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Austrian Economics

Austrian economics, so named for its country of origin, is distinguished by its methodological precepts. The Austrian approach, as adopted variously around the world in the twenty-first century, was launched by Carl Menger (1840-1926), who taught at the University of Vienna. Menger's writings, particularly his *Principles of Economics* (1871) and his *Investigations into the Method of the Social Sciences* (1883), set out the principles and methods that would guide the development of an Austrian tradition.

Menger rejected the German historicism of Wilhelm Roscher (1817-1894), which offered an empirical and intuitive approach to economic understanding; and he deviated markedly from the eighteenth-century British classicism of David Ricardo (1772 -1823) and John Stuart Mill (1806-1873), which featured long-run relationships among the different economic classes of people (workers, capitalists, and landlords). Menger's economics, especially in hands of subsequent theorists, does bear a striking resemblance to the invisible-hand theorizing of Adam Smith (1723-1790). However, the appropriateness of linking Menger and his followers to the reputed father of economic science is a contentious issue among modern Austrians.

Menger focused on the individual market participant and on his or her choices as governed by perceived needs and wants. This general approach to economics was termed *methodological individualism* by sociologist Max Weber (1864-1920). Consistent with this method is Menger's notion of economic value, which most directly reflects the purposes of the individuals doing the valuing rather than the objectively defined goods being valued. Menger's approach, now embedded (though not consistently) in modern economics, stood in contrast to Marxism's labor theory of value and classicism's cost-of-production theory of value. This shift in focus from the object being valued to the subject doing the valuing is termed *methodological subjectivism*.

Methodological individualism and the closely related methodological subjectivism allow for a straightforward accounting of the gains from trade. Individuals value various goods differently, such that trading goods allows both traders to gain. Direct exchange (goods for goods) leads quite naturally to indirect exchange (goods for more-easily-tradable goods for actually-sought-after goods). The more-easily-tradable goods are called *media of exchange*. In the marketplace, the range of acceptability of such media narrows, giving rise to *a most commonly accepted medium of exchange*. This is Menger's theory of money—with early monies taking the forms of salt or cattle and later monies silver or gold. (The fact that modern paper money is a result of governmental institutions overriding the would-be choices of market participants is seen as supporting Menger's theory.)

The object of trade, whether direct or indirect, is never the whole of the supply, such as the diamond supply or the water supply. Rather, it is the smallest quantities of the goods subject to potential trades, that is, the marginal unit. Because of relative scarcities, the value of the marginal unit of diamonds exceeds the value of the marginal unit of water—despite water's being the more useful of the two goods. This is Menger's resolution of the so-called diamond-water paradox, which was identified by Adam Smith (who distinguished value in use from value in trade) but not satisfactorily resolved until the Marginalist Revolution of the 1870s.

Menger was one of three revolutionists, the other two being British economist William Stanley Jevons (1835-1882) and French economist Leon Walras (1834-1910), each of whom formulated the issues mathematically by writing the equations for total and marginal utility (Jevons) and for the interrelationships among all the prices in a market economy.

Historians of economic thought sometimes see the Austrian theory as applying only to the demand side of the market—with supply and demand finally

being juxtaposed by Alfred Marshall (1842-1924), who drew supply from the classicists and demand from the marginal revolutionists. But Menger applied his value theory to the means of production as well as to the ends. Consumption goods were designated as goods of the first order. Markets for goods of the second, third, and higher orders guide the time-consuming production activities that proceed from the highest to the lowest order.

Eugen von Böhm-Bawerk (1851-1914) developed Menger's conception of the production process into a theory of *Capital and Interest* (vol. 2, 1889). The rate of interest governs the extent to which resources can profitably be tied up in the production process: The lower the interest rate, the more roundabout, or time-consuming, the production process. Unfortunately, Böhm-Bawerk's use of a crude arithmetic reckoning of roundaboutness (the average period of production) diverted attention from the otherwise Mengerian construction and played into the hands of critics who questioned the existence of such a metric.

In his *Theory of Money and Credit* (1913), Ludwig von Mises (1881-1973) used marginalist thinking to account for the value of money and, drawing on Böhm-Bawerk's capital theory, set out a theory of the business cycle. Interest rates held artificially low by central banks stimulate production and cause production processes to be unduly roundabout. In the absence of sufficient resources to complete all of the production processes, the boom eventually gives way to a bust. In essence, the boom-bust cycle is an instance of economic discoordination attributable to an interest rate that does not reflect the unfettered choices of market participants.

Mises systematized Austrian economics in his *Human Action* (1949), calling it praxeology, which literally means action logic. He distinguished between economics and history, denying that there is a unilateral testing of the proposition in one of these disciplines with propositions in the other but recognizing that the two disciplines are essential complements in our understanding of real-world economies.

In his *Prices and Production*, Friedrich A. Hayek (1899-1992) developed the business cycle theory, offering this means-ends theorizing about booms and busts as an alternative to the circular-flow theorizing of John Maynard Keynes (1883-1946). By many accounts, Hayek's theory lost out to Keynes's primarily because of its lack of politically attractive policy prescriptions. Israel Kirzner (b. 1930) developed the essential entrepreneurial aspects of the Austrian theory and, along with Hayek, offered a market-as-a-process view that stands in contrast with the more conventional mathematics of market equilibria. In both microeconomic and macroeconomic contexts, the Austrians have argued that governments are ill advised to override market forces with central planning or to augment those forces with economic stimulants. The policy prescription of *laissez faire* is emphasized by Murray Rothbard (1826-1995) in his *Man, Economy, and State* (1962).

Through his introduction and selection of articles, Kirzner offers, as an Austrian sampler, a three-volume *Classics in Austrian Economics* (1994). Dating from the mid 1970s, numerous books and articles make Austrian economics a living tradition. Some are intended to compete with modern mainstream thinking and others to reconcile with it.

Roger W. Garrison
Auburn University

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