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The Foundation and Procedure of Austrian Economics

Austrian economics refers to economists all over the world who trace their method of dealing with economic topics to Austrian economist Carl Menger, who wrote during the mid-19th century. Menger showed that in order to describe the facts of human history, a social scientist must have a theory of how those facts can be related to human choices. The social scientist must ask: "How can I explain the facts by referring to the choices of particular individuals." Since his own speciality was economics, Menger also showed how economic theory helped to explain historical facts. Economic theory, he pointed out, was a system of deductive logic based on the assumption that the behavior of all economic subjects is *purposeful*. In other words, the economic theorist assumes that all behavior is aimed at accomplishing some goal.

In contrast to the economists of the 19th century, many of today's professional and academic economists attempt to describe economic facts by means of mathematical and statistical models. Modern Austrians regard such models as too mechanical. They stress the fact that the subjects of such models are not purposeful, creative, innovative, and shrewd human actors. The subjects are merely robots that are programmed by the model-builder to behave according to algorithms. Following the logic of Menger, modern Austrian economists criticize the model-builders for providing little help in interpreting, or understanding, how human beings contribute to the conditions we observe.

The robots of the economic models also operate in an environment that is created and interpreted not by the subjects themselves but by the model-builders. Because of this, Austrian economists often regard model-builders as *elitists*. Forgetting that human beings are not robots, some of the model-builders proceed to make grandiose plans for the members of society as if the members are incapable of accomplishing their objectives without the planners' help. They also criticize the goal of central planning as being unachievable because of the knowledge problem. The planning that occurs in a market economy is the consequence of millions or billions of separate minds each with particular knowledge of his or her situation. To expect a central planner to be able to duplicate such knowledge is unreasonable.

Austrians criticize too heavy a reliance on models and their assumptions of algorithmic behavior. They emphasize the abilities of real human actors to create their own algorithms or even to operate without algorithms. In addition, the Austrians suggests that individuals may be able to create or change the conditions that non-Austrians assume to be exogenous. At the very least, individuals can interpret the conditions in a way that the economist would find difficult to understand. Austrians say that individuals are not robots. Normal human beings possess all the talents that the model-building economist claims to possess.

The great potential of individual planning, as opposed to central government planning, is exhibited best in the hypothetical free market economy. Austrians maintain that non-Austrians do not sufficiently appreciate this potential. If individuals operate in a free market economy, their creativity tends to achieve its greatest expression. Except for cases in which property rights are especially costly to establish and enforce (such as property rights to clean air) and the monopoly price, individual creativity will be manifest in the satisfaction of consumer wants. Austrians have a special place for the role of the entrepreneur, which non-Austrian economists have virtually excluded from their descriptions of the market economy.

Entrepreneurship refers to distinctly human action under the conditions of the pure market economy. To understand the entrepreneur in the market economy, one must contrast an imaginary economy containing only robot factor-suppliers, robot producers, and robot consumers with a hypothetical free market economy containing these robots plus pure entrepreneurs. This enables one to see how the distinctly human characteristics get manifested in the role of the pure entrepreneur.

Once the role of the pure entrepreneur is identified and made clear, the Austrian economist proceeds to show how different actors in a more realistic market economy act entrepreneurially – i.e., how workers, consumers, and savers each act as entrepreneurs. Following this, the economist focusses specifically on those individuals who get into positions where they manage businesses and bear the uncertainty connected with profits and losses. Such individuals create firms, finance and/or manage corporations and other businesses, and become major players in the stock market and futures markets.

Once entrepreneurship is defined, the Austrian economist proceeds to describe: (1) economic interaction in the "real" market economy, (2) the concept of interest, and (3) the trade cycle of boom and recession. In doing this, he uses a combination of imaginary constructions containing robots in some roles and entrepreneurship in others. These constructions are complemented by examples of interaction. To give examples, the economist begins with what most economists have called the comparative static method. According to this method, robots begin in equilibrium, a change in the data is introduced, and then the behavior needed to reach some new equilibrium is modeled. This model of adjustment to a new equilibrium is supplemented by a discussion of the imagination, creativity, and inventiveness of real human actors who were in the positions described in the model. In other words, the model is used as a foundation for a further discussion of the entrepreneurship that would present under the assumed conditions.

Send comments to:

Gunning's Address

J. Patrick Gunning
Professor of Economics/ College of Business
Feng Chia University
100 Wenhwa Rd, Taichung
Taiwan, R.O.C.
Please send feedback

Email: gunning@fcu.edu.tw

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