

# The Austrian School of Economics<sup>1</sup>

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**Abstract:** This paper presents an overview of the Austrian school of economics. Even though it started with Carl Menger and the intellectual circle in 19<sup>th</sup> century Vienna, its theoretical and philosophical roots go far back to the Scholastics and even the Greeks starting with Socrates (469-399 B.C.), Plato (427-347 B.C.), Aristotle (384-322 B.C.) and later John Locke (1632-1704), Richard Cantillon (1680-1734), David Hume (1711-1776), Kant (1724-1804), Anna Robert Jacques Turgot (1727-1781), Adam Smith (1732-1790), Franz Brentano (1838-1917), and others. On the other hand, this school faced considerable amount of difficulties as it confronted the German Historical School and the old mercantilists and protectionist doctrines of Europe after Carl Menger (1840-1921). The second generation included such economists as Eugen von Böhm-Bawerk (1851-1914) and Friedrich von Wieser (1851-1926) who defended the school against the German Historical School. Then the third generation of Austrian economists such as Ludwig von Mises and Friedrich von Hayek followed the traditional path of the school even after its migration from Austria to the United States. Others such as Joseph Schumpeter (1883-1950), however, later denied their Austrian roots. Now the fourth generation Austrian economists attempt to theorize Austrian philosophy in a coherent and realistic way into mainstream economic theory.

**Keywords:** Austrian Economics, Carl Menger, Praxeology, and Methodology.

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# Introduction

The Austrian school is a discipline in economics that bases its formalism of economic theories on logic and introspection. This school comes in contrast with the methodology used by many mainstream economists today, which focuses on methods used in the natural sciences. Hence, Austrian economics has become against much of what is going on among neo-classical economists and at the same time, it is almost against everything that the Keynesians have to say. The Austrian School is usually associated with groups who call themselves classical liberals or libertarians. These groups mostly call for a reduction in the role of government in the social, economic, and political aspects of the society to its minimum level. The story of Austrian economics started with Carl Menger (1840-1921). However, the ideas and basis of the school go far back to the philosophical findings of many scholars, both before and after the Renaissance. At the same time, Austrian economics continues to evolve considerably since the death of Menger. This paper focuses on some of the Pre-Mengerian, Mengerian, and Post-Mengerian ideas that ultimately shaped the Austrian school of economics. Then it goes further and considers the methodology of the Austrian school in brief detail. Finally, it concludes by listing and discussing some of the contributions of Austrians economists in modern economic theory.

## Pre-Mengerian Era

The origins of Austrian economics go back to the Greek philosophical tradition starting with Socrates who first introduced the idea of wisdom as a psychoanalytical product of a specific function of the mind. Socrates method was the name given to this way of thinking. In the later generations, philosophers such as Plato and Aristotle interpreted this Socrates method in their own way. In his famous book, *the Republic of Plato*, Plato introduces a utopia and concludes by noting that the whole function of a society is to move towards this utopia. He also identifies a role for a “king,” “genius,” or “the best of men” who could lead this massive collective movement towards this utopia. On the other hand, there was Aristotle who believed that the universe functions based on certain unchanging and fixed laws. Hence, the process of gaining wisdom (epistemology) is the study of these fixed laws. Hence, two distinct philosophical ideas emerged from the Greek philosophical tradition: Plato’s utopianism and Aristotle’s realism.

Before the emergence of the Renaissance, the Scholastics were the most influential. More specifically are the followers of the famously known figure of the 15<sup>th</sup> century Europe, St. Thomas Aquinas (1225-1274). He and his followers who conducted most of their academic work at the University of Salamanca in Spain, started a new movement which redefined the role that philosophy played in relation to religion. Then there were Sir Francis Bacon (1561-1626) and Rene Descartes (1596 - 1650). Even though they rejected the scholastics method, they emphasized the mind as the centerpiece in a methodology of science. John Milton (1608-1674) wrote his famous book *Areopagitica* in 1664. The name of the book comes from the famous Athenian Isocrates (B.C. 436-338) who wrote a speech named "Logos Areopagiticos." Areopagitica's importance is its significance and the

emphasis that it puts on the idea of freedom, liberty, and individual rights. However, at the same time that Milton stresses the importance of these democratic ideals, he emphasizes the fundamental principles and assertions of having civil and democratic societies. This way he moves away from making any ideological introspection about the very ideas he sought to explain and defend. Then came John Locke (1632-1704) who along his work *Essay Concerning Human Understanding* (1690), wrote other manuscripts that focused on the importance of education, property rights, and toleration in a civil society.

Richard Cantillon (1680?-1734)<sup>3</sup> who is probably considered one of the first scholars who explicitly looked at economics from a deep perspective, wrote his famously known book *Essay on the Nature of Trade in General* in 1730. Cantillon, who was born in Ireland but lived in Paris as a bank broker, became a well-known figure for both the Physiocrats and many classical liberal theorists starting with Adam Smith. Cantillon wished to theorize economics by constructing long-run equilibrium theory and a theory of output. Then Hume (1711-1776) considered one of the most influential classical liberal theorists. Some of Hume's works include *Inquiry Concerning Human Understanding* (1777) and even his less formal manuscript *Essays, Moral, Political, and Literary* (1742).

Adam Smith (1723-1790) has two major books *The Theory of Moral Sentiments* (1759) and most certainly his *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776). Then Anna Robert Jacques Turgot (1727-1781) came with his famous book *Reflections of the Formation and Distribution of Wealth* (1774). Then Thomas Robert Malthus (1766-1834) wrote *An Essay on the Principle of Population* (1798). Then Jean-Baptiste Say (1767-1832) came with his famously known books *A Treatise on Political Economy* (1803), *Economic Sophisms* (1845), and *Selected Essays on Political Economy* (1848).

In the 19<sup>th</sup> century, Austria with the development of the many intellectual circles devoted to the Marxist and socialists ideals, Franz Brentano was a figure who called for the revival of Aristotle. Brentano was a leading figure in the philosophical development of Austrian economics. He was a close friend of Menger. Menger used this in his development of the methodology of Austrian economics by stressing the importance of a theoretical framework based on the idea that the universe is based on fixed and unchanging laws.<sup>4</sup>

## Carl Menger

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<sup>3</sup> There is still some uncertainty among historians about the life of Richard Cantillon, but most agree that he was born in 1680.

<sup>4</sup> Menger gets this idea from his Aristotelian roots through the ideas of Brentano. This idea came in contrast to the methodology of the German Historical School which had Hegelian roots and stressed the importance that there are no fixed laws in the universe (i.e. every theory has an exception). Hence, the “correct” method of conducting research in the social sciences is an empirical analytical one (see Caldwell 2003; Vaughn 1994).

The major movement in Austrian economics started with Carl Menger's views against the German Historical School (GHS). The GHS included such figures as Karl Knies (1821-1898), Gustav von Schmoller (1838-1917), and Adolf Wagner (1890-1944). This school emerged in the 19<sup>th</sup> century and it still influences the literatures in philosophy, economics, sociology, political science, and psychology. Although the GHS and the Austrian school were two opposing schools, their members had many close interactions. For example, Werner Sombart who was one of the most important figures of the GHS was a friend of Mises and the teacher of Ludwig Lachmann (1906-1990). On the other hand, another economist, Othmar Spann also a part of the GHS, was a teacher of Hayek. GHS members were against any lawful theoretical study of the social sciences especially economics. Instead, they argued for a scientific/empirical method. They were in favor of a historical and practical interpretation of economic science. The GHS was a continuation of the ideas of the German mercantilists of the seventeenth century and eighteenth century cameralists. These theorists were in favor of a state-run economy. The name of G.W.F Hegel (1770-1831) comes to mind as the leading philosopher whose ideas shaped the philosophical basis of GHS. Richard Dien Winfield, for example, presents positive outlook of Hegel's economics by emphasizing his positive view of property rights in a free society. However, Hegel believes that this system of property rights and market system is possible only with government intervention. As Gordon argues:

Hegel saw the state as the director of the economy. "Civil Society," though not a part of the state, fell under its authority. To allow unrestricted scope to the supposed laws of classical economics was to subordinate a higher entity, the states to a lower, and the economy. Instead, the economy should be manipulated to enhance the state's power (1993, 5).<sup>5</sup>

The *Methodenstreit* was a fight between the German Historical School and the Austrian school of economics. However, the two major figures that led the school were Carl Menger from the Austrian side and Gustav Schmoller from the German side. Menger's book; *Investigations into the Method of the Social Sciences* started the conflict (Caldwell 2003). Menger argued for a theoretical method of inquiry in the social sciences. He also discussed the idea that every correct theoretical abstraction of social and economic changes is the result of actions of individuals and agents in the economy. This theoretical perspective introduced by Menger is *Methodological Individualism*. This battle was a starting point for future progress in both the German Historical School and the Austrian school. This was the starting point for the Austrian school of economics that based its theoretical analysis on the methodological subjectivism and an individualist<sup>6</sup> interpretation of the methodology of science. Now, let us look at Menger's life in more detail.

Carl Menger was born on February 18, 1840 in Galicia. His father, a lawyer, and mother, a daughter of a wealthy merchant, alongside his two brothers Max and Anto were very influential in Menger's intellectual career. He studied economics in the University of

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<sup>5</sup> This is a reference from the summary paper of the actual book. However, this paper uses only the contents in the book.

<sup>6</sup> The term individualistic stems from individualism. Individualism is a political, social, and economic philosophy, which acknowledges the importance of individuals in the social and economics structure and most importantly human behavior. Libertarianism, classical liberalism, neo-liberalism, and new-conservatism are four schools of thought that are rooted in the philosophy of individualism. These schools stress the importance of rule of law, education, tolerance, free market economy, limited government, and individual rights and responsibility as the necessary elements of a civil society (see Boaz 1997).

Prague and the University of Vienna. After that, he started working as a journalist in 1863. During this time, he wrote a myriad of newspaper articles, comedic novels, and even established a daily newspaper. His career picked with the publication of his *Principles of Economics* in 1871. In 1876 Menger became a tutor of the eighteen-year old Crown Prince, Rudolph von Hapsburg. At the same time that Menger presented his arguments, The German Historical School guided by Gustav Schmoller constantly attacked Menger and his theoretical position. In 1883, he published a book named *Untersuchungen über die Methode der Socialwissenschaften und der Politischen Oekonomie insbesondere* that focused explicitly with the idea of method and methodology in economics. This book created a wave of disagreements and attacks from the historicist towards Menger and his followers. Hence, Menger wrote another manuscript in 1884 *The Fallacies of Historicism in German Political Economy*, which presented Menger's view of the errors and flaws of the methodology of the German Historical School. This was the beginning of the famously known Methodenstreit, which started with the Austrian School and the German Historical School. Menger was also known for his role in the "Marginal Revolution" in the 1870s alongside with Marie-Ésprit Léon Walras (1834-1910) and William Stanley Jevons (1835-1882). Finally, he died in February 26, 1921 (see Vaughn 1994; Cubeddu 1993; Gordon 1993).

## Post-Mengerian Era

### Second Generation

The second generation of the Austrian School consisted of two figures, Eugen von Böhm-Bawerk (1851-1914) and Friedrich von Wieser (1851-1926), who expressed the ideas of Menger. Menger established economics as a science based on logic and deductive reasoning. Wieser and Bawerk took Menger's ideas and applied to economic theory by reinterpreting such theoretical ideas as value, price, capital, and interest.<sup>7</sup> In another book, *The Positive Theory of Capital* (1891), Bawerk concluded by stressing the idea, that interest rate is the normal rate of profit. He also introduced the theory of time preference in regards to capital. Wieser defined the study of neoclassical economics as the understanding and analyzing of such concepts as opportunity cost, scarcity, and resource allocation. In his two famous books, *Natural Value* (1889) and *Social Economics* (1914), he established his theoretical composition of economic ideas such as the theory of imputation. At the same time that Wieser and Bawerk theorized in economic theory based on their theoretical methodology of logic and introspection, they continually attacked the Marxists and socialist doctrines of collectivism and government interventionism. One of these debates was the "Economic Calculation Debate," which was a critique of socialism from the Austrians that concluded that socialism is an inefficient economic system because it fails to provide an accurate measurement of the components in an economy.

### Third Generation

Then there was the third generation of Austrian theorists, namely Ludwig von

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<sup>7</sup> For example, Bawerk's *History and Critique of Interest Theories* published in 1884 is an account of some of the interest theories developed by previous economists. Bawerk's concludes that interest is an inherent and to use a more modern terminology "endogenous" institution in the market system.

Mises (1881-1973), Joseph Schumpeter (1883-1950), Friedrich von Hayek (1889-1992), Felix Kaufmann (1895-1949), Lionel Robbins (1898-1984), Alfred Schütz (1899-1959), Oskar Morgenstern (1902-1976), Fritz Machlup (1902-1983), Paul N. Rosenstein-Rodan (1902- ), and even Sir John Hicks (1904-1989)<sup>8</sup>. It was at this moment in time that the research of many Austrian school economists dispersed. Their migration from Austria to American Universities was a new start for the school.<sup>9</sup> Although these figures continued the Austrian tradition, they brought the ideas of the Austrian school to United States. Mises and Hayek were two economists who continued the tradition; however, Schumpeter shifted his ideas towards the thoughts of Walras one of the three figures who started the Marginal Revolution in economics. The works of others were very marginal in terms of the development of the Austrian tradition. Mises wrote his *Theory of Money and Credit* in 1912, which developed a regression theorem about the emergence of money as a spontaneous phenomenon through the market system. Then he wrote his *Nation, State, and Economy* in 1919, which developed a theoretical economic framework for post war economies of WWI. Then he wrote his *Socialism* in 1921, which is one of the classic works against socialism. In that book, he concludes that since Socialism does not have a defined set of private property rights and does not allow a free exchange of goods and services in the economy it will fail. On the other side, Hayek wrote great pieces that were part of the economic calculation debate (see Hayek 1945, 1937). While in Austrian, Mises set up a *Privatseminar* at the Chamber of Commerce in Vienna, which attracted such figures as Hayek, Machlup, Morgenstern, Haberler, and Rosenstein-Rodan. This was a breathing ground for many of the works later conducted in Austrian economics. With the start of WWI and later WWII, many of these leading Austrian figures moved to America. The story of the Austrian school as it moves to the United States becomes more interesting. While Hayek is in Chicago, he becomes one of the leading defenders of classical liberalism and libertarian ideas. He along with Gunnar Myrdal wins the 1974 Noble Prize in economics “for [his] pioneering work in the theory of money and economic fluctuations and for [his] penetrating analysis of the interdependence of economic, social, and institutional phenomena.”<sup>10</sup> At the same time, Mises established an intellectual center in New York University where he taught and motivated many students such as Israel Kirzner and Murray Rothbard (1926-1995) to continue the Austrian tradition.

## Fourth Generation

The fourth generation of economists included such figures as Peter Boettke, Karen Vaughn, David Gordon, Murray Rothbard, Henry Hazlitt, Richard Wagner, James Buchanan, Vernon Smith, etc... Austrian economics has rooted in many of the newly founded disciplines in economics such as institutional economics, experimental economics, public choice theory, environmental economics, and it still influencing many macro and micro theories. There are now institutions such as the Cato Institute, Mises Institute, American Economic Foundation, and others that encourage and promote the Austrian

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<sup>8</sup> Figures such as Sir John Hicks, especially after the Keynesian Revolution, distanced themselves from their Austrian roots.

<sup>9</sup> For example, Mises went to New York, Machlup to Buffalo, Rosenstein-Rodan to MIT, and Haberler to Harvard. For more information about this migration, (see Vaughn 1994).

<sup>10</sup> For more information about the specifics of the Noble Prize see:  
<http://nobelprize.org/economics/laureates/1974/index.html>

philosophy in the American and the world political arena. On the academic side, such universities as George Mason, New York, Auburn Washington, etc... are the theoretical backbone of the school's growth today. Now, let us look at the methodology of Austrian economics.

## Methodology of Austrian Economics

Methodology of Austrian economics is usually associated with one term, praxeology. Praxeology is a term that has major philosophical and theoretical roots. However, Ludwig von Mises first used this term as the distinctive methodology of Austrian economics in his famously known book *Human Action*.<sup>11</sup> For example, Vernon Smith who won the 2002 Noble Prize in economics "for having established laboratory experiments as a tool in empirical economic analysis, especially in the study of alternative market mechanisms," writes about the significance of praxeology in the works of Mises in this way:<sup>12</sup>

The core of Ludwig von Mises's thought is the theory of human action, or praxeology, the general science he seeks to articulate. Within this general science is included\_ embedded in it\_ catallactics, or the science of exchange...This is because praxeology is neutral with regard to any value judgments concerning its data \_\_that is, the ultimate ends chosen in human action (1999; 195).

On the other hand, Mises himself writes:

It is no longer enough to deal with the economic problems within the traditional framework. It is necessary to build the theory of catallactics upon the solid foundation of a general theory of human action, praxeology. This procedure will not only secure it against many fallacious criticisms but clarify many problems hitherto not even adequately seen, still less satisfactorily solved. There is, especially, the fundamental problem of economic calculation (1949, 7).

In another part of the book, Mises defines the historical-classical liberal roots (Cantillon, Mill, Hume, and Smith) of praxeology this way:

The general theory of choice and preference goes far beyond the horizon which emphasizes the scope of economic problems as circumscribed by the economist from Cantillon, Hume, and Adam Smith down to John Stuart Mill... [Hence,] out of the political economy of the classical school emerges the general theory of human action, *praxeology* (1949, 3).

Murray Rothbard who is probably one of the best students of Mises and many of his works were an inspiration of the ideas and works of Mises, writes about praxeology in this way:

Praxeology is the distinctive methodology of Austrian school...While the praxeological method is, to say the least, out of fashion in contemporary economics as well as in social sciences generally and in the philosophy of science it was the basic method of the earlier Austrian school and also of a considerable segment of the older classical school... Praxeology rests on the fundamental axiom that individual human beings act, that is, on the primordial fact that individuals engage in conscious

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<sup>11</sup> However, Mises was not the first to use the term. As Mises notes: "The term *praxeology* was first used in 1890 by Espinas. Cf. his article "Les Origines de law technologies," *Revue Philosophique*, XVth year, XXX, 114-115, and his book published in Paris in 1897, with the same title" (1949, 4).

<sup>12</sup> To find more information about the Noble Prize See: <http://nobelprize.org/economics/laureates/2002/>

actions toward chosen goals (1997; 58-9).

Even though a considerable part of the literature of Austrian economics focuses on the idea of defining praxeology, it is still a vague concept not only among economists but also among other social theorists. This ambiguity is not only due to the complexity of the concept, but also the fact that economists have shifted so much away from the principles of conducting economic research which certainly includes a deep understanding of the methodology of science.

## Contributions of Austrian School in Economic Theory

The ideas of Austrian economists shaped many of the theorization of economist throughout the 20<sup>th</sup> century. These include Public choice theory, Constitutional Economics, Chicago school of economics, Experimental Economics, and even Institutional Economics. Although many of the founders of these disciplines in economics were not Austrian economists, their ideas show a deep understanding and belief in the Austrian philosophy of methodological individualism and methodological subjectivism. Let us look at some of these disciplines in economics.

### Public Choice Theory

Public Choice Theory is a discipline within economics established by two economists Gordon Tullock and James Buchanan. This school was one of the emerging disciplines of economics that emerged from the Chicago school of economics in the 1950s and 60s. However, it was in 1986 when Buchanan won the Noble Prize in economics in 1986 for “development of the contractual and constitutional basis for the theory of economic and political decision-making” that this school gained its popularity (Ostrom, 1987). Public choice analyzes governments and other “collective choice” entities from an economic perspective by using an individualistic methodology.<sup>13</sup> Buchanan was against the “romanticism” and ideological view of the government and its role in the political, social, and economic dynamics. Public choice theory introduced the idea of a “market failure” meaning that governments can fail and they are not this ideal entity composed of supernatural or metaphysical beings whose desires and wants are only for the good. They are composed of individual agents who are striving for their self-interest. Of course, public choice theorists believe that this self-interest mechanism is both ethical and rational.<sup>14</sup> Buchanan is the most influential figure in the start of public choice theory. He based his theoretical analysis on the ideas of Knut Wicksell (1851-1926), Frank Knight (1885-1972), and the Italian tradition of public finance. Boettke presents the intellectual fathers of Buchanan this way:

From Knight, Buchanan got his basic economic theory framework and the idea that economics is not a science in the traditional meaning of that term. From Wicksell, Buchanan learned that politics

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<sup>13</sup> This individualistic methodology is one of the Austrian roots of public choice theory.

<sup>14</sup> In works composed by public choice theorists especially Buchanan there is this reference to the ideas of classical liberal theorists especially Adam Smith as the basis of a moral philosophical view of individual activity in the market place (see Tullock & Buchanan 1962; Smith 1759, 1776).

needs to be understood in an exchange framework. Efficiency in the public sector would be guaranteed only under a rule of unanimity for collective choices. From the Italians, Buchanan learned that public finance theory must necessarily postulate a theory of the state, and that it would be best to reject either the Benthamite utilitarianism or the Hegelian idealism in postulating such a theory. In retrospect, once these three elements were brought together, then the necessary foundational framework for Buchanan's contributions to the economics of the public sector were there, what remained was the working out of the implications (1998, 3).

Public choice theory, hence, is a combination of the classical liberalism doctrines of free and open market, rule of law, and individualism combined with the ideas of such philosophical figures as F.A. Hayek, Frank Knight, and Knut Wicksell (Mueller 1989).

## Constitutional Economics

Constitutional Economics is again one of the disciplines in economics that emerged out of the works of Buchanan. It is rooted in some of the ideas of public choice theory in the sense that it is looking for a realistic definition of the role of the government in social, political, and economic dynamics. However, it goes further to interpret this new definition of the government from the constitutional perspective. Hence, the constitution, which defines all the social and political institutions in a certain geographical region, reflects a newly realistic definition of government and its role in the society. Therefore, this is an ethical moralistic philosophy view of economic theory. As Buchanan, argues, "Economics is a 'science' but not like the physical sciences. Economics is a 'philosophical' science and the strictures against scientism offered by Frank Knight and F.A. Hayek should be headed" (1979, 280). In another instance, where Amartya Sen who won the 1998 Noble prize in economics "for his contributions to welfare economics"<sup>15</sup> writes, "Buchanan is very impressive in terms of the breadth of his interest. In my judgment he had done more than most to introduce ethics, legal political thinking, and indeed social thinking into economics" (1990, 263). Hence, constitutional economics is a subjective theoretical interpretation of economic policy and a change in the role of government based on this new definition.

## Experimental Economics

Experimental economics started in 1960s with one of its most influential figure Vernon Smith. The whole idea behind experimental economics is to test and analyze certain aspects of human behavior in certain fixed and controlled economic conditions. However, this method of conducting research in economic science is different from the works that econometricians do in economics. The philosophy behind experimental economics comes from the philosophy that the social construction follows certain fixed and unchanging laws.<sup>16</sup> Hence, instead of testing economic theory through empirical analysis, experimental economics, wishes to test the subjectivity of economic theory in an

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<sup>15</sup> For more information about the Noble Prize see <http://nobelprize.org/economics/laureates/1998/index.html>

<sup>16</sup> This is the Austrian interpretation of the Aristotelian philosophy, popularized through the works of Franz Brentano and Menger in 19<sup>th</sup> century Austria.

objective setting based on an individualistic methodology.

## Conclusion

In this paper, there was a brief overview of the Austrian school of economics. The Austrian school emerged from the dynamic classical liberal movement shaped by the many social and political currents such as the Scholastic school, Renaissance, Reformation, etc... Every thinker, philosopher, economist, sociologist, and scholar throughout the long productive years of this school gave a distinct and influential flavor to it. This school was influential in the disciplines in economics as Public Choice Theory, Experimental Economics, Constitutional Economics, Institutional Economics, and even the Chicago school of the 1980s and 1970s. This school is growing at a rapid rate and it is becoming an influential part of the political movement not only in the U.S. but also in other parts of the world. As Mises puts it, “the main and only concern of the Austrian economists was to contribute to the advancement of economics. They never tried to win the support of anybody by other means than by the convincing power developed in their books and articles” (1996, 72)

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