Abstract
The Austrian theory of the business cycle has been gaining attention in the popular press and in political circles since the onset of the most recent recession (December 2007). While the artificial boom and subsequent malinvestments fit the Austrian theory, the question in the popular press is, “Which economic policy is the best to alleviate the recession?” However to an Austrian economist, this question is miscast. It should be, “Which economic policy best converts the malinvestments into economically viable capital structures?” since only through a regenerated structure of production can sound economic growth take place. This paper analyzes, from a firm’s point of view, the various policies that are currently in use (modern Keynesianism) to cure the recession and contrasts these policies with those which an Austrian analysis of the business cycle would recommend.

Introduction:
The collapse of the housing market has renewed interest in business cycle theories. The Austrian theory of the business cycle has been gaining attention in the popular press and in political circles, because Austrian theorization of the boom fits the housing bubble better than the mainstream theories do. Unfortunately, the major focus of the Austrians has been explaining how the boom inevitably leads to a bust, leaving aside the liquidation and recovery phases. In essence, the Austrian Business Cycle Theory (ABCT) has not emphasized the effects of the recession as much as other major schools have. This paper attempts to fill in these gaps and explore the mechanics of how businesses convert malinvestments into usable capital structures.

In standard ABCT, the boom is generated by an expansion of credit, lowering interest rates and misshaping the term structure of interest rates. Entrepreneurs are misled by these false signals and start to build up malinvestments. This boom is artificial
and cannot be sustained. The upper-turning point of the business cycle comes as a crisis. It reveals itself as a credit crisis, a real resource crisis, or a combination of the two. A credit crisis appears if the central bank slows the rate of monetary expansion or stops it entirely. A real resource crisis appears if the lack of actual capital goods manifests itself. The result of the artificial boom and build up of malinvested capital is a misalignment in the capital structure of the economy.

To rectify this situation, the malinvested capital needs to be reallocated. The reallocation of capital to a sound production structure is the Liquidation Phase of the business cycle (a.k.a. “The Recession”). The Liquidation Phase is necessary to realign the capital structure. Austrians have long said that the solution to the recession is to “liquidate the malinvested capital,” but what does this actually mean? How do companies do this? What is it like from their point of view? At the extreme, it is through the bankruptcy of some businesses that capital can pass from inefficient uses to more efficient uses. However, not all businesses fail in the liquidation phase. How do the firms that are accumulating losses, but not yet ready to fold, convert their malinvested capital into profitable structures? It is within this context that we will now turn to the point of view of a business or firm.

**Getting to Breakeven:**

When a business is in crisis—that is, constantly losing money—its goal should be to do everything it can to reach a breakeven point, where they stop incurring losses. The idea is that once a business is at breakeven, it can then plan for profitability. Let us examine the two approaches to reaching breakeven.

Consider a business with the following situation: It manufactures a product in which the gross margin is 25%. This means that the labor and material constitutes 75% of the cost of production (its variable costs). As long as a business is able to meet its variable costs, it will stay in business. If the firm is not able to cover its variable costs, it crosses the shut-down point. If the remaining 25% only covers its fixed costs (its overhead), it will break even. When a business accumulates revenue above fixed and variable costs, it begins to make profits. This crossover is the breakeven point.
Let us assume that the business described above has fixed costs (the overhead) at $10,000 a month. This means that the firm must sell $40,000 a month just to break even ($30,000 pays labor and material, and $10,000 pays the overhead).

Now, let us assume that the economy is in a downturn and that the firm is losing money, say $2,000 a month. The business is able to cover its variable costs, but it is not breaking even. This problem can be viewed either as having insufficient sales or having excessive overhead (fixed costs).

If the business could magically expand sales, it would have to first create more product, which means that the variable costs would increase. In this example, the gross margin is 25%; and let’s assume that the margin and the costs are held steady. Therefore, in order to cover the monthly shortfall of $2,000, the firm would have to increase sales by $8,000, in which $6,000 (75%) will go to variable costs.

However for every dollar by which the business can lower its overhead (and other fixed costs), it no longer needs to generate four dollars in sales. By cutting costs, it can operate profitably with lower sales figures.¹

A firm in financial trouble has a greater multiplier in cutting costs than it does in increasing sales. In this case, the multiplier is four times. This fairly obvious point is resisted not because it is some magical or accounting trick. The reason why this is resisted is that no person wants to have his salary cut and no department wants to have its budget slashed. It is very difficult to look a person in the eye and tell him that there is a cut. Nevertheless, it is a necessity. This is why, during a business downturn, most prudent companies immediately turn to cost-cutting.

Cost-cutting measures help to turn the malinvestment into proper capital structures.

**In the Context of the Business Cycle:**

Suppose that a firm overextended itself when, during the boom, it purchased new capital equipment. There was a miscalculation by the firm because it was reading false market signals—the interest rate was too low. With the downturn of the economy, the

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¹ Many businessmen argue that it is wrong headed to cut advertising dollars first, when a company experiences trouble. However, what we are demonstrating is that it makes perfect sense. With a lower overhead, fewer sales are needed to get to breakeven.
firm is squeezed on both sides: revenues shrink and input prices grow. The firm must do something to stay in business. If it is unable to stay in business, then the firm’s assets are sold to other businesses that can better employ those resources. The malinvestment of the failed firm is either put back into the economy through the liquidation process or it is scrapped.

However, let us suppose that this firm does not close its doors. How do cost-cutting measures help transform the malinvested capital? Let us add some detail to our example to help clarify our point. Suppose at the beginning of the business cycle that the natural rate of interest is 6% and our firm is examining a project that has a discounted cash flow of $104,000. If the upfront costs are $100,000, the internal rate of return is 4%. The firm will not take up this project at this time. Now, suppose that the central bank expands the money supply and market interest rate falls to 1%. At this rate, it makes sense for the firm to borrow the money and start the project. During the boom phase, liquid capital is converted into capital goods and equipment. As the new money works its way through the economy, prices and interest rates begin to rise. When interest rates return to the original level of 6%, the firm will begin to suffer an economic loss of 2% (or $2,000 per period). In order for the firm to make up this difference, it either must raise revenue by the $8,000 as described above, or it must cut $2,000 out of its overhead costs.

So far, we have assumed that the level of sales and costs have remained constant. We can consider this to be the best case scenario. In a recession, the volume of sales tends to drop off and input prices tend to rise. Thus, profit margins are further squeezed, thus shrinking the gross margin. If, for example, the gross margin falls to 10%, then it will take an increase in gross revenue of $10,000 to cover the $2,000 shortfall.

**Governmental Policy to Help Firms Get Back to Breakeven:**

The need for politicians to do something grows as the severity of the recession deepens. With regard to active fiscal policy, there are two broad approaches to alleviating the recession: increasing spending or cutting tax rates. The Keynesians have argued that the best policy to cure a recession is to stimulate aggregate demand. With an

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While in the market there are many different interest rates, we are supposing that the relevant rate for our firm, in terms of risk and duration, falls to 1%.
injection of spending through individuals, households and firms, business revenues will climb and these firms will make up for the shortfalls. Suppose that the government chooses to stimulate Aggregate Demand by directly increasing the purchase of consumer goods. If the firm is experiencing a $2,000 shortfall, the amount needed in additional sales is $8,000, assuming constants costs and a gross margin of 25%. In other words to turn the malinvestment into a sustainable capital structure, it will take $8,000 of direct and sustained government purchases. On the other hand, to get the same effect, it will only take a reduction of taxes on the firm of $2,000. Thus, in general, the tax cut approach will place a lower burden on the government (taxpayer).

Active Fiscal Policy:

The manner in which the government injects economic stimulus into the economy has different implications. Four injection channels will be briefly examined: grants, direct cash to consumers (e.g., the Bush Rebates of 2001 and 2008), government contracts to businesses, and tax cuts.

Grants:

The most significant positive aspect of a federal grant to an institution is that the grant is a direct infusion of cash that can be used to cover any shortfall in revenue. If a non-profit institution has the shortfall of $2,000, then a $2,000 grant will cover the immediate crisis. However, such an action is merely temporary; it only lasts as long as there is a flow of money coming from the grant. Furthermore, when institutions spend this money, they create further distortions in the economy, a Cantillon Effect. A basic principle of Say’s Law is that we must first produce and add to the level of societal output before we can gain the wherewithal to consume. When the government grants additional purchasing power to institutions that have failed to sufficiently contribute to the social product, the result is a distortion of the normal market patterns of production. A further consequence is that when the grant runs out, the distortions will have to be corrected. Any amount of malinvested capital will have to be subsequently liquidated as well. Finally, standard public choice analysis recognizes the creation of perverse
incentives that are created by these injections. They, too, will eventually have to be corrected.

**Cash Directly to Consumers:**

In 2001 and again in 2008, the Federal Government directly injected cash into the economy by giving tax rebates to those who filed tax returns. In 2001, the tax rebate was between $300 and $600 depending on whether the recipient’s filing status was single, married or head of household. In 2008, a similar tax rebate stimulus program was enacted that gave most taxpayers a rebate of $600 (single) $1,200 (married) and a $300 tax credit per child.

The design of these plans was to increase the amount of consumption spending by the public. The naive approach to macroeconomic recovery is the focus on GDP, while ignoring the underlying capital structure problems. The intense focus of GDP misleads one into recognizing that consumption is the largest component and therefore, if one merely stimulates consumption, then GDP will rise and the recession will be over. Such thinking views the problem with the economy is that there is insufficient aggregate demand. Unfortunately, we cannot consume our way to prosperity. The key to economic growth is a properly aligned capital structure that is guided by market forces.

To the extent that the tax rebates went into savings and to pay down personal debt, it was a good thing because this additional savings (deferred consumption) can now be used for the realignment of the capital structure. However, the portion of the stimulus that went into buying consumer goods does nothing to realign the capital structure. Instead, consumption spending promotes the maintenance of the misaligned capital structure and is also subject to the problem of overcoming the gross margin. In other words, the malinvested business with the $2,000 loss will need $8,000 in additional sales to cover the shortfall.

Furthermore, the tax rebate stimulus plan is a one time occurrence. It is temporary. Even if the firm was able to overcome the shortfall this period, what happens next period? The liquidation process is delayed; and during this time some capital goods, which could have been converted into other industries, are now no longer able to be converted into more profitable industries.
Government Contracts to Businesses:

There was much discussion by the politicians about adopting “Shovel Ready” plans to stimulate the economy. Clearly such projects do not help realign the capital structure into patterns that market forces desire. Instead, they are distortionary, perpetuate the problem and usually make it worse in terms of recessionary duration and depth. Any benefit to a particular firm is also subject to the duration of the government contract. Additionally, perverse incentives are created by this relationship. The firm now has an incentive to lobby the government for an expanded role in the economy so that it can gain future contracts. If these contracts do expire, then any distortions created from the government’s artificial demand will also have to be liquidated and realigned.

Tax Cuts:

There are two major points that should be elaborated upon. The first is that, in general, the broader the tax cut, the fewer distortionary effects it will have. Perhaps, the term distortion should now be explained. The economic pattern that emerges from the market is not distorted if prices are free to fluctuate, if individuals are able to buy and sell on the open market, and if private property rights are enforced. A distortion is when an exogenous entity (government) is able to override the normal market signals by directly buying or selling on the market, or by implementing rules and regulations that disrupt the market’s normal pattern. In light of this fact, a tax on a particular good or service is distortionary. Thus, the repeal of a particular distortionary tax will also reduce the amount of economic influence of the government. The larger point is that anything that has been distorted will have to be realigned in the future, or the distortion will grow over time, building pressure as water does on a dam.

Malinvested capital comes in many different forms. Sometimes capital is malinvested when something is created when something else should have been created instead. Consider the situation where mining equipment was built but cash registers should have been made instead. However, a broader definition of malinvested capital is that where there is not enough savings to sustain the capital project to completion. If
more savings could be obtained, then the capital project would be converted into a proper investment. Cost-cutting measures are a form of internal corporate savings.

The second major point is that a tax cut is more economical than that of attempting to stimulate sales. The distressed firm that has been our example would benefit directly from a tax cut of $2,000. Such a tax cut would return the firm to the breakeven point. The reduction of taxes on savings, retained earnings, or corporate income in general will free up resources for businesses to use to realign the misaligned capital structure.

Austrians versus Keynesians:

We have been arguing that when an economy is in a downturn, cost-cutting is much more powerful than stimulation by government. The fastest way out of a recession or depression is to bring down the cost to business. Companies that can begin to profit at a lower scale of business can then prepare to expand as they achieve profitability. If government lowers the cost of business through simplified taxes and making the relationships between business and government as low a cost as possible, profitability will return much more quickly.

The Keynesian argument and program is to attempt to stimulate spending on behalf of the public. This was the idea behind the so-called "cash for clunkers" program. The government tried to stimulate the sales of automobiles, hoping to restore profitability to the companies and thus stop the layoffs or even increase employment.

It should be mentioned that there are liberal and conservative Keynesians, but both subsets agree on the paramount imperative of increasing sales rather than cost-cutting. Conservative Keynesians would argue for fiscal stimulus by cutting taxes. This was the approach of the Kennedy administration (1961 to 1963) and it provided an argument for what would later be called supply-side economics. President Kennedy lowered tax rates significantly, but did not decrease spending by the federal government, and thus ran deficits. He did not significantly cut government intervention and regulation.

Liberal Keynesians favor increased government spending to stimulate sales in the economy, which is the policy of the Obama administration and was the policy of the
previous Bush administration. The concept was to stimulate sales through government spending and tax rebates. Both presidents increased the amount of regulation and direct costs on business substantially. The results so far are that the stimulus package has seemingly little effect.

The Austrian solution is a combination of cutting both governmental expenditures and tax rates. Probably the best example of this policy was during the Harding administration (1921 to 1923). President Harding cut both government spending and taxes by about 25% and in about six months pulled the country out a severe recession in which unemployment rose to 12%. It was one of the quickest and most successful efforts dealing with a business downturn in U.S. history.³ The Harding administration later made several mistakes, including raising tariff rates and allowing the Federal Reserve to inflate the currency.

**The Austrian Multiplier:**

This emphasis on lowering business costs and taxes might be called “The Austrian multiplier.” While Keynesians claim to have a spending multiplier, it has yet to be seen. The Austrian multiplier would vary from business to business depending upon its gross margin. For every dollar of costs cut from a business’s bottom line (e.g., through a tax cut), there will be a multiplier equal to the reciprocal of the firm’s gross margin. The one advantage of the Austrian multiplier is its immediacy; it does not have to go through a government bureaucracy or depend upon the spending habits of the public.

The Austrian multiplier effect can be seen when government regulation and taxes are increased. For example, if a business is operating at a 33% gross margin and government implements an expensive round of new regulations, to pay for that regulation, the firm will have to increase its sales by three times the cost of regulation or cut other business expenses. Cutting and downsizing become especially true if the

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company cannot raise its prices to tax the consumer to pay for the cost of regulation.\(^4\) However, the effects of reducing regulation would stimulate businesses become subject to the Austrian multiplier effect all the while having little to zero effect on the federal budget. In fact, with fewer regulations there could be more business activity, which lead to higher tax revenues and, without the rules and regulations to enforce, the size of the governmental payroll could also shrink thus adding to the fiscal health of the government.

**Conclusion:**

In summary, the point that can be drawn from the above analysis is the Austrian multiplier which emphasizes cost-cutting. Reducing government regulation and tax cutting are far more potent toward helping the economy than any Keynesian attempt to increase spending and sales. Cutting the costs across the board helps all firms. Whereas Keynesian government spending programs are specifically aimed towards particular industries and can cause malinvestment in those areas. We conclude that the Austrian approach will improve employment opportunities, enhance the structural productivity of firms, and slow falling government revenues far better than the Keynesian solution.

\(^4\) Companies will try to shift the burden onto the consumers as best they can. However, the incidence of a tax depends upon the elasticities of supply and demand. Since supply is never perfectly elastic, the producer will always bear some of the burden of a tax.