Modern Applications of Austrian Thought

Edited by
Jürgen G. Backhaus

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Modern Applications of Austrian Thought

Austrian economics is often criticized as being hostile to empirical research and seen purely as an ideology. On the contrary, the purpose of this book is to show that Austrian economics provides an interesting approach to most conceivable subjects in economics.

The book includes Austrian analysis of health economics, labour economics, taxation, business cycle theory and property rights. The authors include Roger Koppl, Laurence S. Moss, Bart Nooteboom and Gerrit Meijer.

This book will prove invaluable to students studying economics and prove to be interesting reading for the applied economist in any area of application.

Jürgen G. Backhaus holds the Krupp Foundation Chair of Public Finance and Fiscal Sociology at the University of Erfurt in Germany. He is also the founding editor of the *European Journal of Law and Economics.*

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Preface

Austrian economics is often conceived as an ideology. People are thought to stir in the older mud of unintelligible writings, and henceforth disagree among another. It is also often said that Austrian economics is not empirical. With this book, I try to dispel all three of these notions. I believe that Austrian economics is a sensible way of approaching current economic issues, it is not backward-looking and it can make sense when mainstream economics does not. Austrian economics may be clustered by economists who emphasize ideologies. These ideologies actually differ, but their study is not the purpose of this book. Austrian economics is also often criticized as being hostile to empirical research. The studies in this book prove the contrary.

The purpose of this book is to show that Austrian economics provides an interesting approach to most any conceivable subject in economics, and this is demonstrated by the table of contents. We have, using the index of the *Journal of Economic Literature*, tried to cover each sub-discipline of economics that is currently taught at most Western universities. This provides for an impressive compendium that is meant to be a reference source for researchers who may have a particular research project in mind, but cannot readily deal with mainstream theories in their effort to understand a particular programme. These graduate students or researchers may find a framework for their own research design in their own studies.

1 Ideology, by and in itself, as Schumpeter (1949) has pointed out, is not only a vice, but can also be a virtue. If it drives particular research programmes, a free market of ideas should ultimately divide the grain from the chaff. We are interested in harvesting the corn. It is true, and it cannot be contested, that a lot of what passes for Austrian economics is published on the fringe. This is true for any economic approach one can think of. Even the current mainstream of economics is tainted in this way (Stigler 1980). This problem can only be resolved once the free competition of ideas leads to a better refinement of propositions, models and solid conclusions. It is even

conceivable that a Marxian-Austrian perspective could lead to particulars that cannot be otherwise captured. We do not have an Austrian-Marxist contribution in this collection, but I would never have hesitated to include one, had I received one.

2 As regards method, in textbook renditions it is often said that the Austrian approach stood for the deductivist method, while its conceived counterpart, the so-called historical school, stood for inductivist methods. Nothing could be further from the truth. Menger, although he started from observing financial markets as a journalist, was not empirically minded. Hayek, on a Ford Foundation grant, observed empirical facts in order to determine business cycles. The difficulty, in my mind, does not lie in the method. The approach, since it is based on individual judgement, required case studies showing individuals' decisions. This can only be done on the basis of very careful case research. In this sense, there is little disagreement between the Austrian school and the mainstream.

3 As for the third issue, the contributors to this volume have no problem with empirical work, and hence the case can be laid to rest.

Prof. Dr. Jürgen Backhaus Lic. jur.
March 2004

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A

General economics and teaching

1 The applied economics of the modern Austrian school

Laurence S. Moss

Introduction

One criterion for assessing the significance of a school of thought in economics is to ask, "What problems can it solve with the tools that it has developed?" This question has long haunted the proponents of the modern Austrian school. During the 1970s and 1980s, Israel Kirzner, Ludwig Lachmann, and their students offered their readers (1) lengthy discussions about the subjectivist underpinnings of market behavior, and (2) exhaustive discussions of what it means to claim that markets "coordinate" the economic behavior of private individuals and the behavior of the associations to which they belong (Kirzner 1973, 1976, 1985a, 1986, 1992; Lachmann 1973, 1976, 1977). In the eyes of the rest of the economics profession it appeared that modern Austrians were unable and perhaps entirely unwilling to provide any specific analytic tools that might help predict and control the outcome of the market process.[1] This may explain why modern Austrians have earned a reputation as "methodologists" and have received little recognition for their practice of normal science. Modern Austrians do indeed attach greater importance to a cultivated and sophisticated understanding and appreciation of the market process than they do to "mere" prediction and control (see Dolan 1976; Vaughn 1994). This, however, is a matter of personal preference and not one of logical necessity. Indeed, there is an applied side to the teachings of the modern Austrian school that sometimes is unnoticed. I shall emphasize this aspect of the Austrian contribution here.

At the outset, I readily admit that Austrian writers have not been kind to those in the profession who claim to have derived models that can predict the future course of market activity in such detail that profits can be made. Modern Austrians consider such claims mostly ill-conceived, or, even worse, fraudulent (see Skousen 1988). The Austrian school is a "humbling school," one that cautions other economists not to pretend that they can make marvelous forecasts about future market conditions. Austrians have most consistently ridiculed the pretensions of statistical economists and econometricians who, whether for private gain or for media reputation, declare that they can estimate some specific market rate, such as short-term interest rates, with enough accuracy to guide business decision-making or (in some circumstances) orchestrate national economic planning (Hayek 1978: 23–24; Mises 1949: 352; cf. Vaughn 1994). This war against arrogance and pseudo-science constitutes perhaps the greatest of all the practical achievements of the modern Austrian school. Unfortunately, it has contributed to the reputation of modern Austrians as mavericks in the economics profession. This verdict is particularly harsh, and in this chapter I shall offer a more balanced view.

The first section takes a careful look at statistical economic research and offers evidence that Austrian theorizing has not emerged in a historical vacuum. Indeed, Austrian economics can be appreciated as a defensive reaction to the long struggle against ferocious price inflation, first in Central Europe and later, in a less virulent form, among all major industrialized nations. The second section returns to the problem of hawking economic research for business consulting purposes and highlights an inner tension that exists within modern Austrian economics over precisely this problem, the practical significance of economic knowledge. The third section outlines the varieties of modern policy analysis and at the same time distinguishes the intentionally limited focus of the Austrian school from the wider interests that mainstream economics offers. In the final section, I offer some concluding remarks.

Statistical economic research

Modern Austrians stubbornly refuse to join the legions of professional economists who search for (stable) empirical economic relationships among the truckloads of economic data that are now available to researchers. Most agree with Mises's verdict that there are no "constant relations" in economics, as there are in the natural sciences (Mises 1949: 354). Economists who pretend these constants exist and apply for funding to try to hunt for them are committing an elementary blunder. In his Nobel lecture, Hayek (1978) criticized those in economics who try to mimic the natural scientists by employing methods that are quite inappropriate to the study of complex social phenomena. Elsewhere, however, Hayek (1967a) admitted that it is appropriate when studying complex social phenomena to recognize that certain patterns or sequences of events tend to occur in similar situations. The modern Austrians Gerald O'Driscoll and Mario Rizzo (1985: 27) have expanded on Hayek's insights here. They admit that economists can predict certain patterns of market activity and anticipate certain broad sequences of events. If they can do this, then of course the Austrians can go one step further, and provide some analysis and discussion of the linkages between statistical regularities and the underlying market processes at work.

While Austrians make much of their differences with the econometricians, there is nothing about the Austrian brand of methodological discussion that rules out the possibility that a major discovery in statistical research will help improve our understanding of the market process and aid us in a search for new statistical patterns. This statement requires some clarification.

The place to start is with Mises himself. Early in his career, Mises flatly denied that there was any sense in trying to express the relationship between money and prices in the form of a simple deterministic equation.[2] Mises was reacting in part to Irving Fisher's classic book *Theory of the Purchasing Power of Money*, published in 1911, which provided an important quantitative statement of the quantity theory (Fisher [1911] 1971; cf. Mises [1924] 1953: 136). Still, Mises agreed with Fisher that money and prices were connected in some systematic way, with changes in the money supply causing prices to change. Mises, in his *Theory of Money and Credit*, offered a "market process" account of the popular quantity theory of the purchasing power of money ([1924] 1953: 97–186). Mises's account was intentionally qualitative and not quantitative, and, perhaps as a consequence, he was able to offer a more insightful interpretation of the existing statistical record regarding the empirical connections between money and prices.

Observing that individuals hold cash balances as part of their daily routine, Mises ([1924] 1953: 139–140) offered a subjectivist account of how private efforts to adjust cash balances at a time when nominal balances are increasing throughout the relevant currency area lead to price rises. On the basis of this analysis, Mises agreed with the older "currency school group" that insisted that the cause of a sustained rise in prices was an overly rapid growth of the money supply (ibid.: 219–231). Mises assumed that most responsible political leaders found inflation to be quite unacceptable. Using a broader definition of the money supply that included bank deposits subject to check, Mises evaluated the large variety of institutional reforms to identify those that would make it difficult for the money supply to rise and inflation to follow.[3]

After World War II, Mises came to realize that instructing politicians about what they should do when they consistently lack the political will to do it will not produce useful results. This realization led Mises to a prescient analysis (1978b – written in 1946) of the connections between political parties, politicians, credit-financed booms and the subsequent economic crises that follow. Others, including Hayek and Murray Rothbard, expanded on Mises's teachings. It was generally agreed in Austrian circles during the 1950s and 1960s that adherence to the "trade cycle theory" was the hallmark of the Austrian school. For this reason, the Austrian theory of the credit trade cycle held pride of place among Mises's contributions to the modern Austrian school.[4] It is sufficient for our purposes here to credit Mises with an early and persuasive version of the political theory of the business cycle and with a keen understanding of the phenomenon now dubbed "rent seeking" in the economic literature (Tullock [1962] 1993).[5]

The consistency between statistical research and Austrian school theorizing is nicely brought out by one important episode in Mises's career: the experience of the Central European economies during the early 1920s. The historical record in Central Europe, seemed to contradict the alleged connection between money and prices. Many of Mises's contemporaries, especially those working for the central bank, delighted in querying why if it is true that the rapid growth of the money supply causes high prices, the majority of market participants – despite rising prices – complained of a "shortage" of money (Mises [1924] 1953)?[6] Mises answered this question with novel tools of analysis.

He pointed to the critical role expectations play in markets. According to Mises, when an episode of inflation has proceeded for some time, people make commitments to pay prices according to the criterion of what future prices will turn out to be. They believe that they will have enough cash on hand to meet those extra cash obligations because they expect their private cash balances to rise along with the higher prices.[7]

If the money-issuing authorities were to retrench and try to stop the inflation by slowing down the rate of growth of the money supply, people would experience a veritable "shortage" of money. Indeed, they would complain of a shortage even if the money supply's rate of growth were to remain constant. To state this another way, the community's real balances decline while at the same time their nominal balances increase because the increase in the nominal balances is smaller than they had expected. This explains political lobbying to keep the inflation going, so that many can meet their contractual commitments and avoid financial embarrassment.

Mises went on to suggest that a statistical time-series plot of the ratio of some index of the quantity of money to prices would show a downward trend during prolonged inflationary periods.[8] This statistical record mirrors the disappointed price expectations.

My efforts here to link the evolution of Mises's pioneering contributions to monetary economics to some of the stylized findings of statistical economics will not satisfy many of Mises's strongest critics. Milton Friedman, in an informal interview that took place in 1988, was uncharacteristically harsh in his assessment of Mises's credentials as an applied economist (see Hammond 1992). According to Friedman, Mises claimed that the more prolonged the inflationary boom, the more severe the subsequent business crisis. Friedman claimed that the opposite relationship is in fact true, as he himself demonstrated in earlier published work.[9] Friedman faulted the Austrian school in general and Mises in particular for showing a wanton disregard of the statistical record.

Surprisingly, Friedman did not comment on the many other parts of Mises's monetary economics, such as his theory of price expectations, which was developed to help rationalize the actual statistical series. Nor did Friedman offer any opinion on the role Mises played in promoting statistical research in Austria by his association with the Austrian Institute for Trade Cycle Research. It is quite obvious that any correct overall assessment of Mises's contribution to statistical economics would have to balance a number of contributions, rather than single out one episode while ignoring others, as Friedman appears to have done. Suffice it to say that the evidence, while mixed, certainly provides no basis for the claim that modern Austrian school members are opposed, as a matter of methodological principle, to careful statistical analysis.

Let me conclude this section on an even more constructive note. A statistical pattern has come to light that may offer fertile ground for Austrian research. William J. Baumol, Richard R. Nelson and Edward N. Wolff (economists not associated with the Austrian school) have pointed to a surprising statistical regularity. Apparently, there is a tendency among the industrialized nations of the world to grow increasingly homogeneous with regard to technology, productivity, and per capita income. This is the "convergence of productivity phenomenon" (Baumol *et al.* 1994). It seems to me that the Austrian theorists now have a dramatic statistical illustration of how quickly and effectively the market system encourages its participants to utilize information and apply it in valuable ways (Hayek 1945; Thomsen 1992). This is what now happens with accelerating speed among the industrialized nations. It is proving increasingly difficult for one trading nation to maintain a significant productivity lead over the others.

The development of new institutions in communications and transportation is what has probably hastened the diffusion of scientific as well as what Hayek has termed "circumstantially relevant" business information (1945: 80). This rapid utilization of knowledge has now become a veritable global phenomenon. To the best of my knowledge, modern Austrians have not as yet taken up this topic for research and analysis. Austrians can explain what institutions serve to promote this development and its probable impact on material progress. When they do this work – and there is no reason why they should neglect such international developments – they will be following the precedent set by Ludwig von Mises in his monetary debates during the interwar period. Again we see statistical economics and Austrian economic theory developing side by side in mutually supportive ways. It was the historical situation in Central Europe that prompted Mises to develop the subjectivist foundations for the so-called quantity theory, and it may indeed be the important "convergence of productivity phenomenon" that will inspire additional useful research about the production and diffusion of information in years ahead.

Practical advice sold to business

We have seen that modern Austrians do not (and should not) rule out the possibility that broad statistical relationships both exist to suggest conceptual innovations and can themselves can be explained in terms of market processes. Austrians remain skeptical if not contemptuous of those who pretend to have the power to discover lucrative arbitrage opportunities in the market and then try to sell this information to others.[10]

In a market setting, anyone may discover a veritable "rule to make it rich." Some may go the next step and exploit their rule to their personal advantage (Mises 1949). Such discoveries are usually the province of entrepreneurs, and it is not likely that standard statistical research can produce any information about where economic profits can be found. Statistical categorization necessarily strips economic information of its distinctive or local aspects and therefore of much of its relevance to making money. In addition, by the time the statistical series have been published, individual actors in the chain of production will have had an opportunity to exploit these patterns and thereby destroy whatever market value the information might originally have had.

Both the "rational expectations" school and the modern Austrians agree that anyone who claims to have a "rule to riches" is more likely than not a huckster and mountebank (Malkiel 1992). This is because as an empirical matter there are an ample number of "soldiers of fortune" in the market to exploit differences in prices and promote economic coordination. Mises (1949: 252–255) and later Kirzner (1976) analyzed the type of mental and conceptual activity involved when the entrepreneurial function is exercised in market settings. Entrepreneurs are alert to opportunities and are lured to make commitments toward the exploitation of these opportunities by the prospect of what Kirzner (1985b) called "open-ended" profits.

Interestingly, the problem of the self-destructing nature of rules to riches has also come to haunt the Austrian school for its claims to have "explained" the precise series of economic events that lead up to a business crash. From a logical point of view, if the modern Austrian theorist were to foresee this series of events, the possibility exists that entrepreneurs who take up the study of economics can themselves profit from this knowledge (cf. Mises 1949: 871–872). And if they were to profit from this knowledge, wouldn't their actions substantially alter the economic sequence?

Consider one important example. Throughout his career, Hayek insisted that the "Ricardo effect" lay hidden within any boom phase of the business cycle (see Moss and Vaughn 1986). Furthermore, the Ricardo effect provided the ultimate explanation as to why government attempts to prolong the boom phase of the cycle indefinitely must end in failure. According to Hayek, if the credit expansion boom does not come to an end sooner for some other reason, it must come to an end when consumer product prices advance ahead of wage and resource prices. The Ricardo effect lowers real wages and encourages a shift toward labor-intensive methods of production. A lowering of the real wage of labor makes short-term (labor-intensive) projects appear to be more profitable than long-term (capital-intensive) methods of production. The Ricardo effect may account for the sudden wave of bankruptcies among the large fixed-investment projects that occurred toward the end of many nineteenth-century business cycles.[11]

If, however, Hayek's Ricardo effect were publicized among investors, the investors would speculate by purchasing the stock (or stock options) of those firms primarily involved in the management of short-term investment projects. The resulting rise in the capitalized value of the business organizations would bring an earlier end to the boom itself. By 1943, Mises began to admit that this consequence was possible (Mises 1943). The action of self-fulfilling prophecies may indeed unravel each and every one of the so-called laws of the market. In short, the Austrian emphasis on "entrepreneurial alertness" may provide a logical reason why certain historical patterns of market activity tend to reverse themselves and disappear over time. Some students of Austrian economics claim that the credit expansion business cycle has itself become a phenomenon of the past. In the end, the only pattern prediction that endures is one that claims that pattern predictions themselves tend to vanish!

Policy advice to policymakers

Austrians are not shy about offering practical advice on matters of public concern. Surely the growth of the modern bureaucratic state has been viewed with alarm by those fearing the threats to liberty posed by state power more than they fear threats posed by unchecked market power in the hands of cabals, or cartels or by the general machinations of business (Rothbard 1977; cf. Mises 1944). I shall restrict myself here to the strictly twentieth-century concern of the Austrian school: that the unprecedented growth of national governments may have a negative effect on the development of those economic institutions that themselves contribute to rising living standards.

Economists who criticize others

Austrians are upset by economists who pretend that their special training in economics contributes to a heightened awareness of what some might call the "aesthetics" of economic justice. These critics delight in proving that such policy analysis is simply one economist's private subjective value judgments carefully packaged in the rhetoric of economic reasoning. Such a juxtaposition of norms and science is, in short, an awful fraud of the public trust. Indeed, in his celebrated critique of John Kenneth Galbraith's *Affluent Society*, Hayek (1967b) pointed to the author's repeated practice of substituting his own preferences for those of the people he studied (see also Mises 1944). As we shall see, Austrian economists insist that where something cannot be scientifically proven to be true, the economist is forbidden to speak. Among modern economists this normative position, which acts as a self-imposed gag order on what the Austrians can contribute to public debates, is seen as quite eccentric.

Instrumental critiques

Consider a law that promises to increase the supply of housing by holding down rents. Modern Austrians delight in showing how laws such as these are "wrong-headed." Rent controls, usury laws, and minimum wage laws are all wrong-headed. They are wrong-headed because they lead to results that are precisely the opposite of those originally intended. This type of policy analysis, one that passes judgment on the suitability of certain means to stated ends, is the crux of much modern Austrian policy analysis. Such critiques of government policy are persuasive if not exciting, and at seminars and public engagements modern Austrians tend to focus on analyses of "wrong-headed" government intervention (Mises 1929). Unfortunately, not all governmental laws and regulations can be criticized in this way.

Efficiency critiques

Some government interventions do actually achieve their intended results. For example, command and control clean-up requirements at industrial water dump sites do actually make the areas better for recreational lake users (Frederick 1982). Also, some recipients of government welfare actually do use the funding to provide for the care and comfort of dependent children (Murray 1984). Only a madman would deny that sometimes legislation does achieve its stated mandates. This does not mean that government laws and their implementation are unassailable on other grounds.

Indeed, Austrians point out and describe alternative methods of intervention that have been used in the past to achieve similar objectives. The comparative study of different institutional reforms allows a comparison of the pros and cons of the different methods. Finally, modern Austrians spell out in shocking detail the political consequences of some interventions, such as those that propose to replace the market with national planning (Hayek 1944). Other interventions, such as direct controls to overvalue a local currency, sometimes lead to borderline body searches and household raids that cause lovers of individual liberty to recoil in disgust (cf. Yeager 1976). All of this and more constitutes a contribution to policy assessment, but none of it allows efficiency comparisons. Efficiency comparisons are what mainstream economists do best: a dollar comparison of one intervention to another in order to determine which achieves the policy objectives at the smallest opportunity cost.

Much of the clamor for government intervention in the twentieth century stemmed from one individual or small group of individuals trying to extract subsidies from other individuals. Redistribution politics fuels the well-known phenomenon of "rent seeking" (Tullock [1962] 1993; Robbins 1962). The modern Austrian may secretly agree with the mainstream economist that what the subsidy receivers receive is only a tiny part of what the losers lose but will, ironically, refuse to conclude that this sort of legislation is "inefficient." To say an intervention is not wrong-headed but "inefficient" is to imply that the losers lose more utility than the winners win. Unfortunately, according to the modern Austrian school, such a comparison of psychological states is invalid because interpersonal comparisons of utility are impossible to make (Rothbard 1956; Pasour 1987). Even if one feels in both body and soul that the losers lose more than the winners win, "feeling something" is not proving it to be true.

Unlike modern Austrians, mainstream economists are eager to use market prices as simple "indices of worth" and thereby compare levels of gain against levels of loss. After World War II the scientific economic journals filled with articles of this sort and the field of welfare economics grew in stature (Mishan 1983). Generally speaking, modern Austrians have not contributed to this literature.

Austrians insist that it makes no sense to compare governmental interventions and deduce which program is "least harmful" to the economy. Suppose the problem is to compare a government-run rent subsidy program with another program involving the construction and provision of public housing by the government. Generally, an economist would propose a measure of utility gained and resources consumed and then go on to recommend the program that promised the greatest benefit–cost ratio. Such constructions rely on dollar prices as measures of utility and perform a variety of heroic arithmetical operations in which interpersonal comparisons of utility are made with something approximating complete abandon (Mills 1986). Modern Austrian theorists recoil at the thought of making such efficiency comparison, and some will go so far as to say they insist on remaining "pure" (Hoppe 1994). This stubbornness is an example of "scientific purity" in a world in which most economists keep busy by providing the public with what it enjoys most of all: that is, the scientific measurement of waste. By refusing to compromise about the legitimacy of "efficiency" calculations, the modern Austrians rule out the possibility of a measured criticism of those government policies that may not be wrong-headed (that is, they do achieve their intended outcome) but "succeed" only at a large and in some cases an enormous economic cost. Unable to offer an efficiency critique, modern Austrians choose to remain outside the major policy debates that fascinate many mainstream economists.

A scientific welfare economics

According to one line of analysis that has taken root among adherents of the Rothbardian branch of the Austrian school, no government intervention can ever be scientifically demonstrated to have raised social welfare (Rothbard 1956).[12] The reason is that all government intervention relies on the initiation of either direct coercion or the threat of coercion, and therefore at least one person's utility level has been lowered. Those who derive benefits from the government intervention will naturally find their utility levels raised. Unfortunately, interpersonal comparisons of utility cannot be made on any precise quantitative basis and so (therefore) no act of government intervention can be said with any degree of scientific precision to have raised social welfare (ibid.: 255n). It is argued that the opposite conclusion can be reached when it comes to voluntary market trade. Market exchange would not occur unless both parties expected to gain utility. Since market activity is mostly based on mutually advantageous trading, only market activity can be said with any degree of scientific precision to raise social welfare. This sweeping conclusion does not involve any interpersonal comparison of utility and therefore, according to its proponents, it is not an efficiency critique and hence passes scientific muster.

The first version of this argument appeared in a remarkable essay by Murray N. Rothbard (1956). Two decades later, I pointed out that from a logical point of view one could not reach the implied conclusion that the removal of some forms of government intervention would invariably make everyone better off (Moss 1974). The reason was that the absence of a coercive intervention does not automatically lead to a world of voluntary trading. In the absence of government hegemony in the marketplace, gangs competing for merchant contributions may emerge in the vacuum created by the destruction of the central taxing authority. Indeed, the extent of felonious behavior in the former Soviet Union may be a dramatic example of this phenomenon.[13] As Thomas Schelling (1984) reminded us, the substitution of "disorganized" for "organized crime" can make everyone worse off (1984: esp. 172 *passim*). I insist that any thinking and feeling person can reach such a conclusion even if interpersonal comparisons of utility are impossible. As David L. Prychitko has pointed out, Rothbard's scientific proof that only the market system can be said to raise social welfare has been deduced from "a questionable view of science [namely, that] we only scientifically 'know' that which can be deduced from 'absolutely true' axioms" (1993: 525). Surely we can also "know" other things as well, such as the tremendous extent of suffering that accompanies national sovereignty movements when they eliminate ethnic minorities and so on. Reasonable thinkers can conclude that the suffering of the many outweighs the joys of a few even if a precise scientific measure of net utility gain cannot be made. In Prychitko's words, "The *immeasura-*

bility of utility gains and losses in no way entails their complete *inaccessibility* to analysis" (ibid.: 583).

Comparative institutional analysis

Modern Austrians have excelled at the careful analysis and evaluation of contemporary institutions. By "institutions" I mean all those decision-making procedures and routines both within and between organizations that affect the performance of the market system.[14] Institutions of great interest to the Austrians are those that (1) connect the national treasuries and the central banks; (2) link special interest groups, such as unions and manufacturers' lobbies; (3) guide political parties and the competition among them to obtain votes from special interest groups; (4) emerge when governments try to reshape international payments mechanisms; (5) arise out of central planning agencies trying to plan the economy; and (6) connect government policies to third-world business investment. The list of institutions evaluated by modern Austrians is thus quite long (see Mises 1951; Hayek 1971, [1933] 1979, 1988; Rothbard 1962).

If there were a single political attitude that permeates Austrian policy analysis, it would be this: Austrians distrust broadly popular democratic processes because they fear that the voters are doomed to place their short-run private interests above the policies that are needed to sustain the market system. Although Mises implored men and women to trust their "rightly understood long-run interests" as the surest safeguard against the abuses of demagogues and popular democracy, he and especially Hayek advocated specific constitutional reforms in case human diligence failed (cf. Yeager 1976). Constitutional reform is designed to limit the excesses of popular democracy by restraining popular emotions from voting out the basic framework and legal structures needed to support a market system.

A survey of all this important work is beyond the scope of this chapter, but it will be sufficient to summarize the policy component of this work as follows: Modern Austrians have been and remain keenly interested in the problem of how incentives come to be (or fail to be) aligned within and between these large institutions. Through the judgments they have made about this phenomenon, they have provided rich insight into our understanding of contemporary economic history.

Under the nineteenth-century international gold exchange system, local political leaders were given a powerful excuse for not capitulating to the inflationary financing of government programs. Politicians could blame the international community for preventing them from catering to the interests of local political parties that wanted to redistribute income by effecting artificially contrived changes in the quantity of money. The Austrians explained how large budget deficits financed by money-supply creation would diminish gold reserves in the banking system and threaten financial default and currency devaluation.

Mises and Hayek predicted that once the reigns of the gold-exchange standard were loosened, especially as happened after World War II, national governments would end up under the control of leaders who would find inflationary finance irresistible (see, for example, Hayek 1972). It has been over a half-century since the end of the war and the installation of the International Monetary Fund. It has been more than a quarter of a century since the U.S. government removed the last links between the dollar and gold in 1971. The feared hyperinflation has not yet arrived, but neither have clusters of prices moved in any other way than steadily upward in the United States and also among other industrialized nations (Yeager 1976). The problem national governments face is not whether to accept a mild inflation but rather how much inflation is politically feasible because, whatever its conceptual merits, deflation has become politically unacceptable. The proponents of the Austrian school have been the veritable chroniclers of and astonished witnesses to this development.[15]

If there is one common theme to the policy writings of the modern Austrian school, that theme is how to discipline and constrain the appetites of vote-gathering politicians for issuing money. It is well known how Hayek labored to compare the consequences of monetary nationalism (i.e., separate currencies and flexible exchange rates) with the outcomes of alternative institutional arrangements such as the gold exchange standard (Yeager 1976). In his later years Hayek endorsed "private competing money" as the best institutional device to avoid sustained inflation (1976). Here Hayek departed from Mises, who rested his hope in a return to full-bodied gold coins.[16] While a specific topical index to the modern Austrian school would fill many volumes, what all these writings have in common is the attention paid to the broad problem of aligning incentives and responsibilities within alternative institutional structures so that the basis for material economic progress is not destroyed or diminished. The wisdom that modern Austrians have brought to these questions is quite literally unsurpassed in the policy literature and constitutes another important contribution of the school to practical problem solving.

Conclusion

The conclusion I reach is quite defensible and I hope entirely persuasive. It is clear that characterizing the modern Austrian school as being entirely embroiled in methodological discussions and having little to contribute to the leading policy problems of the day overlooks the historical record. It is somewhat misleading to claim that the modern Austrian school asks interesting questions but (by implication) lacks adequate tools to provide proper answers to these questions (Vaughn 1994). As I have demonstrated here, important questions have been raised, and important answers have been offered.

This is not to deny that by refusing to use money as the "measuring rod" of utility, modern Austrians have excluded themselves from the enormous policy literature that calculates benefit–cost ratios and makes efficiency comparisons of different forms of government intervention. Remaining "conceptually pure" has (apparently) led the Rothbardian variant of Austrian economics into the uncomfortable corner of arguing that only deductive logic matters in policy analysis. This position gives no place at all to historical understanding and common sense, which are also pertinent to our understanding of the linkages between government intervention and private economic welfare. Finally, by excelling at comparative institutional analysis, Austrians have pioneered the analysis of rules and institutions well in advance of other contemporary schools of thought, such as the "public choice school" and the "Coaseian property rights school."[17] I offer this chapter as a modest contribution toward correcting the historical record by pointing to these Austrian contributions.

Notes

1 Milton Friedman plainly speaks his mind as follows: "the so-called Austrians, or von Misesians [champion a] philosophy which admits no role whatsoever for empirical evidence – it's entirely introspective – [and] leads to an attitude of human intolerance. . . . The scientific work [on the modern Austrians] is from my point of view useless" (quoted in Hammond 1992). See also Ernesto Screpanti and Stefano Zamagni, who remark that Austrians "refuse to reduce economics to a discipline that seeks observed regularities or mechanical laws from which quantitative predictions can be derived" (1993: 389).
2 Mises characterized the mechanical version of the quantity theory as the "erroneous transference of static law to the dynamic sphere" ([1924] 1953: 152).
3 In preparation for the 1953 edition, Mises added a section to his *Theory of Money and Credit* entitled "Monetary Reconstruction," in which he stated, "The eminence of the gold standard consists in the fact that it makes the determination of the monetary unit's purchasing power independent of the measures of governments. It wrests from the hands of the 'economic tsars' their most redoubtable instrument. It makes it difficult for them to inflate. This is why the gold standard is furiously attacked by all those who expect that they will be benefited by bounties from the seemingly inexhaustible government purse" (p. 438).
4 According to Rothbard, Mises's cycle theory was the "only such theory integrated with general micro-economics and built on the foundations of the analysis of individual action" (1988).
5 On the political business cycle, see Mueller (1989: 277–306).
6 On the German Reichsbank's stubborn refusal to believe that "printing money in favour of businessmen . . . could have any inflationary effect," see Yeager (1976).
7 In Mises's words, there is a "maladjustment between depreciation and circulation" ([1924] 1953: 229). Unfortunately, Mises makes no mention of this controversy in his short autobiography (1978a). Mises credits himself and his colleague Wilhelm Rosenberg with preventing the collapse of the Austrian crown in 1922 (ibid.: 78).
8 Mises must have added this discussion in the 1924 second edition of his *Theory of Money and Credit* ([1924] 1953: 228). Mises's formulation was essentially the inverse of the one described in the text. Mises objected to the use of prices indexes (ibid.: 187–190) and preferred to use a single price. The price he used was the price of gold – expressed in local currency – the price established in

the international market. Mises stated that the behavior of the ratio of the money stock to its gold price had "often been shown by simple statistical investigations" to have fallen during the course of the inflation, suggesting that the commodity (gold) value of the stock of money had shrunk. This shrinking is what creates the impression that there is a "shortage" of money rather than an overabundance (ibid.).

9 According to Friedman, "I looked at the relationship between the amplitude of a recession and the amplitude of expansions and amplitude of the succeeding recessions. There's zero correlation. On the other hand, there's a very high correlation between the amplitude of the succeeding expansion. That's utterly inconsistent with the von Mises theory. It seems to me that that one little bit of evidence is decisive refutation of von Mises" (1969: 271–275).

10 "Entrepreneurs . . . would never venture to take their economic life into their hands because an expert advised them to do so. Those ignorant people who operate on the stock and commodity exchange according to tips are destined to lose their money" (Mises 1949: 871–872). Also see Skousen (1988).

11 On the importance of this "empirical fact" in the applicability of the Austrian cycle theory (see Rothbard 1963). On the statistical evidence and its relationship to the Ricardo effect, see Tsiang (1947).

12 On the "Rothbardian wing" of the modern Austrian school and other personal reflections on the sociology of the school of thought, see Vaughn (1994: 99–100).

13 A fuller analysis of this problem remains to be written; see Specter (1994). "U.S. Business and the Russian Mob," *New York Times* (July 8, 1994).

14 According to Richard N. Langlois, there are spontaneously generated institutions such as money and others that are constructed, such as the "outer framework" of society: that is, its laws and rules. Langlois explained that what "unifies both types of institutions, and what makes the same methods of analysis more or less applicable to both, is that both are in large measure regularities of behavior understandable in terms of rules, norms and routines" (1986: 19).

15 Modern Austrians favor neither inflation nor deflation. They prefer whatever the ordinary market process happens to bring. Hayek stubbornly refused to allow the authorities to depart from the market situation in his *Prices and Production* (1935).

16 Mises pointed out that a "metallic currency is not subject to government manipulation" (1949: 786). Compare Rothbard (1965). See Moss and MacDonald (1981: 98–109).

17 On the "public choice" school, see Mueller (1989). On the "property rights" approach, see Coase (1988).

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B

Schools of economic thought and methodology

2 F.A. Hayek's methodological U-turn reconsidered in light of his concept of social facts

G.M. Huussen

The thesis of the U-turn does not do justice to the development of Hayek's thought

The purpose of this chapter is to disprove the thesis of the U-turn. I shall show that even right at the start of his career, Hayek had different methodological ideas from those of his mentor Mises. This argumentation is sufficient for my objective, but it is rather unsatisfactory if we want to gain a better understanding of the development of Hayek's thought. I will defend the thesis that he derived his ideas on the philosophy of science from Mach and the logical positivists.

In my opinion, this more elaborate argumentation is preferable – not because I subscribe to Hayek's ideas, but because any attempt to take up a critical position should be based on a correct understanding of his own intentions.

Hayek wrote only one work, *The Sensory Order* (1952), that was devoted exclusively to the theory of knowledge, although it was to give a basis to theoretical psychology. For the rest we have to manage with his casual remarks and allusions, particularly in his early work.

However, the core of his interest for the philosophy of science is in his criticism of 'scientism', already found in a series of articles in *Economica* (1941–1944) and later collected under the title *The Counter-revolution of Science* ([1952] 1955). Hayek was full of admiration for the 'hard' sciences, but was hesitant regarding the slavish imitation of their methods in the fields of the social sciences. This hesitancy was born out of concern for the empirical basis of economics – that is, the *facts* of the social sciences in general – rather than the wish to achieve an indisputable aprioristic foundation.

The thesis of the U-turn examined

Hutchison (1981: 210) suggests that Hayek initially was profoundly influenced by his mentor Mises, but increasingly shifted towards Popper's direction later on. In order to make this plausible, he distinguishes various