CHAPTER 1

Introduction

It has now become commonplace to point out that Austrian economics has undergone something of a revival in the past twenty years. Certainly, the number of books and articles that take an Austrian view of some issue or another or that make reference to the views of some well-known Austrian economist have grown dramatically since the early 1970s. There are Austrian graduate programs at two universities, New York University and George Mason University, a Ludwig von Mises Institute at Auburn University, and innumerable undergraduate courses in Austrian economics taught at colleges and universities around the United States. Sessions on Austrian themes at professional meetings always draw a respectably sized crowd, and in a few areas such as banking theory and methodology, Austrian ideas are on the cutting edge of the profession. And since the collapse of communism in Eastern Europe and the former USSR, there are few economists who have not heard that the Austrians were right after all about the economic impossibility of socialism.

Although the number of self-identified Austrian economists is still quite small as a percentage of the economics profession as a whole, a marked increase in interest in Austrian ideas – even among those who disagree with most of them – cannot be denied. Yet, despite a greater professional presence of Austrian ideas and Austrian economists now, there is still little general understanding as to what Austrian economics is all about. Austrians say interesting things about the economy that often seem to be true, but how these all relate to contemporary economic theory and practice is still something of a mystery to the profession at large.

Those outside modern Austrian circles are often puzzled by many Austrian claims. Some economists are prone to dismiss Austrian economics as nothing more than conventional economics with a mystifying and wholly anachronistic aversion to mathematics and econometric modeling: As one of my colleagues rather unsympathetically put it, Austrian economics is simply neoclassical economics in words. Others see little more than free market advocacy in Austrian writings. These are people who perhaps have read only Hayek's *Road to Serfdom* (1944), or dabbled in Mises' later writings, or read some of Rothbard's defenses of libertarian politics. Such judgments are not wholly without justification. Austrians do

avoid expressing their ideas in mathematical symbols and most do defend free markets, although this latter activity is hardly unique to Austrians. It is even becoming a rather fashionable activity among intellectuals as the benefits of free markets are increasingly extolled by policy makers from formerly communist countries.

Aversion to mathematics and free market advocacy are distinctively Austrian traits, but they are also superficial identifying characteristics. Those who look a bit deeper often find in the Austrian literature, especially as produced by Ludwig von Mises and Friedrich Hayek, by Israel Kirzner and Ludwig Lachmann, an understanding of market processes that they find enlightening and convincing. Austrians write about the role of entrepreneurship in competitive markets; they describe competition as rivalry, highlight the heterogeneity of products and production techniques that one finds in a market process, and emphasize the role of competition in bringing about new products and new discoveries.

Unlike conventional economists, Austrians are more intrigued by the dynamic and unpredictable change inherent in markets than by the stability that makes equilibrium models appealing tools of analysis. As a consequence, for many economists, especially those who teach introductory courses, who study law and economics, who do public policy analysis and in particular antitrust work, or who have been interested in the contrasts between planned and market economies, the Austrians have touched chords that have resonated with their own intuitive understanding of the economic world, if not always with their theoretical models. Austrian economics seems to be saying something true about the world, something that economists can recognize without being able fully to articulate in the language in which they have been trained.

Indeed, some economists have been so taken with what they call the Austrian "intuitions" that they have felt called to "formalize" them using standard economics modeling techniques. This was the fate, for example, of Hayek's discussion of incentives during the socialist calculation debate when, a decade later, economists such as Oscar Lange (1962) and Leonid Hurwicz (1973) began modeling incentive compatible systems. Or, we might point to the economics of information that was in part motivated by Hayek's essays on knowledge. We also note that Sir John Hicks developed a formal theory of capital he called Austrian (1973) and inspired a cottage industry in modeling time-consuming capital processes (Burmeister, 1974). More recently, Ron Heiner (1983) has attempted to model Austrian insights into the link between uncertainty and institutions in a highly formal manner. Hence, Austrian ideas are sometimes thought to be absorbed into the mainstream. Yet, rather than being grateful for having their fuzzy notions systematized, Austrian are more likely to

complain that the formal models miss the point of what they are trying to say. Where formalization means mathematical models of equilibrium states of the world, Austrians would just as soon pass.

To the uninitiated, this is in many respects the most puzzling aspect of Austrian attitudes. Austrians do not seem to want to play the game by the same rules as the rest of the economics profession, but the rest of the profession is not quite sure what rules they do want to follow. However, here we encounter a catch-22. When Austrians try to talk about the rules – why they do not like the rules of the mainstream of the economics profession or why they think they have better rules – they are accused of concentrating too much on "mere methodology." Methodology is generally believed to be what you do when you cannot do real economics. The cry is often heard: If those Austrians would just forget about methodology and actually do some economic analysis, they would have more credibility. Yet, how do you do convincing economic analysis when your methods are misunderstood or dismissed by those in the dominant game?

The modern Austrian literature reflects this dilemma first by consisting of a disproportionate amount of criticism of mainstream economics and second by containing an unusual amount of methodological writings. Instead of being a source of weakness, however, it is an inescapable consequence of the nature of the Austrian tradition. Austrian writings, as they have emerged since the mid-1970s, present no less than a fundamental challenge to how economists look at the world and do their work. At the very least, Austrian economics is a complete reinterpretation of the methods, substance, and limitations of contemporary economics. At most, it is a radical, perhaps even revolutionary restructuring of economics.

That I describe the Austrian relationship to neoclassical economics as a range rather than a point, however, reflects a deep, divisive, and largely unreconciled debate within the Austrian literature itself. Although current Austrians all acknowledge the same ancestors and emphasize the same principles, the interpretation they place on the relationship of their doctrines to conventional neoclassical analysis divides Austrians broadly into two camps. By exploring the nature of the division between these two camps, we will be in a position both to be clear about what Austrian economics is and is not, and to understand why the answer has been so elusive for so long. But before we describe what it is that Austrian economists disagree about, we should first understand what they have in common.

All modern-day Austrians agree to a few basic propositions: Most fundamentally, they agree that economics should make the world intelligible in terms of human action. This seems to be shorthand for two

related ideas. The first is that a social science should devise explanations about social phenomena that are traceable to the ideas and actions of individual human beings. In more familiar language, economics should subscribe to methodological individualism. The second implication is that since individuals only experience the world through the filter of their own subjective intelligence, economics must explain human action as the responses people make to their subjective interpretations of their internal and external environment. Austrians call this either "thorough-going" or "radical" subjectivism to differentiate it from the more limited subjectivism of neoclassical economics that is content to posit subjective preferences with little attention to other manifestations of human subjectivism in its theories. Such other manifestations include the subjectivism of expectations and of knowledge itself.

Austrians also agree that all human action takes place in time and always under conditions of limited knowledge; this requires that economics not abstract from either time or ignorance in developing its theories. From this, Austrians infer that economics should be about how humans pursue their projects and plans over time, and with limited knowledge of present conditions and with pervasive uncertainty about the future. One prominent area of investigation for Austrians is the institutional remedies humans create to reduce the consequences of uncertainty and ignorance. To paraphrase Hayek, Austrians believe the crucial question economics needs to answer is not why people might be wrong from time to time in their economic decisions, but given the nature of the world they face, why they should ever be right (Hayek, 1978a:86–88).

Although neoclassical economists could also argue that they are theorizing about the human pursuit of projects and plans within the known environment when they model choice as constrained maximization, Austrians are likely to claim that constrained maximization is too narrow a framework to capture the kinds of action that they take to be distinctly human. Human action involves typical economizing behavior, to be sure, but it also involves breaking out of known constraints and discovering new ways of doing things and new wants to satisfy. In fact, the whole Austrian emphasis on uncertainty is linked to a concern with the limitations of knowledge and the way human beings overcome those limitations. To an Austrian, the fact that knowledge is a multifaceted, heterogeneous, disaggregated, often private or tacit and imperfect phenomenon is one of the driving features of the market process. Further, this view of knowledge leads to questions about communication and learning in market processes that take us beyond usual neoclassical concerns.

In sum, all Austrians agree that the market process is best understood as the concatenation of all the actions and interactions of heterogeneous

individuals with differential knowledge and different expectations about the future who pursue their projects and plans through exchange with one another. Following Hayek (1976:108), they are likely to refer to this phenomenon as a "catallaxy" rather than an economy. An economy, they argue, presumes some single intelligence that wishes to "economize" on resources to fulfill an articulable set of objectives. A catallaxy implies a set of procedures within which heterogeneous individuals pursue their own plans in cooperation and competition with one another; a structure where there is no one articulable goal but only many often conflicting individual goals. Further, the interaction of all these purposeful individuals leads to unintended consequences that can never be foreseen in their entirety and always lead to new knowledge as a by-product. This action, interaction, and their unintended consequences is a never-ending process that is not fully captured in contemporary models of economic equilibrium.

Although all Austrians agree with these propositions, not all agree on what follows from them. In fact, two sharply different views of how Austrians should go about constructing economic theories of human action have emerged.

In the current debate, one side of the divide believes that Austrian insights into time and ignorance, subjectivity and processes serve as a vital supplement to neoclassical economics. This side of the argument, most clearly articulated by Israel Kirzner but subscribed to by many others, accepts much of the basic corpus of conventional economics but wishes to change the emphasis in economic explanation away from equilibrium states to the economic processes that lead to their achievement. Kirzner and those who agree with him argue that in economics, equilibrium does no more than describe an end state in a market process, whereas it is the process itself that is of interest. Hence, while accepting the basic legitimacy of the equilibrium construct for theorizing about economic action, these Austrians see their role as one of providing a theoretical supplement to show how equilibrium is in principle capable of being achieved. For Kirzner, as well as for others, the inclusion of an entrepreneurial function in standard economics goes a long way to providing the necessary supplement.

The other side of the debate takes a far more radical view. This side, taking its inspiration from Ludwig Lachmann, believes that taking time and ignorance seriously requires abandoning conventional concepts of equilibrium and developing a whole new paradigm for Austrian economics. This side would argue that all of the disparate threads of Austrian literature can only be woven into whole cloth by abandoning static equilibrium theory entirely and embracing some form of evolutionary

process theory that does not have a static state as an end point. For this group, constant, endogenously driven change is the hallmark of a market process. Interestingly, both sides look for doctrinal support to the same Austrian ancestors – Mises, Hayek, and ultimately Menger. Even more interestingly, both sides are correct in their appeals to the same legitimating ancestry.

In the following pages, I argue that this current controversy, fully articulated only during the 1980s, has roots that go back to the original work by the founder of the Austrian school, Carl Menger's *Principles of Economics*. Both sides claim the same founding ancestor with complete confidence because the same ideas and conflicts that we find in modern debate are present in the pages of Menger's writing. Menger, so often hailed as one of the originators of modern neoclassical economics because of the central role demand played in his theory of value and because of his independent discovery of the principle of diminishing marginal utility, is also the originator of ideas and theories that are not generally captured in conventional neoclassical economics. Although the substance of many Mengerian ideas were easily melded into a neoclassical orthodoxy, the entire organizing principle of Menger's view of the economy, the metaphor that he used to understand economic order, was different from that of his neoclassical contemporaries.

Philip Mirowski (1989) has shown at great length that early neoclassical economics borrowed its method of theorizing from nineteenth-century physics. Mirowski also argues that Menger, unlike his contemporaries, was not at all influenced by nineteenth-century physics and was, in fact, quite innocent of its substance. Mirowski counts this as an inadequacy and accuses Menger of borrowing the mantle of science for his work without the least idea of what science was about (260–261). What Mirowski counts as a shortcoming in Menger, however, I regard as a lucky, perhaps even accidental strength. Menger's innocence of nineteenth-century physics means that he was never completely captured by the methodology of physics that was to lead to the theoretical dead end of modern neoclassical economics that Mirowski so eloquently describes.

On the other hand, Menger did not completely escape allusions to physics; mentions of equilibrium do lightly pepper his prose. Even more, some of his statements about long-run prices can only be understood within the context of general equilibrium states. But equilibrium terminology notwithstanding, physics was not Menger's analogue for scientific economics. Max Alter (1990) has shown that Menger had more acquaintance with evolutionary biology, at least as he understood it, than with physics. Although he had some objections to a slavish borrowing of biological analogies to illuminate economics, the biological analogy was

nevertheless an underlying theme of his work (Menger, [1883] 1985:129–138). Hence, Menger's casual indifference to the characteristics and determination of equilibrium states, but his profound concern with the causes and consequences of economic growth and with questions of increasing knowledge, technological capacity, and increasing economic complexity – all issues that would more naturally be analyzed in an evolutionary context.

At the time of Menger's writing, the discordance between Menger's organizing vision and that of his neoclassical contemporaries was not widely recognized. Menger's successors understandably developed those aspects of Menger's theory that most closely linked up with the emerging neoclassical consensus: his theory of value, opportunity cost, and capital. The side of Menger concerned with processes and change was taken for granted and served no more than as a background assumption to a basically neoclassical program. It was only after 1920 – when first Ludwig von Mises and then, a decade later, Friedrich Hayek engaged in a long and frustrating debate over the economic feasibility of centrally planned economies – that the suppressed Mengerian vision began to be rediscovered.

This debate has justly been described as a turning point both for Austrian economics and for Friedrich Hayek in particular (Caldwell, 1988; Kirzner, 1988; Vaughn, 1990). It kindled a searching if somewhat delayed reexamination of the underlying theoretical presumptions of economic theory and the way in which these presumptions were translated into economic policy. It eventually was to serve not only as a critique of naive applications of neoclassical economics to real-world situations, but, decades later, it was to provide a new set of questions around which to organize Austrian debate.

During the socialism debate, the Austrians increasingly perceived that the reason socialism seemed plausible to neoclassical economists was that they began with a static equilibrium model in which discovery, innovation, changing preferences, and disparate knowledge were ignored. These were the very issues that sixty years earlier had concerned Menger as well. Yet, despite their seminal importance, even Hayek's antisocialism essays – essays that were replete with insights into the nature and use of knowledge in economies, that repeatedly emphasized the dynamic nature of real markets, and that cried to economists to pay attention to the details of market processes rather than stopping short with broad generalization – were not sufficient to engender an immediate revival of Mengerian economics. It would take thirty more years for the insights that Mises and Hayek drew from Menger and applied to the real problem of an alternative economic order to enflame academic debate.

These thirty years were years partly of Austrian assimilation into the mainstream of the academy and partly of Austrian diaspora. Those who assimilated (and they were eminent economists who had left Austria during the 1920s or 1930s, men like Joseph Schumpeter, Fritz Machlup, Oskar Morgenstern, and Gottfried Haberler) carried on inquiry into Austrian themes using accepted neoclassical language and techniques. Those who did not assimilate (Ludwig von Mises was the most prominent example here, although a case can be made that this was Friedrich Hayek's fate as well) existed on the sidelines of academia, marking time and despairing for the future. The perceived triumph of the theory of socialism over its critics had robbed any potential Austrian economics research program of professional credentials.

In the early 1970s, for a variety of reasons both academic and political, the time of Austrian quietude gave way to an awakening of renewed interest in the Austrian tradition. Taking place mostly in the United States, but also in England, Germany, and, to a lesser extent, Austria itself, a new generation of budding economists became attracted to Austrian ideas and Austrian policy views. They were perhaps as much driven by their criticism of the reigning orthodoxy in economics as they were attracted by Austrian ideas. Whatever the motivating force, they once again took up the mantle of Menger and reopened the issues of process, change, growth, and complexity that Menger had begun in his *Principles of Economics*.

The twenty-year period from the early 1970s to the early 1990s has seen a flowering of new Austrian literature. It began with a small, often beleaguered group of people, intrigued with the economics of Ludwig von Mises and talking mainly to each other about his work and the Austrian economics it represented to them. Eventually, the small group grew larger (and older) and opened up their conversation to include friendly voices closer to the mainstream who could help them better understand the relationship between the Austrian tradition and the orthodoxy against which they were rebelling. The conversation continued to widen as others within the profession – such as post-Keynesians, Shackelean radical subjectivists, and institutionalists who have rebelled at some of the same static, equilibrium theorizing that the Austrians criticize, and who have made the same criticisms of the institutionless, ahistorical nature of contemporary theory that characterize Austrian writing – have entered in.[1]

[1] The conversations have not always been free of acrimony. Especially where groups view themselves on opposite sides of the political fence, the language has gotten heated. See for example, William Dugger's intemperate diatribe against Austrian economics (1989:115–124), in a volume of *Researches in the History of Economic Thought* that was intended to present a friendly exchange of views between institutionalists and Austrians.

Out of this conversation has come a self-conscious reflection on what Austrian economics is or might be, after all. (One of my students once quipped that the most accurate definition of a modern Austrian economist is one who asks the question, "What is Austrian economics?") And as we noted above, what has been discovered is that there is no one clear and uncontroversial version of what modern Austrian economics is all about. Some see the strength of the Austrian tradition in its ability to supplement current equilibrium theories with stories of adjustment processes that call upon all the Austrian stock of insights into knowledge, expectations, and creative choice. Others see the only possible resolution of all the tenets of Austrian doctrine to be a recasting of Austrian ideas in an entirely different paradigm. These two positions, exemplified by Israel Kirzner on one hand and Ludwig Lachmann on the other, at the very least seem likely to continue to engender vigorous debate. Clearly, the debate illustrates my contention that not all the important questions in Austrian economics are answered. More important, it marks Austrian economics as a vibrant intellectual endeavor.

In the concluding chapters of this book, I examine the reasons offered by those on each side for their vision of what Austrian economics is all about and offer my own suggestions for the future of Austrian economics. Despite the daunting nature of the task, I ultimately side with the Lachmannians, who argue that if Austrian economics is to have a future, it must lead to a complete recasting of the organizing principle of economic theory. Otherwise, it seems inevitable that the ideas of the new Austrians will either fade from view or be absorbed into the neoclassical orthodoxy in ways that Austrians will claim still miss the point.

A word is in order here about terminology. I use the terms "neoclassical economics" and "mainstream economics" frequently and interchangeably in the following pages. I realize that such a blanket term covers many uncomfortable and perhaps incompatible bedfellows. I suppose one could argue that I am using the terms to mean anyone who is not Austrian and does not also call himself something else (i.e., institutionalist, post-Keynesian, radical political economist, etc.). Such a charge is only partly fair. In fact, I think there is one defining feature of "mainstream" and "neoclassical" economics that warrants the lumping together of many different theoretical approaches. That is a program that explains all human action as variations on constrained maximization where preferences are considered to be given, well-ordered, and stable, and where there is widespread knowledge of constraints. In such a program, the solution to any economic problem is inherent in the data of the preferences and constraints as a matter of "blueprint logic," as Schumpeter might have said (see [1942] 1962:196). This constrained maximization paradigm may be formalized in mathematical terms, but even if it is not,

the logic of neoclassical economics always suggests that such formalization is possible.

What I mean by Austrian economics is not quite so easily stated. Indeed, the rest of this book is an exercise in answering that question. The old Austrian school presents no problems of definition. Austrian economics from 1871 until the 1930s was economics developed by Austrians in Austria. It was not even clear that the national distinction reflected any sharp doctrinal differences with neoclassical economics. However, clearly by the late 1960s in the United States, Austrian economics was regarded by its practitioners as an alternative form of economics analysis from the mainstream, and the set of Austrian economists in this sense was dominated by Americans. How this transition took place is, of course, one of the central topics of this book.

By "new-Austrians," then, I mean those economists who, from somewhere in the 1960s on, residing mostly in the United States, saw themselves as participating in a tradition of economics that began with Menger but was carried forth and modified by Ludwig von Mises. The new Austrians, then, were Austrians by adoption, not by birth, and their allegiance originally was primarily to Mises and only secondarily to the rest of the older Austrian school. For these new Austrians, Mises set the terms of discussion and the topics of debate. We will see that the progress of the new Austrians since the late 1960s has largely been a function of their willingness to go beyond Mises in their exploration of the Austrian paradigm.[2]

My primary goal in this book is to tell the story of the new Austrians and to trace the genesis of the modern debate. That is interesting enough in itself to justify the writing and the reading. The story naturally has a plot, setting, fascinating characters, and intriguing ideas. Even if one does not find much common ground between himself and the conclusions of the modern Austrian school, the genesis and development of the new Austrians illuminate much of twentieth-century economic thought.

There are deeper reasons, however, for coming to understand what the new Austrians are all about. Whether one is an Austrian or not, whether one is sympathetic or not, the new Austrians generally have interesting

[2] Unfortunately, I use the term "paradigm" frequently throughout this work. I am sorry and apologize to the reader immediately, but I simply could not think of another word to capture the idea of an organizing principle or set of ideas. I also use "research program" from time to time. Again, the overused term does convey important meaning as a set of problems to investigate and so is indispensable. I do not hereby mean to suggest that I subscribe to or am offering any accounts of the applicability of either Kuhn's (1970) or Lakatos's (1970) (or anybody else's for that matter) theories of scientific progress.