A Definitional Review of Economics Through the Application of the Leading Theories and Methodology of The Austrian School

Dr. Jeffrey Henderson
Professor of Business Ethics
Dean of Monarch Business School

Abstract

The article examines the shortfalls of traditional definitions of economics from the viewpoint of the Austrian School of Economics as being too narrow and overly mathematical. Important concepts of human action and volition are considered. The discussion centers around the notion that the nature of knowledge within economics is not the same as the hard sciences from where the scientific method originates and that its use in economics is ill-conceived. The study of human action, known as "Praxeology" focusing on the improvement of a person's situation is considered key to understanding the true nature of economic thought. Concepts of scarcity, time, reason, equilibrium are further discussed. Critical concepts such as Methodological Individualism, Methodological Subjectivism, the Theory of Subjective Value and the Theory of Diminishing Returns are reviewed. The critical concept of Entrepreneurialism and the Entrepreneur with their role in the economy is discussed. The discourse closes with a focus on the Austrian Theory of Price and the Theory of the Business Cycle.

Keywords: Austrian Economics, Praxeology, Human Action, Economics, Economic Thought, Individualism, Subjectivism, Subjective Value, Price, Business Cycle, Entrepreneurialism.

Introduction

In considering the leading theories and methodologies of the Austrian[1] School of Economics[2] it serves to first define the study of economics as it is generally accepted in the prevailing literature within academia. The highly regarded and well-known textbook author Paul Samuelson[3] provides a workable definition of economics as:

> The study of how societies use scarce resources to produce valuable commodities and distribute them among different people. (Samuelson, Nordhaus, 1998)

The above definition is interesting in so far as it sets up the intellectual boundaries of economics within the minds of the general reader, many of whom are being exposed to it for the first time. That is, this definition of economics is possibly the first definition to which the multitude of undergraduate students are exposed and as such it shapes the nature of inquiry for those students as they continue their academic journey of learning and development.

Naturally, like many definitions there is often as much importance in what is not included in the definition as to what is. Moreover, the task of defining a study of knowledge as diverse as economics within an 18-word sound bite is destined to come up short simply by the nature of the task. In this respect, we may be willing to provide Samuelson some leeway and understanding as to the difficulty of the task.

Nevertheless, we see that the above definition is lacking certain elements that would otherwise make it more complete and more in keeping with the historical development of the field of knowledge.

First, the above definition uses as the subject the term “societies” which is an aggregation. That is, societies are made of groups and those groups are in turn made up of individuals. The definition gives the reader the feeling that the role of the individual as primary actor in economic exchange is subjugated to that of the society in general. As we will see later, this notion of the aggregate is a fallacy and contradicts a basic premise of the Austrian School of thought.

Second, the elements that are present confine the definition to a narrow view of the use of scarce resources within a production and distribution paradigm. There is no mention of the nature of human action that is critical to the operating of a coherent economic system. In fact, the definition reduces human action to that of the action of an impersonal actor, as mentioned, in the form of society. As we shall see the study of human action is the main precursor to the correct and full understanding of economics as a social science.

Lastly, the definition does not address the issue of value other than mentioning that the commodities are valuable. How those commodities become valuable or are perceived as valuable remains specifically unaddressed. In fact, the notion of value being created in the form of an attribute of the commodity by virtue of the production cycle is inherent in the definition. We shall see that this misinterpretation of value as being a product attribute contradicts one of the main philosophical underpinnings of the Austrian School.

The above is no doubt the result of Samuelson's own perspective. More than most authors, Sameulson is credited with raising the level of mathematical analysis in the profession. With book titles, such as: "Foundations of Economic Analysis" (Samuelson, 1964) and "Linear Programming and Economic Analysis" (Samuelson, Dorfman, Solow, 1987) his focus on mathematical models and statistical analysis is evident.

Keeping in mind the unmatched popularity of Samuelson's textbooks[4], what we see in the schooling of economics is a pre-disposition towards a narrow and overly mathematical understanding of economics which sets the stage for further similar investigation by new generations of students. That is, more mathematics begets more mathematics, more statistical analysis begets more statistical analysis. What the above mathematical and statistical focus provides the reader is in stark contrast to the Austrian School of economics and its own development and understanding of the nature of economics as being primarily a deductive pursuit. That is, from self evident truths the nature of economics can be logically deduced and understood as long as the logician maintains internal validity in the arguments.

Along with the above over-reliance on mathematical formulation mainstream[5] economics has taken on the form of the positive school of thought with its reliance on the scientific method. At the heart of the debate over economics is the notion that being a social science, as Keynes mentions in his letter to Roy Harrod on the opening page, "scientism" is ill-adapted to its use. Further, as Hayek explains:

> it involves a mechanical and uncritical application of habits of thoughts to fields different from those in which they have been formed. The scientistic as distinguished from the scientific view is not an unprejudiced but a very prejudiced approach which, before it has considered its subject, claims to know what is the most appropriate way of investigating it. (1952: 24)

We shall see that the nature of knowledge within economics is not the same as the natural or hard sciences from where the scientific method originates and that its use in economics is ill-conceived.

The above definition will be used to help to illustrate that economics is much more than the usual and generally accepted definition. Further, it will be shown that the viewpoint and understanding held by the Austrian School is a necessary ingredient to not only understanding the broader and more appropriate application of economic thought, keeping in mind its historical development, but also to provide a more meaningful roadmap for the future of economic

understanding and its role within the larger body of knowledge within the social sciences.

Methodological Underpinnings

Given the above seemingly narrow definition of economics and the background of the definition's author, along with the focus of many Keynesian economists following in academic and public life, it is excusable for any student to believe that the study of economics is anything other than the application of mathematical formulations and statistical regression analysis to vague concepts of equilibrium and price theory.

As Professor Hayek (1952) has shown, the study of economics within the twentieth century has been hijacked by "scientism". That is, economists of the last century and present day have removed themselves from the deductive nature of economic analysis and have instead opted for the security blanket of the scientific method. This approach is in contrast to the Praxeological methodology introduced by Professor Mises.

Praxeology

Professor Ludwig von Mises introduced the concept of Praxeology[6] to the economic community in his book *Human Action* claiming that economics at its core is a large encompassing body of knowledge that takes into consideration the very essence of human action and not simply the application of scientific methodology to economic data points. He believed that in order to understand the essence of economics it is necessary to understand the essence of human action. This field of investigation he named Praxeology, or the science of human action, a term originally coined by Alfred Espinas[7] in 1890. One can say that Praxeology is the distinctive methodology of the Austrian School and that Praxeology:

> consist of the logical implications of the universal formal fact that people act, that they employ means to try to attain chosen ends. (Rothbard, 1997: 70)

Supporting the above thought that economics is a broad faculty the economist Isreal Kirzner has written that:

> the praxeological view sees economic affairs as distinguished solely by the fact that they belong to the larger body of phenomena that have their source in human action. The core of the concept of human action is to be found in the unique property possessed by human beings of engaging in operations designed to attain a state of affairs that is preferred to that which hitherto prevailed. (Kirzner, 1976: 148)

Professor Mises taught that the logical structure of human action is derived from the thought that every conscious human action is intended to improve a person's satisfaction and that this fact is known by all persons, that they are self-evident[8] or broadly based in common human experience. In this regard, Praxeology is *a priori* to all experience or we can say it is part of the logical structure of the human mind.[9] Moreover, once you understand that human action is a necessary attribute of human existence and that human action is purposeful in order to attain ends that are considered more desirable, then the rest of economic theory unfolds logically.

Expanding on the above Kirzner further states:

> The particular form that human action will take will necessarily be dependent on a variety of forces that are made up of factors that include those making up the specific environmental conditions as well as that have shaped the character and values of the actor. The conception of sciences as human action recognizes that the form of action as it unfolds in its historical reality is the result of influences that range from the physiological to the religious, the social to the geographical. (Kirzner,1976: 149)

The above clearly shows that the Praxeological approach takes into consideration a wide range of influences when considering human action. It maintains the thought that economics is a broad social science.

Economic theory unfolds once we understand that human desires are basically limitless and that the resources available to satisfy those desires are not. The logical next step is the study of choice. That is, with scarce resources to satisfy unlimited desires we must all chose between economic alternatives. From this discussion of choice and alternatives we are lead to the concept of opportunity costs as every decision as to which desires will be satisfied must be taken at the expense of some other decision that is not taken and there exists an opportunity cost lost in the action not taken. As this deductive logic unfolds all areas of economic thought can be fully explored and deduced. This use of deductive logic, keeping the postulates of Praxeology in mind, forms the underlying rationale and methodology of the Austrian School of Economics.

Value Fee

There are a few other important points to make concerning the above. Firstly, the study of Praxeology is taken as being value free. That is, Praxeology does not comment on the desirability or value of a certain outcome, it merely states that individuals seeking certain ends will use selected means to obtain those ends in a purposeful manner. As Mises states:

> The ultimate end of action is always the satisfaction of some desires of the acting man. Since nobody is in a position to substitute his own value judgments for those of the acting individual, it is vain to pass judgment on other people's aims and volitions. No man is qualified to declare what would make another man happier or less discontented. (Mises, 1998: 18-19)

Moreover, Praxeology does not need to investigate the origin of the volition, i.e.: whether that origin was internally generated or influenced by some external source.

> Economic theory is not based on the absurd assumption that each individual arrives at his values and choices in a vacuum, sealed off from human influence. (Rothbard, 1997: 71)

Thus, if an individual expresses a desire for one reason or another it is of no consequence to Praxeology.

The Element of Time

The actions that Praxeology speaks of occur across time. That is, the individual employs means across time in order to bring into being a certain end state. That end state is sometime in the future, it may be the near future or the far future but will definitely be in the future. This sentiment is expressed in the following quote by Mises:

> Action aims at change and is therefore in temporal order. Human reason is even incapable of conceiving the ideas of timeless existence and of timeless action. He who acts distinguishes between the time before the action, the time absorbed by the action, and the time after the action has been finished. He cannot be neutral with regard to the lapse of time. (1998/1959: 99)

We can say this is so since if individuals could satisfy desires immediately, meaning without the passage of time, then all desires would be attained and would render us essentially without desires. Naturally, we collectively know that this is not the case for the human condition.

Time Preference

Austrian economists also note that end states are preferred sooner than later and that things in the present are valued greater than things in the future. Thus, we see that the foundation for the theory of the time value of money and interest rates is laid through the understanding of Praxeology. This is expressed in the following quote from Professor Leube:

> It was Gian Francesco Lottini (1512-1572) who had already a rough idea of the fact that people value goods that are presently available much more than those available in the future, and, thus he more or less created the fundamentally important theory of time preference which later came to be associated with Eugene von Böhm-Bawerk's work…..It was Ferdinando Galiani (1728-1787) who contributed most effectively to the ultimate development of the modern theories of utility and value, ideas which are closely associated with the 'Austrians'. (2002: 4)

Scarcity

Time also becomes important from a further viewpoint. When we look at the desires that individuals hold we realize that these desires are based on scarce resources. That is, if the resources were not scarce then everyone could have as much of the resource as they wished and therefore could easily satisfy all their desire for that resource immediately. Thus, scarcity and the time element are interwoven within purposeful human action. Rothbard writes:

> The fact that people act necessarily implies that the means employed are scarce in relation to the desired ends; for, if all means were not scarce but superabundant, the ends would already have been attained, and there would be no need for action. (1997: 60)

Time as a Scarce Resource

If we look at scarce resources and assume them away, we are left with one resource that can never change, never be saved up or ever be given away. It is time. Individuals only have a certain amount of time and therefore time will

always remain scarce even if we became the richest individual on earth and had at our disposal the ability to satisfy all of our needs. Thus, considering that Praxeology is the distinctive methodology of the Austrian school we can see from the above that time is also a critical element in the methodology of Austrians. (Rothbard, 1997)

Equilibrium and Time

As many students of economics come to know, mainstream[10] theory makes certain assumptions in order to simplify the analysis of economic phenomena. The ideas of certainty, consistent information and uniformity of knowledge along with the ever-popular notion of equilibrium come to mind. Of these notions equilibrium is potentially the one that causes the most confusion with regards to the true nature of the study of economics. This is so as the concept of equilibrium removes the ever-important element of time. Students are often erroneously taught that economic systems are reaching for some equilibrium point at which the price point, reflective of the interaction of supply and demand, will be static, i.e., never changing.

That is, the idea is put forth that there exist some predetermined elements or prerequisites for a state of equilibrium and the market is able to find or achieve them. Naturally, this situation is and will never be the case and there does not exist any sort of prerequisites that will yield a static equilibrium state since once you approach the theoretical equilibrium frontier changes in the marketplace will create a new theoretical equilibrium point and the process will continue. This point is stated clearly by Mises:

> 'I try in my treatise,….to consider the concept of static equilibrium as instrumental only and to make use of this purely hypothetical abstraction only as a means of approaching an understanding of a continuously changing world.' (as cited in forward of the Scholar's Edition Herbener J., Hermann Hoope H., Salerno J.T., Mises, 1998, p. ix)

As Austrian economists point-out the technical term "equilibrium" is simply an intellectual concept used for illustrative purposes and does not exist in the economic system, per se. That is, as all human actions are dynamic across time, as previously mentioned, it is impossible to arrive at a static concept of price and therefore by extension any equilibrium state.

Otherwise said, and using the classical notion for example, as supply and demand factors change and force the resultant price of a good towards equilibrium the underlying characteristic of supply and demand change and modify and force a new "equilibrium" price. This constant change in the

equilibrium price continues ad infinitum. Thus, there is no such thing as an equilibrium price but rather a serious of equilibrium prices that is ever changing or resetting through time based on changes within the supply and demand constituents. In this regard, the Austrian school always keeps the notion of time ever-present in its underlying view of the economic system, it is focused on the process of equilibrium and not on some illusionary ultimate static state.

Reason

The mortar that binds Praxeology together is reason. That is, purposeful action can only be taken with the sanction of reason and reason plays the primary role or *"vital impulse"* in every action. Otherwise said, it is within human nature to use reason. Mises points this out in the following quote:

> Human reason serves this vital impulse. Reason's biological function is to preserve and to promote life and to postpone its extinction as long as possible. Thinking and acting are not contrary to nature; they are, rather, the foremost features of man's nature. The most appropriate description of man as differentiated from nonhuman beings is: a being *purposively* struggling against the forces adverse to his life. (Mises, 1998: 878)

Without reason there cannot be purposeful action. Since reason is imbued in the actions of men to obtain desired outcomes the economist is able to make certain predictions or deduce certain theorems concerning that behaviour. This is how the Austrian economist proceeds and is why the method of the Austrian School can be called deductive and analytical.

Conversely, and as shown in the above quote, we can say that any action that lacks reason will not fall under the domain of Praxeology. Thus, the simple reactions of animals or insects cannot be considered under Praxeology as they are not human in nature and do not have reasoning behind them. Similarly, the actions of a mad man would fall outside the realm of Praxeology as he is devoid of reason.

The concept of reason is also crucial in understanding a further important distinction between the Austrian School methodology and other schools. Because human action is backed by reason there is a necessary difference that exists in the methodological investigation of that purposeful action and the action of non-purposeful entities. That is, non-human action lends itself to the investigatory techniques of the scientific method, taken from the natural and hard sciences, where under the same circumstances like or similar outcomes may be expected. However, this is not so when considering human action. (Hayek, 1952)

Variable Nature of Human Action

Though human action is purposeful it is not necessarily constant. When we look at human action backed by reason we must keep in mind that it is based on the rationalization of a multitude of complex inputs at a specific point in time. Any decision today may be entirely different at a subsequent point in time for no other reason than the passage of time. Layered on top of this time change is the fact that many variables within the environment will not remain constant or homogeneous due to the complex nature of human systems and their penchant for change. As Rothbard points out:

> each historical point,…,is not simple and repeatable; each event is a complex resultant of a shifting variety of multiple causes, none of which ever remains in constant relationship with the others. (1997: 72)

Ordinal Quality of Human Action

Though we see above that human nature is variable we also see that human nature is not chaotic in the sense of execution. There are a multitude of ever-changing external factors. Mises points out that humans act in sequences; going from one decision on to the next and they do not process a myriad of decisions at the same time. This sequence of human action again introduces a time element into the discussion.

Moreover, humans also make value judgments based on ordinal values and not cardinal amounts. As Mises argues:

> Action sorts and grades; originally it knows only ordinal numbers not cardinal numbers…Acting man sees in these events only a more or a less of the same kind…For acting man there exist primarily nothing but various degrees of relevance and urgency with regard to his own well-being. (1998: 119)

In simple terms this means that as individuals we understand that we prefer one thing or object over another, however, we do not know how much more we prefer it other than in general terms, such as: much less, less, same, more or much more. Otherwise said, I cannot say that I prefer Mozart two and a half times more than Beethoven, though I may feel that I prefer Mozart much more than Beethoven. In this way, value judgments fall outside the boundaries of arithmetic methods.

Economics as a Learning System

Important in the above concept of ever-changing external factors across time is the essential internal element of learning through time. Environmental variables may change and mutate but the critical element behind human action is that humans learn. Through the process of purposeful human action we obtain feedback which illustrates to us that we have been more or less successful in attaining our ends, and we are able to imagine that we might be still more successful if we employed a different set of means. So, we try again changing the mix of means to suit our desired ends for the new experience and knowledge that we have gained. This is a learning process based on incomplete knowledge. The actor at time 'z' is different than he was at time 'y' simply because he has learnt a lesson and can employ that new knowledge in subsequent purposeful action.

Economics as an Encompassing Study

The above discussion brings an even more interesting concept to the fore than that of time and variability. That is, if economics is essentially the study of Praxeology and Praxeology is the study of human action, all purposeful and rational human action across time, then the demarcation of what constitutes economics is much larger than traditionally perceived. This naturally has far reaching consequences for the study of economics as a social science and discipline. This thought is echoed by Benedetto Croce:

> An act is economic in so far as it is the consistent expression of a man's will, at his conscious aiming at a perceived goal. (Kirzner, 1976: 156)

The above shows us that economics is a broad discipline, much broader than many assume, and it helps to illustrate the distance that exist between the definitions that various people hold. Necessarily, if you perceive the faculty of economics narrowly than your definition of that faculty will be somewhat restrictive in comparison to another who holds a broader view.

Economics Versus Economizing

Returning to our opening definition of economics, as provided by Sameulson, we see that he relied on the notion of economizing; economizing being defined as the allocation of scarce resources among competing ends. However, acting in a purposeful way in a Praxeological sense means selecting a means or a behavior designed to further a goal or end state. So, as we see the concept of human action, or the concept of economics, is both broader and more fundamental than the simple concept of economizing that is used by many learned economist.

Through the understanding of the Praxeological methodology Austrian economists naturally hold a broader view of the discipline of economics, one that revolves around the concept of human action. Human action being backed by reason is seen as being unique in so far as it doesn't lend itself to analysis by way of the scientific method adopted from the natural sciences but rather requires the analytics of verbal deduction akin to the original Greek thinkers. This difference is explored below.

End Means Dichotomy

Professor Hayek has pointed out that the study of economics is markedly different than the study of the physical sciences. Within the physical sciences one can study the planets, stars or atoms and make predictions about their movement. However, in economics which is primarily a social science, this type of prediction is not possible. Hayek explains:

> While the astronomer aims at knowing all the elements of which his universe is composed, the student of social phenomena cannot hope to know more than the types of elements from which his universe is made up. (1979: 73)

It is not possible due to the fact that planets and stars, for instance, do not hold motivations and do not "act" in the same manner as individuals making economic decisions, as discussed earlier. Otherwise said, individuals have goals and purpose and they actively try to attain those goals through their actions under the influence of reason.

> The fact that an [human] action is in the regular course of affairs performed spontaneously, as it were, does not mean that it is not due to a conscious volition aid to a deliberate choice. (Mises, 1998: 47)

In so far as the natural or physical sciences are concerned there is no choosing and there is no influence of reason. Planets or atoms act the way they act without them deciding to act a certain way. Otherwise said, there is no volition. Further, atoms will continue to act the same way given the same situation, all other things being equal, each and every time.

Simply reflecting on our own personal history shows that the above does not apply to human beings making economic decisions. Humans often contradict themselves in their actions from moment to moment for one reason or another

known solely to themselves and often they themselves do not fully understand their actions or motives. As Rothbard writes:

> Different individuals value the same things in a different way, and valuations change with the same individuals with changing conditions. (1997: 17)

This view of the economic actor is starkly contrasted by the traditional view of the economic man or “homo economicus” associated with Adam Smith, David Ricardo and their followers.

The Question of Econometrics

In recent times the application of scientific method to the study of economics, or human action, has been wide spread, as in the case of econometrics. Econometricians will study the history of an economy and try to deduce economic laws through the analysis of the data acquired. As mentioned earlier, Samuelson himself was an ardent supporter of this method. However, this methodology is seen by Austrian economists as faulty and misapplied.

Firstly, the study of economics through statistical analysis is considered by Austrian economist solely as being that of an historical review. Granted that this review may yield important insights into a certain period of time in history but its application to different periods is questionable. That is, even if the econometrician was able to determine a constant value at a specific point in time that value is constant only for a certain period of time under certain homogeneous circumstances. Thus, any change in the time element or the background circumstances invalidates any predictive ability of the analysis. Moreover, these “constants” are not the same types of constants as in the natural, physical, or hard sciences and cannot be used for predictive purposes. Otherwise stated, each historical event is not repeatable even if it is similar to other instances, it simply is not homogeneous to other events. Or, as Rothbard states:

> The truth is that there are only variables and no constants. It is pointless to talk of variables where there are no invariables. (1997: 76)

The Misapplication of the Scientific Method

Necessarily, when a “pure and applied scientist” deals with humans as his observed entity he subtracts the most important element that the economist considers mandatory: motivation and desire, otherwise known as volition. Thus,

human action is turned into events and the actor is rendered impotent and homogeneous and the underlying rationale as to why such an event occurred in the first place is lost.

The scientist then continues on his way by analyzing groups of events to find correlations so that he may determine some hypothesis, which he will later test. However, in the social sciences and economics the exact opposite is true. We already know that people have desires, motivations and goals and that they act to fulfill them and that this fact is known by all. That is, people chose the ends which they seek and then the means in which to attain them.

This point has been illustrated by Rothbard who writes:

> The essential difference is that in the natural sciences the process of deduction has to start from some hypothesis which is the result of inductive generalizations, while in the social sciences it starts directly from known empirical elements and uses them to find the regularities in the complex phenomena which direct observations cannot establish. (1997: 66)

Mises further elaborates that:

> Nor is it appropriate for the praxeologist to disregard the operation of the acting being's volition and intention because they are undoubtedly given facts. If he were to disregard it, he would cease to study human action. Very often but not always-the events concerned-can be investigated both from the point of view of praxeology and from that of the natural sciences. But he who deals with the discharging of a firearm from the physical and chemical point of view is not a praxeologist. He neglects the very problems which the science of purposeful human behavior aims to clarify. (Mises, 1998: 26)

Thus, we see the reiteration of the essential element in Praxeology, and by consequences Economics, as purposeful human action.

Economics as Entrepreneurialism

This misapplication of the “scientific” approach has farther reaching effects on the study of economics. For instance, when “scientism” reduces the actor down to the lowest common denominator the actor is stripped of his uniqueness. However, it is this uniqueness that is at the heart of the market and economic

development, not simply because of the concept of volition but due to the more developed concept of entrepreneurialism.

Firstly, the entrepreneur is a unique specimen. Not all entrepreneurs are created equal as every businessman knows. Further, every entrepreneur holds different knowledge and a different understanding of the motivations, desires and future actions of others. What this means is that as entrepreneurs try to satisfy these difficult to know consumer desires they do it in a variety ways, i.e., competition. Some of these ways are profitable and some of these ways are unprofitable. It simply depends on how well and appropriately the entrepreneur has targeted these desires on the demand side and how well and appropriately he has satisfied these demands on the supply side. Another way of expressing this thought is to say that Entrepreneurs are “Arbitragers of Market Knowledge”.

Entrepreneurialism by its nature is subjective as is the overall market and the study of it cannot remove this subjectivism or volition on the part of the entrepreneur. Add to this the ever changing desires of the consumer and the result is an almost chaotic environment of continuously changing inputs and outputs supported by incomplete knowledge. This very point brings us to a discussion on two main pillars of Austrian Economics: individualism and subjectivism, which also happens to be the underlying forces that stand behind the formation of prices (Leube, 2002), as shown below.

Methodological Individualism

Methodological individualism essentially states that economics is the study of purposeful human action and “that only individuals feel, value, think and act” (Rothbard: 71). According to Mises, human action is something that takes place on an individual basis and thus the focus in economics must be on the individual and their motivations and not some artificially constructed aggregate group as expressed in the opening definition provided by Samuelson. Moreover, Mises states:

> First, we must realize that all actions are performed by individuals. A collective operates always through the intermediary of one or several individuals whose actions are related to the collective as the secondary source. (1998: 42)

Following on this premise, Austrian economists believe that it is impossible to add together the various indifference curves of individuals and obtain any meaning from that analysis. Thus, as mentioned earlier, as a premise Austrian economists reject the tools of econometrics and statistics as being solely of a historical nature providing insight into a unique situation of time and place.

Methodological Subjectivism

Methodological subjectivism essentially states that the actions or decisions that an economic actor takes are determined by a set of values known only to him or her. That is, every time an economic decision is made by them a subjective value judgment known only to them has been taken. Further, the actor believes that the action that follows this judgment call will maximize their future economic position vis à vis his existing situation and/or the existing situation of other participants in the economic system as in the case of exchanges.

From this it follows that two distinct individuals will have differing judgments of the same exchange. Moreover, the same individual may have differing judgments of the same exchange or transaction at various moments across time and place. In this respect, Austrian economists keep the ever present notion of time and place within their consideration. This is expressed in the following quote:

> At every step of his very detailed story, Menger emphasizes the subjective nature of the properties, their dependence on the individual's knowledge of time and place, and his attitude towards his wants and the ability of the objects to satisfy his needs. (Leube, 2002: 11)

From the above we can state that Austrian economists differ from their counterparts in so far as they investigate socio-economic phenomena that goes beyond the traditional realm of economics and is applicable to all socio-economic circumstances. That is, they are primarily focused on the reason behind the economic human action. For the Austrian Economist human action becomes the all important aspect of the economic system (Mises, 1998/1959).

The Theory of Subjective Value and Carl Menger

The individual who made the greatest contribution to the above idea of subjectivism was Carl Menger. Professor Menger used the concept of subjectivism as a basis for determining the value of a good. He believed that value was/is determined subjectively and that the value was not an attribute of a product attained through the production process which was widely held during his time. This is reflected in the quote below:

> Menger's subjective revolution amounted to the recognition that value has never been nor will it ever be a property or a substance inherent in goods. (Leube, 2002: 10)

Essentially, beauty is in the eye of the beholder and value is whatever the beholder believes it to be. This notion sets the basis for the foundation for all economic exchanges and transactions.

Along with the above thought Menger created two distinct types of goods, named: free and economic (Mises, 1998/1959). Free goods are those that are essentially super abundant such as air and therefore consideration of them lies outside the realm or jurisdiction of economic thought. Thus, their supply vastly outstrips their demand and they are not considered scarce. The supply of economic goods on the other hand are typically less than or equal to the demand for that good, otherwise said, the goods are scarce. Menger concluded that these are the goods that come under the microscope of economic thought.

As we see above economic goods have a demand which outstrips their supply and are therefore scarce. Since they are scarce, as consumers, we must plan for their use. That is, we do not need to plan our usage of super-abundant goods as there is enough to go around to satisfy all needs at any time.[11]

Carl Menger's thought that value is a subjective view of a good by an acting individual also showed that the actor's determination of value was based on a specific mix of time and place. Otherwise said, an economic actor could easily change his view of a good's value depending on when and where he considered the good in question. Menger firmly believed that value lay in the subjective appraisal of the good by the economic actor and was not a characteristic of the good.

As mentioned, at the time that Menger made this assertion it was not the prevailing mindset and thus was a revolutionary step forward in economic thinking. Moreover, the tendency to attribute value to the production process or as a characteristic of a good remains strong even to this day as evidenced by Samuelson's opening definition.

A supporting view of Menger's theory is the fact that as supply and demand change the value of a good is affected as evidenced in its market price. If there is a large supply of a good, all other things being equal, it is generally met with a lower price in comparison to the situation where the good is scarce. Since this is true we see that value as expressed by market prices is variable since prices vary and therefore value cannot be a static attribute of the good itself.

The Theory of Diminishing Marginal Utility and Value

The theory of diminishing marginal utility and value is another of the major theories that form the basis of Austrian economics. Though it is now taken up by other schools of economic thought it was through the writings of Carl Menger and

Eugen Böhn-Bawerk that diminishing marginal utility took root and helped economics to establish itself as a science. In fact, Böhm-Bawerk writes that:

> the doctrine of marginal utility may be regarded as the crux, not only of the theory of value, but of every explanation of man's economic behaviour, and hence indeed of the entire field of economic theory. (1973: 18)

Unfortunately, for economic thought at the time, the concept of marginal utility was under bombardment from the cost-of-production theory of the classicists as put forward by Alfred Marshall and the labour theory of value as used by the Socialist/Marxist. Both ideas erroneously attributed value to an element of the cost structure of a product whether it was labour or another aggregate.

What we see from these discussions is that the value of a good is determined by its usefulness in its least important use. Böhm-Bawerk illustrated this principle in his text "Value and Price" when speaking of the farmer who produced five sacks of grain. The farmer makes plans for the use of each sack of grain from the most important use to the least important use. If he gives up one sack of grain then he forfeits the least important use, as he would otherwise keep the remaining four sacks to satisfy the four most important uses as originally determined. (Böhm-Bawerk, 1973: 26)

Thus, while holding five sacks of grain each sack is valued at the price that represents the least valued use. No matter which sack of grain is given up it is worth the value of the least used. As sacks of grain are given up the value of the remaining sacks increase as their respected use becomes more important or valued. In this example the last sack of grain is the most important and valued the greatest as it is the sack that he needs in order to feed himself and live. Thus, the value of a good is determined by its marginal utility or marginal satisfaction.

In the original adoption of the theory the Austrians employed the term Psychological school due to the fact that the individual uses subjective values and makes choices. This lead some observers to believe that marginal utility rested on some kind of psychological law, which is indeed false as Professor Mises shows:

> It is a praxeological truth, derived from the nature of action, that the first unit of a good will be allocated to its most valuable use, the next unit to the next most valuable, and so on. (1998/1959: 124)

The Austrian Theory of Price

Related to the above is price theory or the exact nature of the pricing mechanism. As we have seen, the value of a good is a subjective reality known only to the economic actor in question. How the good satisfies his particular needs is the critical element in understanding value and thus in determining a price. When considering the price of a good, we see that it is not determined by considerations such as the cost of the component parts or quantity of labour or the combined cost of the good itself. Rather, it is determined by the subjective nature of the appraising mind of the consumer or groups of consumers making purchase decisions as to the underlying utility of the product or service and how well that product or service will satisfy their desires, wants or needs. Price is essentially this ratio expressed as a data point. This thought is reflected in the following quote:

> In accepting the logic of choice we can only speak of data known to the acting person….This means however, that terms such as “price” cannot be used to identify a certain thing or a physical good. Instead, the “price” necessarily is a phenomenon that is defined only by the interactions of people and as such has no other properties as those which are reflected by these exchanges. (Leube, 2002: 16)

Thus, we see that Austrians believe that price is not a characteristic of a good but a reflection of the desires of the mind of consumers and how they believe the good in question may or may not satisfy those needs. In this respect the price is, as quoted above, a phenomenon and only through the understanding of the desires and satisfaction of the consumers towards those goods can economists speak of prices. In many respects, in the opinion of the author, this type of consideration of price gives life to an otherwise static concept. Prices shift with respect to the desires and opinions of the people who consider the goods and this is a dynamic process that changes across time.

In this respect economists would be wise to keep the role of the entrepreneur in mind, as earlier mentioned, as entrepreneurs are expert in assessing the underlying mood of consumers as to their wants and desires and the level of their intent to satisfy those wants. Tracing back these desires through the value chain of a product or service the entrepreneur is able to make a decision as to whether he may satisfy those desires at a certain price point or within a certain price range. He investigates whether or not he is able to allocate the necessary resources in an economically efficient way to yield the assessed price while at the same time yielding an acceptable return for his effort, i.e., profit.

Unfortunately, too many schools of thought assume that pricing works in exactly the opposite manner with industry attaching a profit margin onto a compiled or

assembled good and bringing it to market at a set price. This view negates the active and intelligent role of the consumer and relegates him to the role of simple observer or passive actor, “price-taker”, within a static environment where only the variables that relate to the factors of production are allowed to vary.

The Theory of the Business Trade Cycle

In further refinement, Austrian economists have taken the underlying theories expressed above and related them to the larger business trade cycle. The Austrian theory of business trade cycles finds its history with Carl Menger and the general approach of the Austrian School of Economics. However, the theory was largely developed by Ludweg von Mises and F.A. Hayek.

Essentially, the Austrian theory of business trade cycles deals with the misallocation of capital that creates the cycles of boom and bust so often observed within national economies. The misallocation of capital is created by a loose money policy of the central government which adversely affects the “natural” rate of interest thus enticing businesses to invest in capital projects that they otherwise would not. (Cwik, 2007)

Professor Mises defines the natural rate and the bank rate as follows:

> The natural rate of interest is the rate that equates saving and investment. The bank rate diverges from the natural rate as a result of credit expansion. (1996: 100)

That is, as the government or central bank increases the supply of money, as opposed to an increase generated by the savings of the society, it artificially moves the natural rate of interest lower. As we know, the more funds available to be loaned at any one time, all things being equal, the lower the resulting loan rate which is attached to those new funds. Moreover, the lower the lending rate the more probable businesses will take advantage of those cheap funds and invest in capital goods and projects that hitherto proved to be too costly.[12] Mises spoke directly to this effect:

> if the interest rate is right, that is, if the interplay between lenders and borrowers is allowed to establish the natural rate, then the market works right. However, if the interest rate is wrong, possibly because of central bank policies aimed at "growing the economy," then the market goes wrong. (1996: 12)

The above effect is the same as when individuals within the society save, however, the end result is different when the money is created by a loose-money policy. When individuals save they indicate to the market place that they prefer to hold funds for future consumption, otherwise they would consume those funds immediately. By indicating that they would rather defer immediate for future consumption, a subjective decision, they also indicate to businesses that these businesses should shift their own focus to future periods. Increased savings reduces the interest rate charged on loans, as there is now more money to lend, and business take advantage of these lower cost funds by investing in capital projects of a longer time period or whose benefit is delayed to later periods.

However, when the government through the central bank reduces the loan rate through increases in the money supply they send false signals through the market place, or as Mises states *"goes wrong",* that erroneously indicate that consumers have shifted their preference to future periods. More money supply reduces the loan rate as in the savings scenario and businesses take advantage of the situation and shift their investment to far-off or longer-term capital projects. However, in this case consumers have not changed their preferences or have not become more thrifty and businesses are misreading the market. Otherwise said, there is a disequilibrium between savings and investment. In a loose money, credit induced environment real savings is still low. Mises expresses this point below:

> Padding the supply of loanable funds with newly created money holds the interest rate artificially low and drives a wedge between saving and investment. The low bank rate of interest has stimulated growth in the absence of any new saving. The credit-induced artificial boom is inherently unsustainable and is followed inevitably by a bust, as investment falls back into line with saving. (1996: 100)

What we see in the above is not just a disequilibrium between savings and investment, but a misallocation of resources within society as a whole. Because there is a misallocation of resources within society the spending of consumers is at odds with the production decisions of businesses from where the consumers obtain their incomes in the first place. Mises illustrates this point as follows:

> In Austrian theory, the possibility of overinvestment is recognized, but the central concern is with the more complex and insidious malinvestment which involves the intertemporal misallocation of resources within the capital structure. (1996: 104)

Sooner or later this cycle or artificial boom must come to an end, and usually does, in the form of a bust as businesses fight for ever increasingly scarce resources and come to realize, often too late, that their interpretation of the market place is false. At this point investment must fall in line with savings.

Thus, we see the difference between savings induced booms which are healthy and provide correct signals to the marketplace and credit-induced booms which are artificially created by loose money, inherently unhealthy and provide false signals to the marketplace.

Naturally, in an economy which is receiving false signals from the unhealthy creation of loose money, businesses have a tendency to hire employees into positions that are now engaged in the longer-term capital projects that otherwise would not be undertaken. As mentioned, there is a misallocation of resources and labour is one of the primary allocated resources within a society and economy. When the bust finally hits employees that have been misallocated are let go from their employment. These employees necessarily have a difficult time finding new employment. Mises mentions:

> During the artificial boom, when workers are bid away from late stages of production into earlier stages, unemployment is low; when the boom ends, workers are simply released from failing businesses, and their absorption into new or surviving firms is time-consuming. (1996: 104)

At this point, the economy is trying to readjust to its natural equilibrium, however, the newly unemployed workers curtail spending and the bust worsens. For Austrian economists the only way out of this downward spiral is to reverse the loose money policy and credit induced capital restructuring that created the malaise in the first place. Money must therefore be taken out of the system to help reverse the trend and return to the natural equilibrium rate of interest which in turn will readjust or re-allocate resources in a balanced way.

In summary, we see that Austrian economists believe that interest rate movements are critical to the proper functioning of the economy in the matching of short and long-term considerations through the matching of consumer preferences with business investment decisions. Interest rates are another form of prices and as we have seen earlier subjectivity plays an important part in the determination of prices and therefore in the determination rates.

Synthesis

We see that the often-quoted definition of the term “economics” is for the most part lacking critical elements that would otherwise provide a more complete understanding of the nature of economic pursuits. Moreover, we see that the modern underlying assumptions of economics, such as: certainty, perfect and uniform knowledge, disregard for the element of time along with the notion of equilibrium, created in order to facilitate understanding, actually has helped to impair a more intelligent understanding of the subject nature.

To complicate matters even further, modern academia has ushered in an era of positivism focused on the scientific method that has cloaked economics in the false veil of precision. More so, studies such as econometrics have made promises that cannot be kept as they have misapplied scientific methodology to a realm for which it is ill-suited.

But perhaps the most critical issue is the fact that modern economics within the 1900’s has had a tendency to homogenize if not completely emasculate the primary actor in the economic system: the acting individual. The individual is reduced to simple data points or is otherwise aggregated to a combined grouping that no longer holds any resemblance to his/her original intelligence. Important concepts such as entrepreneurialism and learning are relegated to the back seat when in fact they represent the very essence of economic growth and innovation so critical to the operation of the economy.

We have also seen that the ever-important concept of human action is indeed the essence of economics and without purposeful human action backed by reason a coherent economic system could not function. In fact, the study of human action, Praxeology, as named by Mises, is the basis for the study of economics not simply as some impersonal mathematical study but as a more complete homo-centric social science based on insight and natural self-evident truths which speak to the nature of the actions of every man and woman.

History and politics have a way of shaping the world that in reflection often seem odd and even incomprehensible to anyone who did not live through the times. In the case of economic thought we see that advances made were often lost or reversed either by the stubbornness of the prevailing gestalt or by a lack of understanding on the part of both inside and outside investigators or organizations. The study of economics is no exception to this fact.

However, even with a prejudiced pattern of history exerting itself against Austrian Economics its underlying premise that the individual acting rationally to better his economic position through time by way of subjective valuations has weathered the storm well and has supported a more comprehensible and intuitive school of thought that continues to gain support. This basis has spawned numerous

subsequent theories through the decades such as the Theory of the Business Trade Cycle mentioned herein.

Austrian Economics has demonstrated itself to be a far-reaching study which includes the full realm of human action which has at its heart purpose, reason and intent. It can claim some of the best thinkers in economics as its own and is a full body of study to rival all other economic schools of thought. With this backdrop of accomplishments Austrian Economics, its methodology and its theories will surely continue to entice and intrigue many scholars and practitioners for many years to come. In fact, it is no doubt the theories and methodology behind Austrian Economics that will continue to challenge practitioners into the future forcing them to revisit and defend their own assumptions and perspectives.

Cited Works

1. Böhm-Bawerk, E., (1973) *Value and Price: An Extract*. (Revised 2nd ed.). South Holland, Illinois: Libertarian Press.
2. Cwik, Paul F. (2007) *Austrian Business Cycle Theory: A Corporate Finance Point of View*. Austrian Scholars Conference 2007.
3. Glasner, D. (1997) *Business Cycles and Depressions* New York: Garland Publishing Co.
4. Hayek, F.A. (1952). *The Counter Revolution of Science*: *Studies on the Abuse of Reason.* The Free Press, Glencoe, Illinois.
5. Hausman, D. (1984) *The Philosophy of Economics: An Anthology Keynes letter to Roy Harrod,* Cambridge: Cambridge University Press.
6. Kirzner, I. (1976) *The Economic Point of View: An Essay In Economic Thought In Studies of Economic Theory*. Moss L. (Ed.). New York:University Press.
7. Leube, K. (2002) *On Menger, Austrian Economics and the Use of General Equilibrium,* Hoover Institution.
8. Mises von, L. (1969) *The Historical Setting of the Austrian School of Economics*, Alabama: Ludwig von Mises Institute.
9. Mises von, L. (1996) *The "Austrian" Theory of the Trade Cycle*. Alabama: Von Mises Institute in The Austrian Theory of the Trade Cycle and Other Essays
10. Mises von, L. (1998) *Human Action: A Treatise on Economics, Scholars Edition,* Von Mises Institute, Auburn: Alabama.
11. Rothbard, M. *Praxeology: The Methodology of Austrian Economics* In Rothbard M. (1997) *The Logic of Action One: Method, Money, and the Austrian School* Cheltenham, U.K.: Edward Elgar.
12. Samuelson, P., Dorfman R., Solow R. (1987) *Linear Programming and Economic Analysis*, Dover Publications.
13. Samuelson P. (1964) *Foundations of Economic Analysis,* McGraw Hill Companies.
14. Samuelson P., Nordhaus W.D., (1998) *Economics,* 16th ed., McGraw Hill Companies.

End Notes

[1] Also known as the Vienna School, the Austrian School was given its name by The German Historical School during the "Methodenstreit" or clash of methodology dialogues.

[2] The Austrian School of Economics is traditionally identified with the first writings of Carl Menger and his Principles of Economics (Grundsätze der Volfswirtschaftslehre) that was published in 1871. Menger's work enabled a series of subsequent intellectual minds to follow in his footsteps over the next one hundred years, namely: Eugen von Bohm-Bawerk, Ludwig von Mises and Friedreich A. Hayek (Nobel 1974). However, the origins

of the Austrian School of Economics can be found in the earlier writings of the Spanish Scholastics of the 15th century and the French Physiocrats of the 18th century.

[3] Samuelson completed his doctorate in economics at Harvard University and his book "Foundations of Economics Analysis", based on his Ph.D. dissertation, spread the mathematical revolution in economics. He won the Nobel Price in Economics in 1970 "for the scientific work through which he has developed static and dynamic economic theory and actively contributed to raising the level of analysis in economic science."

[4] His textbook "Economics" originally appeared in 1948 and is in it eighteenth edition. It has been translated into 41 languages and has sold over 4 million copies.

[5] The study of economics is often split into mainstream and heterodox theories. Heterodox theories supposedly lay outside the accepted body of knowledge and supposedly included such schools as: Austrian, Feminist, Socialist and Marxist economics.

[6] See Mises, Grundprobleme der Nationalokonomie (1933) and Nationalokonomie (1940) and Human Action (1949)

[7] The term Praxeology was first coined by Espinas in his "Revue Philosophique" (Mises, 1998, p.3)

[8] An axiom is self-evident when it must be used in order to be refuted. In the case of human action an individual who wishes to refute Praxeology must use purposeful means to a specific end which is the definition of Praxeology, i.e.: self-evident.

[9] In "Praxeology: The Methodology of Austrian Economics" on page 63, Murray N. Rothbard redefines the thought by stating that in an Aristotelian way the mind apprehends the laws of reality.

[10] The term "Mainstream" is used simply in conjunction with the various schools of economic thought that follow Keynesian ideals.

[11] It is important to note that even super-abundant goods may fall under economic consideration if they for some reason are no longer considered super-abundant or less abundant. That is, the supply-side is radically changed for some underlying reason. An example is breathable air or drinkable water and pollution. If clean air and water become increasingly scarce due to continued pollution then they switch from being considered super-abundant to that of a scarce good. One can also argue that at the point of no longer being considered super-abundant the good now incorporates the cost of the externalities within its pricing mechanism, ie: pollution, that hereto were not being considered or was passed on to the commons. This is one rationale as to the often considered perplexing reason why people are willing to purchase bottled water at a seemingly expensive price point when there appears to be sources of free water available. However, the free water is no longer considered clean or healthy and thus is no longer super-abundant and must be purchased as a scarce resource: we must plan for their use.

[12] This phenomenon is also seen in personal economic affairs. That is, if an individual is able to borrow mortgage funds at a lower interest rate then the "natural" rate, he is thus able to "afford" a higher priced property, the cost of the debt service is lower than it otherwise would be. As a result, the purchase price of the property is artificially elevated due to the availability of cheap money. Otherwise said, the availability of cheap money has artificially increased the "price" of the property. If, on the other hand, the true cost of the mortgage funds were maintained at the "natural" rate the purchaser would not be willing to pay such a high price and the resultant property values would be more realistic (lower) and in line with correctly functioning market mechanisms.