accumulation of capital soars above the increase in population figures. Consequently the marginal productivity of labor, real wage rates, and the wage earners' standard of living tend to rise continually. But this improvement in well-being is not the manifestation of the operation of an inevitable law of human evolution; it is a tendency resulting from the interplay of forces which can freely produce their effects only under capitalism (*ibid.*: 603).

Mises method of showing the effects of capital goods on a nation's standard of living is to compare two identical market economies:

We compare the conditions of two isolated market systems A and B. Both are equal in size and population figures, the state of technological knowledge, and in natural resources. They differ from one another only in the supply of capital goods, this supply being larger in A than in B. This enjoins that in A many processes of production are employed with which the output is greater per unit of input than with those employed in B. In B one cannot consider the adoption of these processes on account of the comparative scarcity of capital goods. Their adoption would require a restriction of consumption. In B many manipulations are performed by manual labor which in A are performed by labor-saving machines. In A goods are produced with a longer durability; in B one must abstain from producing them although the lengthening of durability is obtained by a less than proportionate increase in input. In A the productivity of labor and consequently wage rates and the standard of living of the wage earners are higher than in B (*ibid.*: 498).

Increases in Capital Are Due to Saving and Promoting Entrepreneurs

A logical question to ask is: what is the mechanism that causes capital equipment per capita to rise. Mises answer to this question is increased saving combined with promoting entrepreneurs. Consider the following discussion of the differences between East and West.

The radical change of conditions that bestowed on the masses of the West the present average standard of living (a high standard indeed when compared with precapitalistic or with Soviet conditions) was the effect of capital accumulation by saving and the wise investment of it by farsighted entrepreneurship. No technological improvement would have been possible if the additional capital goods required for the practical utilization of new inventions had not previously been made available by saving (*ibid.*: 609).

Capital accumulation in this passage is due to saving and the wise investment of saving by entrepreneur-promoters.⁴

Restriction of Consumption, Favorable Natural Conditions, Technological Advance, Reduction in Institutional Barriers Are Sources of Saving

If capital accumulation is due partly to saving, what then causes saving. Mises writes that

[a]dditional capital can be accumulated only by saving, i.e., a surplus of production over consumption. Saving may consist in a restriction of consumption. But it can also be brought about, without a further restriction in consumption and without a change in the input of capital goods, by an increase in net production (*ibid.*: 515).⁵

⁴He had previously defined the promoting entrepreneur as representing the fact that some people are more farsighted than others (*ibid.*: 255).

⁵Mises conflates these separate causes in his discussion of capital goods. He writes:

As soon as those present wants are sated the satisfaction of which is considered more urgent than any provision for the morrow, people begin to save a part of the available supply of consumers' goods for later use. This postponement of consumption makes it possible to direct action toward temporally remoter ends (*ibid.*: 490).

Although he does not say so outright, he implies in this statement that the *only* source of saving is the postponement of consumption. It should be obvious from other parts in the text that he does not mean to imply that the postponement of consumption is the only source of saving. The section in which he makes this statement is about the relationship between time preference and capital goods and not about economic growth.

He goes on to identify three additional ways that such saving may appear: (1) more favorable natural conditions, (2) actions that improve technology, and (3) less frequent institutional disturbances (*ibid.*: 515-6).

The idea of more favorable natural conditions refer to weather, catastrophes and such. They are self explanatory. A more significant source of saving is improvements in technology. We can assume that he includes these to show that he recognizes that increases in value productivity may occur without resorting to methods of production that take more time to complete. Thus, he first wants the reader to recognize that increases in value productivity can possibly be achieved by merely extending the length of some production process. Second, he wants readers to recognize that entrepreneurs have incentives to make technological advances that increase productivity. No additional time may be needed, he says, to produce goods by using the new technology.

The third additional form of saving is through less frequent institutional disturbances. He does not have in mind market intervention. He is referring to "war, revolutions, strikes, and other crimes" (*ibid.*: 516).

Laissez Faire a Requirement; Interventionism Detracts from Growth

Mises is not satisfied to attribute economic growth to higher saving and investment. These would not occur without laissez faire:

The fact that the standard of living of the average American worker is incomparably more satisfactory than that of the average Hindu worker, that in the United States hours of work are shorter and that the children are sent to school and not to the factories, is not an achievement of the government and of the laws of the country. It is the outcome of the fact that the capital invested per head of the employees is much greater than in India and that consequently the marginal productivity of labor is much higher. This is not the merit of "social policies"; it is the result of the laissez faire methods of the past which abstained from sabotaging the evolution of capitalism. It is this laissez faire that the Asiatics must adopt if they want to improve the lot of their peoples (*ibid.*: 747-8).

The antithesis of laissez faire is intervention. Thus Mises writes frequently about how intervention reduces the standard of living. An example is the "pro-labor" policy that mandates a reduction in working hours:

Let us assume that there are two countries only – Ruritania and Laputania. In Ruritania the final wage rate is double what it is in Laputania. Now the government of Ruritania resorts to one of those measures which are erroneously styled "pro-labor." It burdens the employers with an additional expenditure the size of which is

proportional to the number of workers employed. For example, it reduces the hours of work without permitting a corresponding drop in weekly wage rates. The result is a drop in the quantity of goods produced and a rise in the price of the unit of every good. The individual worker enjoys more leisure, but his standard of living is curtailed. What else could a general decrease in the quantity of goods available bring about? (*ibid.*: 753-4).

Another example is credit expansion:

What catallactics has in mind when asserting that impoverishment is an unavoidable outgrowth of credit expansion is impoverishment as compared with the state of affairs which would have developed in the absence of credit expansion and the boom. The characteristic mark of economic history under capitalism is unceasing economic progress, a steady increase in the quantity of capital goods available, and a continuous trend toward an improvement in the general standard of living (*ibid.*: 564-5).

Yet another restriction on growth is government debt. Mises makes at least two points. The first concerns borrowed funds that are used for current consumption. These come at the expense of the enjoyment of other goods in the future that lenders to the government would otherwise have had. By reducing saving, government borrowing reduces the standard of living (*ibid.*: 845). The second point concerns borrowed funds that are used to finance long term public investment like “roads, railroads, harbors, airports, power stations, and other public works.” His point is that once a people accepts the use of the government debt for this purpose, “nothing hinders the government from so increasing [the part of public debt that is used for consumption] that it in fact absorbs the whole” (*ibid.*: 846). This is basically a slippery slope argument.

The Ultimate Cause: Higher Labor Productivity Due to Specialization and Trade

The most fundamental question to ask about the relationship between laissez faire and the standard living is why laissez faire has succeeded in raising the standard of living. Mises's main answer is the higher productivity due a further division of labor, which he associates with cooperation, society, and civilization:

Thanks to the higher productivity of social cooperation the human species has multiplied far beyond the margin of subsistence offered by the conditions prevailing in ages with a rudimentary degree of the division of labor. Each man enjoys a standard of living much higher than that of his savage ancestors (*ibid.*: 165).

The fundamental facts that brought about cooperation, society, and civilization and transformed the animal man into a human being are the facts that work performed under the division of labor is more productive than isolated work and that man's reason is capable of recognizing this truth....It is a fact that civilization, when judged from this point of view, is to be considered a benefit and not an evil. It has enabled man to hold his own in the struggle

against all other living beings, both the big beasts of prey and the even more pernicious microbes; it has multiplied man's means of sustenance; it has made the average man taller, more agile, and more versatile and it has stretched his average length of life; it has given man the uncontested mastery of the earth; it has multiplied population figures and raised the standard of living to a level never dreamed of by the crude cave dwellers of prehistoric ages (*ibid.*: 171).

What he has in mind is the idea that humans discovered the higher productivity associated with the specialization and trade. As human relationships began more and more to reflect this discovery, their associations acquired a character that Mises named contractual bonds, cooperation, society, and civilization.

Continuation of Capitalism and Laissez Faire Depends on Public Opinion

If capitalism is so conducive to raising the standard of living, why do people often favor interventionism and even socialism. Mises's answer is public opinion.

In dealing with the problem of shortening the hours of work by government decree, the public is not aware of the fact that total output must drop and that it is very probable that the wage earners' standard of living will be potentially lowered too (*ibid.*: 757).

The classical economists took it for granted that when seeing the evidence of capitalism's success, the ordinary person would eschew interventionism and socialism (*ibid.*: 864). They did not realize that a

social system, however beneficial, cannot work if it is not supported by public opinion...It never occurred to the old liberals that the majority could interpret historical experience on the ground of other philosophies. They did not anticipate the popularity which ideas that they would have called reactionary, superstitious, and unreasonable acquired in the nineteenth and twentieth centuries (*ibid.*: 865).

Learn the Lessons of Economics Or Else

What is needed to maintain capitalism and the wealth it generates is education about the special branch of knowledge called economics. With this in mind, Mises ends his book on an apparently pessimistic note regarding whether popular opinion will become informed about the body of economic knowledge:

The body of economic knowledge is an essential element in the structure of human civilization; it is the foundation upon which modern industrialism and all the moral, intellectual, technological, and therapeutical achievements of the last centuries have been built. It rests with men whether they will make the proper use of the rich treasure with which this knowledge provides them or whether they will leave it unused. But if they fail to take the best

advantage of it and disregard its teachings and warnings, they will not annul economics; they will stamp out society and the human race (*ibid.*: 885).

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