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The Austrian School of Economics: 1950-2000

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The Earlier History of the Austrian School

The doctrines comprising the Austrian school of economics have varied and the relative position of the school within the mainstream of economic thought has moved from the center to the fringe several times throughout the 130 years of its history. Carl Menger, in his *Grundsatze der Volkswirthshaftslehre* of 1871, substituted subjective marginal utility for the classicists' objective cost of production as the theory of value. Friedrich von Wieser introduced the idea of opportunity cost and emphasized its subjective and ubiquitous character. Eugen von Böhm-Bawerk engaged in applying Menger's theory of value to the theories of capital and interest. The next generation's leaders were Ludwig von Mises and Hans Mayer, who emphasized epistemic, ontological and other philosophical themes. A fourth generation of Austrian economists emerged (most of whom would make their academic mark in the US after WWII) that included such major economists as F. A. Hayek, Gottfried Haberler, Oskar Morgenstern, Fritz Machlup and Paul Rosenstein-Rodan. Austrian economics flourished in the period immediately following WWI.

By the mid-30's, however, the idea of a distinct Austrian program, even in the minds of the Austrians themselves, was seriously waning, in part because the mainstream more or less absorbed the important points the Austrians were making. Mises (1933, 214) had argued that while it is commonplace in modern economics to distinguish between the Austrian, Anglo-American, and Lausanne School, "these three schools of thought differ only in their mode of expressing the same fundamental idea and that they are divided more by their terminology and by peculiarities of presentation than by the substance of their teachings." Hayek was even more explicit when he wrote as late as 1968 that while the fourth generation of Austrian economists continued to show their training in Vienna in the 1920s in terms of their style of thinking and theoretical interests, they could hardly be considered a separate school of thought anymore. "A school has its greatest success when it ceases as such to exist because its leading ideals have become a part of the general dominant teaching. The Vienna school has to a great extent come to enjoy such a success" (1968, 52). Yet by the early post-WWII

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period, the basic insights of Mises and Hayek were much less appreciated by their fellow economists.

The main tenets of the Austrian school that members of the fourth generation thought had been fully incorporated into the mainstream are clear. Fritz Machlup (1982, 42) emphasized that Austrian economists had never been uniform in their belief structure, intensely debating among themselves over the relative importance of concepts and tenets. Nevertheless, Machlup offered six "main tenets" which economists trained in the Austrian approach would accept.

1. **Methodological Individualism**: Ultimately, we can trace all economic phenomena back to the actions of individuals; thus individual actions must serve as the basic building blocks of economic theory.
2. **Methodological Subjectivism**: Economics takes man's ultimate ends and judgements of value as given. Questions of value, expectations, intent and knowledge are created in the minds of individuals and must be considered in this light.
3. **Marginalism**: All economic decisions are made on the margin. All choices are choices regarding the last unit added or subtracted from a given stock.
4. **Tastes and Preferences**: Individuals' demands for goods and services are the result of their subjective valuations of the ability of such goods and services to satisfy their wants.
5. **Opportunity Costs**: All activities have a cost. This cost is the most highly valued alternative that is forgone because the means for its satisfaction have been devoted to some other (more highly valued) use.
6. **Time Structure of Consumption and Production**: All decisions take place in time. Decisions about how to allocate resources for the purposes of consumption and production across time are determined by individuals' time preference.

Machlup offers two other tenets of the Austrian School that he considered "highly controversial."

7. **Consumer Sovereignty**: In the marketplace consumers are king. Their demands drive the shape of the market and determine how resources are used. Intervention in the marketplace stifles this process.
8. **Political Individualism**: Political freedom is impossible without economic freedom.

Machlup also hinted at the Austrian view of markets as a process, i.e., the adjustment process and path toward equilibrium, rather than the correctness and usefulness of equilibrium theory and the conditions of static equilibrium.

Machlup's six main tenets are all positions more or less embraced by mainstream economics. The key to what differentiates Austrian economics from mainstream economics in Machlup's eyes then seems to be the controversial tenets seven and eight. Unlike the previous six tenets, these two have a normative edge to them. Both, on some level or another, seem to be saying that free markets are superior to government intervention. Indeed, in his piece, Machlup points out that contrary to many Austrians who view their economic statements as *wertfrei*, "nevertheless, the label, 'Austrian economics' has come to imply a commitment to the libertarian program" (1982, 45). Thus, in Machlup's mind Austrian economics is neoclassical economics with a free market bent. No doubt Machlup is proud of his educational pedigree in Vienna, but even more so because it had proven so successful in getting its main teaching accepted as part of the dominant teaching in economics.

For Austrians like Machlup trained in the 20's, the defining characteristics of Austrian economics are tenets held in common by the mainstream. But if we agree with this statement, how does the notion of an Austrian school of thought distinct from the mainstream make sense? The answer to this question lies in the advances Austrian economics achieved post-WWII, in particular in the unique contributions that Mises and Hayek made in the 1940s in *Human Action* (1949) and *Individualism and Economics Order* (1948). For Mises and Hayek the ideas in these works were merely statements of "modern economics," but in the hands of the fifth (Rothbard, Lachmann and Kirzner), sixth (e.g., Rizzo, Lavoie, Garrison, White, Block and Salerno) and seventh (e.g., Selgin, Boettke, Horwitz, Prychitko) generations of Austrian economists these ideas would become the framework for an alternative paradigm in economic science.

Redrawing the Lines: Mainstream and Austrian Economics Dehomogenized

In the 1920's and 30's Mises and Hayek were engaged in an intellectual battle with the socialists over the feasibility of socialism (see Boettke, ed. 2000). The great debate that ensued between these two and the socialist's most prominent figure, Oskar Lange, came to be called the "socialist calculation debate." Mises maintained that since socialism, by definition, precluded the possibility of private ownership of the means of production, no market prices that reflect the relative scarcities of resources could emerge. Without market prices to guide production, he argued, socialism is unable to rationally allocate resources among competing ends. Strictly speaking, socialism is impossible.

Lange responded by claiming that market prices are unnecessary to rationally allocate resources. The socialist central planners need only establish shadow prices and then instruct industry managers to produce at that level of output which set price equal to marginal costs, and minimize average costs. If the planning board selects the wrong prices, simple trial and error would quickly reveal the correct prices. Lange postulated an adjustment process within his model similar to the process that underlies the Walrasian model.

Hayek responded to Lange's rebuttal by pointing out that Lange's model assumes everything it needs to prove. Only in a state of final equilibrium where final prices are known could the planners set price equal to marginal costs, and minimize average costs. In the Walrasian model equilibrium is guaranteed through a pre-reconciliation of plans. In equilibrium agents plans dovetail with one another so that all opportunities for mutual learning have been exhausted. The Walrasian model clarifies the conditions under which equilibrium could say to be obtained, but the model is silent on how actors' plans could be adjusted in an equilibration process. The pre-reconciliation of plans is a defining characteristics of equilibrium, but the key theoretical question that economists must address is how in the absence of such pre-reconciliation individual actors will be lead to reconcile their plans with one another. Hayek argued that individuals outside of the equilibrium state will be moved to discover the opportunities for mutual learning since each unexploited opportunity represents possibilities for improvement in their lot in life. The ceaseless activity of the market is driven by the opportunities for mutual gain. If the data of the market were frozen this activity would converge quickly on a state of affairs where all mutual gains are exhausted. Due to the constantly changing nature of market conditions, this equilibrium is constantly shifting. What allows capitalism to discover the knowledge necessary to allocate resources effectively is the competitive market process. Only via this process can we generate the knowledge necessary to make rational allocation possible. Lange's model left no room for the activity of economic life and as such his model could not address the dynamic problems that socialist planning would have to confront in practice.

Later Mises buttressed Hayek's argument with his notion of the entrepreneur. The entrepreneur, Mises stated, is the driving force of the market process. Entrepreneurs both create and respond to the changes in market conditions and through their profit-seeking push the market in the direction of clearing. Absent the institutional framework of private property that allows entrepreneurs to appraise the economic situation via the price system socialist planning must fail. While Hayek's work in response to the market socialists focused on fleshing out the importance of the market as a process that generates a price system that enables us to make use of dispersed knowledge, Mises subsequent work not only restated his argument on the impossibility of economic calculation under socialism, but also developed his notion of the entrepreneur as the driving force in the market economy.

It was only in the years following the socialist calculation debate, in the late 1940's, that Mises and Hayek fully understood that their view of the nature of the economic process was fundamentally different from the view of the rest of the economics profession (see Kirzner

1987). The increasing emphasis by Mises and Hayek on uncertainty, entrepreneurship, knowledge and market processes all emerged in the calculation debate. The calculation debate forced Mises and Hayek to really elucidate their understandings of the market process and made them realize the implications of their own ideas. They were blind-sided by the fact that Lange (and Lerner) used neoclassical arguments to construct a defense of socialist economic organization. Although by the 30's it seemed as though the mainstream had incorporated Austrian ideas rather fully, it became clear to those trained under them in the late 40's and 50's, that the Mises and Hayek understanding of the economic process was very different and far from being accepted by the profession at large. The dividing line between Austrian and mainstream ideas was redrawn and with it the Austrian school, as a distinct school of economic thought, reborn.

The Post-WWII Perspective of Austrian Economics

Against this backdrop grew the next generation of Austrian economists who trained post-WWII in the 1950's. The tenets of market process theory and a focus on the importance of entrepreneurship are conspicuously absent in Machlup who trained in the 20's. Only post-WWII did the importance of these elements to Austrian economics (along with several others to be discussed later) emerge. How then did Austrian's trained in the 50's view Austrian economics?

We can see these differences most clearly by looking at the way an Austrian trained in the 50's defined his school of thought and contrast them with Machlup's understanding. Kirzner (1986) acknowledges the correctness of Machlup's six tenets but points out, that the existing list does not take into account the theoretical advances made in the 1940s by Mises and Hayek.

In light of the contributions made by Mises and Hayek in the socialist calculation debate, Kirzner believes two more tenets must be added to Machlup's six to complete the list. These are:

a) Markets as a process-- the notion of markets and competition as learning and discovery processes.

b) Radical uncertainty--uncertainty pervades all our actions and is the ubiquitous context in which all choice must be made.

While these ideas only become articulated in the post-WWII work of Mises and Hayek, they were partly evident as far back as the early 30's. Indeed, Kirzner points out that the Austrian critique of "functional price theories," and calling for "causal-genetic theories" was an early expression of the importance of market process theory (see Cowan and Rizzo 1996). The

Austrians were stressing the importance of understanding the sequence of events causing prices to emerge over the sterile description of static equilibrium. But Austrians in the Mises circle in Vienna, Kirzner says, did not recognize this insight as a radical departure from mainstream economic theory.

For Kirzner, it is this notion of market process and uncertainty that distinguish Austrian economics from the mainstream. Kirzner's work, while emphasizing the uncertainty present in all human decision-making, has primarily focused on the entrepreneurial market process (e.g., 1973). Ludwig Lachmann, on the other hand, tended to emphasize the elements of radical subjectivism and radical uncertainty inherent in the economic process (e.g., 1977). The different emphases of these two scholars led to the internal theoretical debate within the Austrian school in the 1970s and 1980s on the equilibrating properties of the market process (see Vaughn 1994). O'Driscoll and Rizzo's *The Economics of Time and Ignorance* (1985) sought to build on the twin themes of uncertainty and market process and restated the theoretical contribution of the Austrian school of economics in relation to contemporary economic theory and policy. O'Driscoll and Rizzo's work appealed to an audience of heterodox economists, who found the emphasis on subjectivism, time, uncertainty, and indeterminancy within the economic process a welcomed relief from the sterile theory of neoclassical economics. The debate between Kirzner and Lachmann remains unsettled in the literature, but as much of modern mainstream theory moved away from general equilibrium models so have Austrians ceased to focus their theoretical attention on the issue of whether the market process converges to general competitive equilibrium or not.

Beyond Microeconomics

Our story has emphasized the distinguishing characteristics of the Austrian approach in the field of microeconomic theory. The Austrian position with regard to macroeconomic theory can be summed up as holding the position that while there may indeed be macroeconomic problems (unemployment, inflation, business cycles) there are only microeconomic explanations and solutions. There are no aggregate relationships unmoored to individual choices that matter for economic analysis. This position, of course, brought the Austrians into opposition with a post-WWII economics dominated by Keynesianism and its emphasis on the relationship between aggregate variables. Hayek had identified this aggregation problem with Keynes' economics in his earlier debate with Keynes in the 1930s. He argued that aggregation masked the structural composition of an economy that must be scrutinized if the economist hopes to understand overall economic performance (see Caldwell, ed., 1995).

While their work on capital theory (e.g., Kirzner 1966 and Lachamann 1956) provides a bridge between microeconomic and macroeconomics, Israel Kirzner and Ludwig Lachmann tended to emphasize the microeconomic tenets that constituted a unique Austrian understanding of the market economy, while the other fifth generation economist Murray Rothbard tended to emphasize the macroeconomic analysis that would differentiate the Austrians from other schools of economic thought in the 1960s (see Rothbard 1962, 661-764; 832-839; 850-879). The key to this, in Rothbard's mind, was an explanation of the costs and consequences of government pursuing inflationary credit expansion. Rothbard argued that the "bust" in the business cycle was causally linked to the earlier government generated "boom". The market economy is self-correcting and will quickly eliminate the earlier government generated errors in investment, unless the process of adjustment is interfered with by government policies.

Rothbard's message, like the similar message provided by Mises and Hayek during the 1930s, was rejected by the majority of economists in the 1960s who believed that the role of the economist was to provide sage advice to government policy-makers on how to maintain the economy in full employment. But for a generation of economists coming of age in the late 1960s and early 1970s, the earlier macroeconomics consensus was fracturing in light of the theoretical incoherence of the Keynesian synthesis and the empirical record of Keynesian demand management policy. The Monetarist counter-revolution led by Milton Friedman, and the New Classical revolution led by Robert Lucas, effectively displaced the Keynesian hegemony in macroeconomics by the mid-1970s. In that mix, a resurgent Austrian school of economics must also be mentioned. Hayek was awarded the Nobel Prize in 1974, and his pre-Keynesian theories of the economic process started to get a wider reading. A group of younger economists earning their PhD's precisely at this time who were raised on Rothbard's writings capitalized on the moment to pursue new work in macroeconomics.

Gerald O'Driscoll's *Economics as a Coordination Problem* (1977) was the first systemic examination of the work of F. A. Hayek that placed Hayek's work on monetary theory and the trade cycle within a broader unified framework of economics. Roger Garrison began to present the Austrian cycle within a standard model for a comparative analysis in the 1970s. Garrision's work culminated in his *Time and Money* (2000), where he argues for a switch from the labor based macroeconomics of Keynesianism and Monetarism to a capital-based macroeconomics championed by the Austrians. Peter Lewin's *Capital in Disequilibrium* (1998) and Steve Horwitz's *Microfoundations and Macroeconomics* (2000) are other contemporary contributions to Austrian macroeconomics.

In addition to the problems of the trade cycle, Rothbard's work emphasized the fraudulent and destructive force the government represents with its monopoly position over the money supply. Hayek also wrote against government monopoly of the money supply and in the 1970s called for the “Denationalization of Money” (1976). Again, young scholars raised on Rothbard’s writings on the problems of government money were able to exploit the inflationary period of the 1970s and offer a radical argument for “free banking.” Lawrence H. White’s *Free Banking in Britain* (1984) led to a burgeoning literature on how a system of competitive currency would in fact operate. This “free banking” strain of modern Austrian economics has had considerable success in addressing the mainstream of the economic profession, and it is not uncommon for work in this field to be published in the leading professional journals (see, e.g., Selgin and White 1994).

Economic Systems and Economic Development

The collapse of the Soviet-type economies in the late 1980s was the most significant political economy event since the Great Depression. Standard models of optimal planning, and the macroeconomic examination of Soviet economic growth proved to be unable to explain the collapse of the Soviet system and offer advice for the transition from socialism to capitalism. The Austrian economists had long been the most vocal critics of the socialist economic system in the economics profession. Don Lavoie’s *Rivalry and Central Planning* (1985) was perfectly timed in order to capitalize on this historical situation. Lavoie’s work demonstrated how the market socialist model of neoclassical economists diverted the debate into statics and how a re-examination of the dynamic character of the market economy should transform economic research to focus on questions of the institutional environment and the entrepreneurial character of economic activity. Following up on Lavoie’s work, Boettke (1990) addressed the origin of the Soviet political and economic system and Prychitko (1991) took up the challenge of the workers’ control model of socialism. The modern Austrian focus on the importance of institutions in providing the incentives for the acquisition and use of information and entrepreneurial innovation has merged considerably with the work of the New Institutional Economics of James Buchanan, Ronald Coase, Douglass North, Gordon Tullock, and Oliver Williamson (see Boettke 1993, 2001).

Development economics has also been transformed in the wake of the collapse of communism. Scholars are now emphasizing the underlying institutional environment and cultural preconditions that enable countries to realize generalized prosperity (see Lal 1999). Recent work in economic development is taking up the task of testing Hayek’s claims about common law traditions and the rule of law (Mahoney 2001). In short, in the area of economic systems and development, Austrian ideas are making significant inroads into the mainstream of contemporary research.

Conclusion

Contemporary Austrians straddle heterodoxy and orthodoxy within the economics profession. They offer a heterodox critique of formal theory, but contribute to the policy consensus that has emerged in the past 20 years that has moved away from state led development to a more *laissez-faire* position in international and domestic policy. But the intellectual battleground today is much more defined by methodological issues than ideological ones. Indeed, many of the policy wisdoms which flow from an Austrian analysis of the market economy are part of the common knowledge of market oriented economists, but the Austrian methodological stance and theoretical agenda that generated those wisdoms are rejected by those who still pursue the model and measure research strategy in economic science. Thus, today the Austrian school finds in a strange position with regard to their fellow economists. They believe others have stumbled upon the right answers to many practical policy questions but for the wrong reasons.

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