

**Human Action -
Epistemological Aspects of the Austrian School of Economics**

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ABSTRACT

This paper presents an interpretation of the epistemological foundations of the Austrian school with special emphasis given to Ludwig von Mises' theory of human action. The main conclusion of the analysis says that the specific advantage of the Austrian approach lies in its application to complex economic problems, and that it is most useful when it is not regarded as an opposing paradigm that stands in mutual exclusion with the mainstream. Both approaches may profit when Austrian economics becomes to be seen as a method whose strength is in focusing research on economic policy issues and these areas where the application of mainstream economic models often are extremely limited. "Austrian scholars" could profit if they were more open to the results of conventional economics – be it mathematical modelling or econometrics. As the ideal then appear studies, which make use of the numerous and various results of mainstream economics but apply these in a way so that the investigation integrates the central aspects of human action such as meaning, ends and means along with the aspects of time, the limitations of knowledge, and the subjective-individualistic character of values in the form of a "sequential analysis".

I. Origins of Austrian Economics

Precursors of the ‘Austrian school’ include Richard Cantillon, A.R.J. Turgot, Jean-Baptiste Say and Frédéric Bastiat. Among the ‘neo-classicals’ Philip Wicksteed and William Stanley Jevons are to be mentioned, while the definite modern foundations were laid by the ‘original Austrians’ Carl Menger and Eugen von Böhm-Bawerk and their successors Ludwig von Mises and Friedrich August von Hayek who refined and enlarged the approach.¹ Murray N. Rothbard was the most prominent representative in the United States. Although they are variously linked to ‘Austrian economics’, J. A. Schumpeter, Oskar Morgenstern and Gottfried Haberler do not belong to this school. The unifying concepts of an Austrian school proper are radical subjectivism of valuation, the marginalist and sequential character of human valuation, thinking and action; they include the attention for time and the limits of knowledge, and the recognition that social phenomena are complex. In this respect, one can include the Spanish scholastics in the forerunners of the Austrian school of economics²

The Austrian school emerged with the publication of Carl Menger’ Principles.³ Although originally conceived as a complement to the German historical school, a controversy evolved, called the *Methodenstreit* and an artificial opposition was created between the “deductive” Austrian school and the “inductive” German historical school. The so-called ‘historical school’ in Germany applied scientific positivism to the study of economics with the expectation to find in history a laboratory that would allow the distillation of economic laws and economic development laws specifically. This approach was oriented towards empiricism. The research program of the German historical school called for the discovery of empirically founded deterministic functional relationships. This school presumed that like the natural scientist, the social scientist, too, was expected to make prognoses and to provide rules and recipes to be applied to governance.⁴ In a more sophisticated and refined form this spirit continues to live on and can be found today in

*) Federal University of Sergipe (UFS), Brazil, and The Continental Economics Institute (www.continentaleconomics.com)

¹ For a historical overview see Randall G. Holcombe (ed.), *Fifteen Great Austrian economists*, Auburn, Alabama 1999 and for the impact of the Austrian school in the U.S. see Karen I. Vaughn, *Austrian Economics in America. The Migration of a Tradition*, Cambridge 1994

² Rothbard, de Soto

³ Menger, *Volkswirtschaftslehre*

⁴ This way the German historical school was also understood as “Staatswissenschaft” and its practitioners saw the prime function of their discipline in guiding governmental decisions.

Keynesian macroeconomics and econometrics. In contrast to the empiricist approach, Carl Menger⁵ saw the proper foundation of economics not in the objective world outside of human acts and valuations, but in the individual acts themselves, in the subjective valuations of the individual and in human action.

II. Major Contributions of Austrian Economists

With Carl Menger, Austrian economics gained its prime principles of individualism, subjectivism, and marginalism.⁶ In continuation of this approach, Eugen von Böhm-Bawerk⁷ developed a theory of capital based on subjectivism. He was the first to introduce the concept of time into capital theory and to explain the interest rate in terms of time preferences. By focusing on the intertemporal aspects of capital, Böhm-Bawerk provided the basis for the development of the Austrian theory of the business cycle. Ludwig von Mises⁸ and Friedrich von Hayek⁹, by elaborating on Böhm-Bawerk's approach, formulated a theory of the business cycle, which points to credit expansion as the beginning of investments that exceed sustainable funding in real terms. Economic crises are interpreted as a process of retrenchment, when the overexposure to capital formation gets corrected. In the 1920s, Mises and Hayek became the leading exponents in the socialist calculation debate, when, based on the foundations of Austrian economics, they put forth the thesis of the "impossibility of rational calculation in socialism".¹⁰ Mises and Hayek later on deepened the analysis of various aspects of economic behavior, with Mises stressing the a priori implications of human action¹¹, and Hayek putting forth his theories of knowledge and market coordination¹². Murray Rothbard, systematized large parts of the Misesian theory and became one of the leading figures of the libertarian movement.¹³

⁵ Carl Menger, *Irrthümer des Historismus in der deutschen Nationalökonomie*, Wien 1884

⁶ Carl Menger, *Grundsätze*

⁷ Eugen von Böhm-Bawerk,

⁸ Ludwig von Mises

⁹ Friedrich von Hayek,

¹⁰ Cf. F. A. Hayek (ed.), *Collectivist Economics Planning: Critical Studies on the Possibilities of Socialism*, London 1935 and Benjamin E. Lippincott (ed.), *On the Economic Theory of Socialism*, New York 1964 (first edition 1936)

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¹² Hayek, *Eucken*

¹³ Murray N. Rothbard, *Man, Economy, and State. A Treatise on Economic Principles*, Auburn, Ala. 2001 (The Ludwig von Mises Institute), first published in 1962

Overview 1

Main Scholars of Austrian Economics and their Major Contributions

SCHOLAR	MAJOR CONTRIBUTION
Carl Menger (1840-1921)	Subjectivism of Valuation Methodological Individualism Marginalist Analysis
Eugen von Böhm-Bawerk (1851-1914)	Subjectivist Theory of Capital Intertemporal Allocation Time Preference Theory of Interest
Ludwig von Mises (1881-1973)	Subjectivist Monetary Theory Theory of the Business Cycle Impossibility of Rational Calculation in Socialism Theory of Human Action
Friedrich August von Hayek (1899-1992)	Theory of Capitalist Production Theory of the Business Cycle Theory of Knowledge Theory of Market Coordination
Murray N. Rothbard (1926-1995)	Libertarian Economic Theory
Israel Kirzner and faculty of New York University	Entrepreneurship Subjectivity and Uncertainty
Hans-Herman Hoppe (1949 -	Property rights Institutional Analysis
Scholars of the Ludwig von Mises Institute	Misesian economic theory, Libertarianism
Faculty of the Mercator Center of George Mason University	Market Processes Public Choice

III. Austrian Methodology

The major feature of Austrian economics is its radical individualistic-subjective approach to economics, including macroeconomics. While Austrian economics shares many elements with neoclassical economics, there are also a number of distinctive aspects, which make it unique and distinct from the mainstream.

Austrian economics – as its unifying theme¹⁴ - rejects mechanistic modelling in favor of a theory of human action. Human action is seen as being individualistic and based on subjective value judgements. Human action as purposeful and implicitly rational behavior sets it apart from behaviorism and strict determination. Thus Austrian economics does not accept the concept of a unity of science¹⁵ in the form of methodological monism. Economics is not part of the natural sciences but deals with human action: it is a distinct form of science called *praxeology*. The organizing principle of human experience is the individual Ego and not external observation. The central laws of human action are to be found *a priori*, and not *a posteriori*. In this form, the laws of human action have apodictic validity; they are not contingent to experience but are the logical implications of the premise that “man acts”. Because the complexity of action cannot be observed or isolated, empirical statements can neither confirm nor refute a theoretical sentence about human action.¹⁶ By making human action – in contrast to the decision-making-approach - the central theme of economics, various aspects that are specific of the Austrian approach enter the realm of investigation, foremost among them: individualism, time, sequence, uncertainty, and adaptation. If one will dare to distinguish the Austrian school by one major criterion, it would be “human action”, and would stand in contrast to “equilibrium”¹⁷ The concept of “human action” is the distinguishing factor that separates Austrian economics

¹⁴ See Ludwig von Mises, *Nationalökonomie. Theorie des Handelns und Wirtschaftens*, Genf 1940 and the English version scholar's edition: *Human Action*, Auburn, Alabama 1998 as well as Murray N. Rothbard, *Man, Economy, and State: A Treatise on Economics*, Princeton, N.J. 1962

¹⁵ Rothbard, *The Mantle of Science*

¹⁶ “Behavioristic laws” are not statements about human action just as psychology, medicine or body chemistry do not deal with human action as it is defined by Austrian economics. Laws or propositions found in these disciplines are no more economics than technology or the laws of physics that rule a production process. The Austrian approach is quite strict in defining economics and sets it also apart from motivations research.

¹⁷ Mises, quote

from “neo-classical formalism” and the hypostatization” (Mises) of Keynesian aggregate analysis.

Averages and aggregates cannot serve as determinants, and they do not allow for the establishment of causal relationships. An economic theory, which bases its principles on such a method is scientifically unsound. It imposed an inadequate model of science on the study of society.

In the words of Hayek¹⁸:

“To me it seems as if this whole effort (of econometrics) were due to a mistaken effort to make the statistically observable magnitude the main object of theoretical explanation. But the fact that we can statistically ascertain certain magnitudes does not make them causally significant, and there seems to me no justification whatever in the widely held conviction that there must be discoverable regularities in the relation between those magnitudes on which we have statistical information. Economists seem to have come to believe that since statistics represent the only quantitative data which they can obtain, it is these statistical data which are the real facts with which they deal and that their theories must be given such a form that they explain what is statistically ascertainable. There are of course a few fields, such as the problems of the relation between the quantity of money and the price level, where we can obtain useful approximations to such simple relations – though I am still not quite persuaded that the price level is a very useful concept. But when it comes to the mechanism of change, the chain of cause and effect which we have to trace in order to be able to understand the general character of the changes to be expected, I do not see that the objectively measurable aggregates are of much help.”

In contrast to the early Austrians¹⁹, Mises (1940, pp. 88; 1998, pp. 92) rejects the idea that one does need philosophical, cultural or psychological introspection into human action. The logical implications of human action are given to us as human beings. We do not need additional information about the meaning of purpose, means, and preferences. For the role of economics, i.e. the study of human action in a monetary economy based on the division of labor, empirical disciplines that deal with human behavior are of little avail, as they are either irrelevant for economics or their validity is not strict enough. Although

¹⁸ Friedrich August von Hayek, *The Economics of the 1930s as seen from London*, in: *The Collected Works of F.A. Hayek*, Vol. 9, *Contra Keynes and Cambridge*, ed. by Bruce Caldwell, London 1995 (University of Chicago Press)

¹⁹ Carl Menger, *Grundsätze der Volkswirtschaftslehre*, Wien 1871, pp. 88 and Eugen von Böhm-Bawerk, *Kapital und Kapitalzins*, Innsbruck 1909, pp. 237

Austrians may agree that economics deals with choice²⁰, the Austrian approach does not concentrate on choice per se, but on the logic of human action, which implies choice but also transcends it. The concept of decision-making, for example, which dominates modern economics, is very limited, as it suggests that human beings confront predominantly an intellectual task when making choices. Human action is active choice, it involves that an act is being done, and as such it goes beyond calculation. Action involves the human being in the completeness of his existence including his existence in time. As human action involves the person in the whole of his existence, time and the expectations about the future settings play an essential role, and the process of subjective evaluation goes beyond short-term maximization and will necessarily include a range of values and the longer term.²¹

Value and rationality are intimately linked to individual subjectivity. Human action is based on meaning, it is centered in the individual "I". Human knowledge is basically individual, subjective, heterogeneous, disaggregated, private, largely tacit, and necessarily incomplete. Assumptions, constructs and ideologies substitute for this incompleteness. Human action contains a profound tendency to err. That markets fail (with respect to the criteria of equilibrium theory) is as simple as the observation that any human action is inherently erroneous, making continuous adaptation the foremost mark of economic activity. Markets are means of coordination and represent a continuous process of discovery.²² When Austrian economics favors the market economy, this comes as the result of this theoretical perspective, which sees markets as the best available means in order to guide individual adaptation and to generate knowledge. It would be wrong to presume that for Austrian economics markets are necessarily ubiquitous and to assume that calculation must be found in all aspects of human life. The power of politics (including force) along with ideologies and traditions are probably the single most formative elements for individual thinking. Radical subjectivism does not exclude non-economic behavior or denounce it as irrational. Human valuation is subjective and the individual may regard certain purposes as *res extra commercium*.

²⁰ Cf. James M. Buchanan, Is Economics the Science of Choice?, in: Roads to Freedom. Essays in Honor of Friedrich A. von Hayek, ed. By Erich Streissler et al., London 1969, pp. 47-64

²¹ „Action aims at change and is therefore in the temporal order...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.” (Mises 1998, p. 99)

²² Cf. F.A. v. Hayek, Der Wettbewerb als Entdeckungsverfahren, in: Freiburger Studien, Tübingen 1969

Overview 2

Concepts of Human Action

- Human action is conscious behavior
- Human action is tautologically rational
- Human valuation is based on subjective meaning
- “Utility” is intentional specific valuation
- Human action is teleologically oriented
- Human action is active choice
- Human action is centered in the personal “ego”
- Human action is sequential in time and space
- Human action is imperfect and incomplete
- Human thinking is interior action
- Human thinking is imperfect and incomplete

IV. Modelling

In a misplaced effort to imitate the natural sciences, large parts of modern economics practice constructivism, as “the economy” or “the price-level” as mental constructs are put in the center of investigation. In a variety of models, averages and aggregates are supposed to have an existence outside of human action, and these entities are then supposed to move (animate) and determine the system. One construct stands in functional relationship with some other variable, or it is assumed that one average will even cause the change in some

other.²³ If one construct does not properly work, it must be redefined until it finally fits.²⁴ The ideal is to construct the economy as an automat with the government function as the machine master.²⁵ This machine-economy is modelled as a system that can be accelerated and slowed-down by proper government policies.²⁶

The ideal of science that is being followed in large parts of the modern social sciences is an erroneous imitation of the natural sciences.²⁷ While the definite points of reference have somewhat changed from physics to – more recently – evolution theory, the main features are still imitated and lie at the heart of the social sciences' modern research program.

Probably the most important of these features is the search for determination. Ideally, time and space are irrelevant. Given the same initial conditions, the laws will be valid universally. In order to achieve this transferability, theory becomes basically the endeavor

²³ Without the assumption of cause and effect, macroeconomics would be futile, as it is supposed of being able to give instruments of action to governments.

²⁴ It was the Marxist approach, as the first major structure-functional systems theory, with which this difficulty of defining its “agents” appeared and continues to plague this theory up to the present. Methodologically at the same level are the definitional problems that plague macroeconomists in determining its quantitative aggregates. Definitional exercises of this kind must not be confounded with the increasing exactness of measurement that characterizes the natural sciences.

²⁵ Drawn to its final conclusion, these models make the behavior of consumers and businessmen deterministic, while the government is the only agent left free to act. It is only a matter of consequence that the government must be idealized as a benevolent despot leading to a profound contradiction within mainstream economics when public choice theories appeared.

²⁶ Paul A. Samuelson, for example deemed it for certain in 1956 to say that “economic science is not only neutral to the question of the desired rate of capital accumulation – it is also neutral as to the ability of the economy to realize any decided-on rate of capital formation. I repeat: With proper fiscal and monetary policies, our economy can have full employment and whatever rate of capital formation and growth in wants.” In 1962, Samuelson put forth the thesis: “We no longer regard cyclical swings as immutable facts of nature, like the inevitable plagues that man could do nothing about before the age of penicillin, sulpha, medical care and public health. Fiscal and monetary policies can ameliorate, moderate, and perhaps even compensate fully for such tendencies toward sluggish investment opportunities.” Quotes in: George M. Furstenberg and Jin-Ho Jeong, *Owning up to Uncertainty in Macroeconomics*, in: *The Geneva Papers on Risk and Insurance*, Vol. 13, No. 46, January 1988, pp. 12-90

²⁷ Many practitioners of sociology, for example, are as keen as probably most economists are, when following this scientific paradigm. Sociology may lack an easy gate to quantification in comparison to economics but the structural similarities between sociological systems theory and macroeconomics are as striking as the similarities between the rational choice approach in micro-sociology and microeconomics. It seems also interesting to observe that the “human action”-approach in sociology as represented by Alfred Schütz is at the fringes of mainstream sociology. Cf. Talcott Parsons, *The Social System*, Glencoe, Ill. 1951 for the “macro-approach”; J. Coleman, *Foundations of Social Theory*, Cambridge, Mass. 1990 for the “micro-approach”, and Alfred Schütz, *Der sinnhafte Aufbau der sozialen Welt*, Wien 1932 for an approach based on individual meaning.

to aim for higher abstractions. The ideal is reductionism – or elegant mathematical simplicity.

In the perspective of Austrian economics, science itself is a praxeological concept and such directly tied to human action. Science is the refined and systematic way of the practical approach to objects (including the human body). In this process of study, technology and science go hand in hand, and both, science and technology, are *praxeology* applied to these areas of human interest. Science is a form of human action and the method of the natural sciences is the appropriate form of dealing with the outer world. In physics, chemistry or biology, the total complex is easier to ascertain than its elements. Reductionism is the practical form of investigation in order to find the ruling laws. In contrast to these areas, social and economic phenomena are simple at the elementary level, but highly complex (and basically directly unobservable) in their totality. Exact measurement, the possibility of isolation and repetition of experiments, non-interference between subject matter and the observer, along with determinism do not hold for these complexes that are formed by human action. The proper approach of the natural sciences becomes “scientism” when applied to the theory of human action. Yet by that the approach is no longer consistent. There is no escape from the concepts of human action, i.e. purpose, ends, means, knowledge, and subjective values, when human action is to be understood, explained and evaluated, and this, by itself, applies also to science as a field of human action. Only if we were to assume that “the economy” had an existence of its own outside of human action, could we rightfully apply the methodology of the natural sciences.

In the view of Austrian economics, the methodology of the social sciences must be different from the natural sciences because the subject-object relation is different. In the natural sciences, the analytic approach consists of repeated observation, exact measurement, and reductionist explanation. In order to do this, the elements of the object must be isolated, and thus the model is necessarily closed. The ideal of explanation is finding a simple (usually also aesthetically appealing) law, which informs about the factors of determination. The model should be universal, complete, and the result should consist in abstracted reduction.

Austrian economics holds that this approach does not work for the social sciences, and even if it should work, it is unnecessary; at best the results will be mediocre. The reason for this

is that we already know the basic elements of human action. The categories of *praxeological thinking* are directly given to us, because human action is common to all men as human beings. Ends and means are *a priori* categories of human action, while the elements of natural objects can only be known *a posteriori*. Therefore, the direction of investigation in the social sciences must be reverse to that of the natural sciences. In the natural sciences we usually know about the object as a whole before we know the parts. Therefore, the natural way of inquiry must be reductionism. On the other hand, while the basic and meaningful elements of phenomena such as money and markets are not observable, they are given to the investigator *a priori*. We know what human action is, and we know that markets and money do not exist outside of human action and apart from meaning. What we do not know right away are the resulting complexities as a consequence of interrelated human actions. These complex phenomena cannot be grasped as a whole. One cannot observe a market or investment without relating them to human action and to human meaning. Money is not just a piece of printed-paper. The theory of human action is needed in order to explain what is going on and why markets, money, or investments do exist.²⁸

In order to study human action itself or systems of human action (economics, sociology, etc.), reductionism is inadequate. Here, we have to start with simple essential abstractions (which are easy to make such as man acts) to the more complex abstractions that will come closer to reality (which are difficult to achieve) with the ideal of explaining total or at least a large part of complexity.²⁹

Austrian economics, in Hayek's view³⁰, discards "(t)he hope of becoming more 'empirical' by becoming more macroeconomic", and it limits the validity of mathematical modelling, as it presumes that the relevant economic phenomena "belong to that intermediate sphere that lies between the simple phenomena of which people can ascertain all the relevant data and the true mass phenomena where one must rely on probabilities."

²⁸ With "ends" and "means" representing the central category of explanation.

²⁹ Reductionist-deterministic propositions in the social sciences are often fruitless and/or paralysing be it Marxist laws or the efficient market theory in finance. Quite often their essential paradoxical character can hardly be disguised. In addition, they usually violate their own scientific ideal, as they are immunised to empirical falsification.

³⁰F. A. Hayek, *The Keynes Centenary: The Austrian Critique*, in: *The Collected Works of F. A. Hayek*, Vol. IX, *Contra Keynes and Cambridge*, ed. By Bruce Caldwell, Chicago 1995, pp. 247-255

Overview 3

Features of closed versus open models

CLOSED MODEL	OPEN MODEL
Natural Sciences – Neoclassical Economics	Social Sciences – Austrian Economics
deterministic	Non-deterministic
universal	time-and-space-dependent
complete	incomplete
reductionistic	complex
from complex to simple	from simple to complex

V. Praxeology

The concept of human action contains its essential analytic concepts *a priori*. These include ends, ranking, sequence (time) and means as logical categories whose abstract validity is thought to be invariant and common to all men. They are essential to the definition of a human being as a purposeful (rational) and acting (active) being, and the meaning of these categories is directly given for the human mind. “All the concepts and theorems of praxeology are implied in the category of human action. The first task is to extract and to deduce them, to expound their implications and to define the universal conditions of acting as such.” (Mises 1998, p. 64) Rationality in the theory of human action is an analytic category; it is not a statement about actual behavior seen in the light of outside criteria. Human action is conscious behavior, and as such it is, firstly, *per definitionem* rational, because the imposition of other criteria would violate the principle of subjectivism; secondly human action must be rational as human action involves thinking in terms of ends and means and preferences. By substituting individual subjectivism for so-called “objective criteria” in the evaluation of ends and means³¹ all that is being done is the replacement of the subjective criteria of one person by that of the outside observer (or some presumed

³¹ It is widely ignored (probably due to Lionel Robbins interpretation of Austrian methodology) that most personal value judgements refer to means. One might also say that it is a matter of subjective value judgement what differences are made between what is end and what serves as a means. In a simple example one could argue that the final end of eating must be “nutrition” and the way to obtain this goal must be “efficient”, thereby ignoring the typical human peculiarities of taste in this area of choice.

authority) that by necessity must be as subjective, as it is also tied to an individual with his limited knowledge.³² Values are subjective and variant, and they do not allow for inter-subjective comparisons. They also cannot be measured because measurement refers to outside phenomena. Praxeology studies human action, and it the logical implications of human actions from which it gains its central categories such as ends and means, valuation, time, data, scarcity, ranking, prices, money and time.

“What distinguishes the praxeological system from the logical system epistemologically is precisely that it implies the categories both of time and of causality. The praxeological system too is aprioristic and deductive. As a system it is out of time. But change is one of its elements. The notions of sooner and later and of cause and effect are among its constituents. Anteriority and consequence are essential concepts of praxeological reasoning. So is the irreversibility of events. In the frame of the praxeological system any reference to functional correspondence is no less metaphorical and misleading than is the reference to anteriority and consequence in the frame of the logical system.” (Mises 1998, pp. 99)

Praxeology is neither a nomothetic-empirical nor an ideographic-empirical science. It is an aprioristic science as it formulates analytic sentences *a priori* about human action by discursive-deductive reasoning. The results of praxeological investigation are categorical statements. In the same vein praxeology allows a special form of prediction: categorical prognosis, which is apodictic but non-quantitative. For example that a credit-induced boom will result in a bust, is a categorical prognosis, but when exactly the crisis will appear, cannot be known, as this depends on the special circumstances of each case. (Mises 1998, pp. 866)

VI. Economic Calculation

Human action uses calculation as a means. Economics as a part within the general theory of human action refers to this part of choice, which uses monetary calculation as its prime means: human action under the conditions of a monetary market economy. It would be

³² For Austrian economists, it is one of the prime endeavors to reveal the “conceit of knowledge” (Hayek), following the steps of Adam Smith when he characterized the intellectual basis of the actions of authorities.

wrong, however, to assume that the act of choice itself were calculation.³³ For Mises (1998, pp. 201) it is important to note that it is only money and markets that allow rational calculation (capitalist accounting). Calculation in a society without money and markets is pure fiction.³⁴ Economic calculation as it is done in capitalist accounting is the unifying principle of a market economy and represents the prime instrument of choice, but it is not choice in itself. Economic calculation beyond a market economy and in its respect to the individual consumer and entrepreneur is a senseless effort.³⁵ To be meaningful (and not just an exercise in math), economic calculation requires as preconditions: division of labor, private property for the means of production, and market exchange based on money. With the thesis, that only monetary calculation in the context of these conditions makes it praxeologically useful, the Austrian theory is in opposition to an approach, which concentrates on “direct” (money-less) exchange or abstracts from the essential conditions of monetary market economy. In the view of the Austrians, large parts of classical and neoclassical economic reasoning are fundamentally wrong or meaningless for the problems of a monetary market economy.³⁶

The individual time horizon for action varies and is different from one person to the next. Human action in time is based on the choice between earlier or later, and follows the fundamental praxeological law of time preference.³⁷ Human valuation takes place in the present although the time horizon of individual valuation may go beyond one’s lifetime and even towards eternity. The orientation towards the future results from the principle of human action, and preference-ranking pertaining to the future is its necessary condition.³⁸

³³ Preferring a over b, and b over c does not change by substituting a for 8 p, b for 15 r and c for 7 p. The act of choice is still a ranking process (Mises, 1940, p. 189). Only the introduction of money would allow calculation.

³⁴ In this context, calculation is not abstract, but refers to money expressed in numbers. The meaningful use of concepts such as “capital”, “profit” and “loss” as well as “consumption”, “savings” or “investment” requires their representation as monetary numbers. Any other use is highly fictitious, and may be used only for illustrative purposes or for specific analytic purposes as a means of contrasting.

³⁵ For something to have a monetary value means nothing more than being able to ascertain its historic or expected price, i.e. to say that it was sold and bought at this price in the past or that it might be sold at this price in the future (Mises 1940, pp. 204).

³⁶ The neglect of this Austrian proposition seems to lie at the center of the various critiques brought forth by neoclassical economists against Austrian theorists and seems in fact to represent the major rift between these two lines of thinking.

³⁷ For Mises (1940, pp 444) this is not a “psychological law”; it is deduced from the concept of human action. Without preference for earlier over later consumption, action could not take place but would turn itself into eternal waiting.

³⁸ Any human act involves sequence and thus implies a ranking process that extends into the future.

Economic action must take into calculation that production takes time and that there are differences in the usage-time of different goods. Money is the essential means for being able to make such comparisons, although calculation by itself does not mean valuation, which is always subjective.

In the process of production, physical capital is used up and finally vanishes, and with the satisfaction of past demands, new demands arise. In the process of production, new production methods may be found, making current physical production goods obsolete. This implies a constant transformation of physical capital, and along with it goes a continuous process of varying valuations. Therefore, concepts like the preservation of capital, and, along with it, saving and investment, only make sense when they are based on monetary calculation. Individually, saving is the excess of production over consumption, but the physical content of production and consumption do constantly change.³⁹ The macroeconomic approach is blind to one of the most important sources of saving (and dissaving). Only from the individual perspective, and based on monetary calculation, does it appear that capital formation is also possible without reducing current consumption due to new discoveries of salable natural products and the implementation of production processes with higher productivity in the production of saleable goods. In addition, a different institutional framework, which improves the capitalist environment, a higher net result allows for an enlarged capital base without foregoing consumption. The constructive versus the destructive institutional and political forces that work against capital formation become obscured in the macroeconomic perspective. Systematic capital destruction can go along with high growth and high investment as macroeconomic accounting cannot differentiate between valuable and wasteful activities. Government intervention, credit allocation in the “public interest”, soft budgets, bailout-guarantees along with excessive money creation and fiscal dirigisme are the common policy features that distort individual economic calculation and work towards the destruction of capital – although for some time the application of these policies may be accompanied by seeming prosperity.

³⁹ While the meaning of saving is evident for an individual when used as money income minus spending for consumption, it becomes void of economic meaning when applied to the economy as a whole. It can only be misleading to value a newly applied capital good (investment) other than relating it to expected profits. It is also misleading to speak of “periods”, when production and consumption in a market economy are continuous processes, where constantly new and different production processes are being applied and where valuations change along with the change of data.

Monetary calculation is essential for making rational economic plans in a system of division of labor. But this method can operate effectively only in a setting of certain social institutions, i.e. an “institutional setting of the division of labor and private ownership of the means of production in which goods and services of all orders are bought and sold against a generally used medium of exchange, i.e., money.” (Mises 1998, p. 231)

VII. Money and Interest

Economics as a part of the theory of human action deals primarily with a monetary economy based on the division of labor. Direct exchange and Robinson Crusoe-models may serve as theoretical points of reference, but their fictitious character must be kept in mind. By focusing on money, Austrian economics contrast strongly in relevance when compared to other models of economics. When applying its methodological principles to money, Austrian economics regards such phenomena as the interest rates or the demand for money as the results of human valuation. The central focus of the Austrian theory of money is directed at the theory of interest, as it reflects most clearly the aspect of subjective valuation.

In its originary form, the interest rate is the discount that human action must give to later available goods compared to the earlier available goods, which may render the same service. Otherwise man would not act. Human action implies by necessity a preference for the immediate. To put it in another way: In an imaginary world without an originary interest rate, saving would become infinite.⁴⁰ The central thesis of Mises’ (1998, pp. 521) monetary theory consists in the proposition that the monetary rate of interest may deviate from the neutral rate due to money creation (or its contraction) in the credit markets.⁴¹ If the money rate falls below the neutral rate and thus deviates from the originary rate of interest,

⁴⁰ On the other hand, an unlimited rise of this rate would finally eliminate saving. The difference between the originary rate and monetary rate of interest becomes obvious when thinking about the elimination of interest income (by expropriation or taxation). Then, saving would stop and cause the consumption of accumulated capital as its consequence, precisely because the originary rate of interest cannot be removed from human valuation (Mises 1998, pp. 524).

⁴¹ A somewhat different starting point is given by Hayek as his theory also contains elements of the „real business cycle“, making his approach in this regard “un-Austrian”, see his “Pure Theory of Capital”, London 1941; for Mises, in contrast, the central point is prolonged growth of credit creation, which may also be the result of reduced risk perception, when government or central bank bailout guarantees are presumed to exist.

the monetary rate will deviate from the original valuation between present and future goods, and, as future goods have become relatively cheaper the demand for them increases. By using sequential analysis, while most mainstream models use immediate or “all at once-adaptation”, the Misesian theory points out that money affects the economy heterogeneously. Money cannot be neutral because it enters the economy not at once nor at the same time, nor in the same quantities for all economic agents. While money may or may not change the price level, it always will change relative prices and with it the relative fortunes of individual economic agents. In the words of Mises (1998, p. 552):

“The essence of monetary theory is the cognition that cash-induced changes in the money relation affect the various prices, wage rates, and interest rates neither at the same time nor to the same extent. If this unevenness were absent, money would be neutral; changes in the money relation would not affect the structure of business, the size and direction of production in the various branches of industry, consumption, and the wealth and income of the various strata of the population.”

The monetary rate of interest cannot be a neutral rate of interest in the sense that it would be the monetary expression of the original rate of interest, because changes in money affect prices not homogeneously and all prices at the same time. Money enters the economy at specific recipients and affects the rest of economic actors in different ways.⁴² Only perfect foresight could transform the monetary rate of interest into a neutral rate by applying a price premium. But the formation of expectations about a certain direction of prices is disparate and must remain uncertain.

This monetary theory based on individual valuation and sequential analysis leads to the Austrian theory of the business cycle, which holds that credit expansion and contraction bring about deviations of the monetary rate of interest from the originary rate thus transmitting false signals and leading to misallocation between the production of immediate and future goods. Easy money creates an illusion of wealth and thus instigates an enlargement of the production process while consumers aspire for the acquisition of goods that rank higher in their time scale.⁴³ But as the real wealth of the economy cannot be

⁴² Even if the change in the quantity of money could be known in time, and if it were known for which kind of activities it enters the economy, it is impossible to know *ex ante* how this will affect the different prices. It is principally impossible to foresee how, when and to what degree individual valuations will change.

⁴³ In the boom period, goods that were regarded as “luxuries” now appear to be within one’s reach.

increased by money, disproportionalities occur within the economy, which later on require reversals brought about by a recession.

VIII. Economic Analysis

Changes in data cause individual adaptation and these take place in time beginning with the identification and valuation of data changes and including the effects of intended and unintended consequences. This is where economic analysis comes into play as an instrument of human action. While not much specific knowledge is needed in order to know about the immediate consequences of data changes, economics as a scientific endeavor is needed when the long-run effects may deviate from those of the short run. The praxeological reason for the existence of a form of enquiry called “economics” results from the insight that only systematic investigation will generate the knowledge that informs about the deviations of the long-term consequences from the short-term results.

Studying the long-term effects requires studying the various steps following the short term. The method of inquiry thus requires “sequential analysis. The central aspects that guide the sequential process of economic analysis are to be found in the basic elements of human economic activity such as subjectivism of valuation, economic calculation and relative prices. In this view, the inherent property of human action is the incompleteness of knowledge on which it is based. In the Austrian perspective it is the very essence of human action to go wrong. Action takes place in time, it is sequential, and while action takes place, data change. The conditions of the future necessarily deviate from the past, and they must be different from expected results because otherwise men would not continue to act. In this sense, current market prices are always “wrong”.⁴⁴ Disequilibrium becomes to be seen as the cause for human action. Based on human action, the focus of the Austrian theory is not directed to equilibrium but to the process of adaptation. The construct of an equilibrium situation does have significance as an analytic point of reference, but it must be kept in mind that equilibrium situations are mere constructs and have no existence outside of the model. Economic behavior is a continuous process of corrective action. In order to

⁴⁴ Otherwise they would not change. Prices express expectations and thus relate to the future. It is the error about “equilibrium conditions” which makes prices change.

investigate this adaptation process, which leads to the formation of a new relation between prices, non-monetary exchange theorems are of little help. Monetary calculation by consumers and producers is the unifying principle of the market; it is the link that connects all of its parts. Profit and loss in their monetary expression are the guiding principles of action in a market economy. Economic analysis must take into account that individual action in a monetary market economy is based on current relative prices, and an economic analysis that “abstracts” from monetary prices is an inadequate tool of inquiry, when it is to be applied in a meaningful way to an economy that makes use of wide-scale division of labor. Economic analysis in the Austrian tradition is the sequential analysis of relative prices as they emerge from individual human action in the context of a monetary exchange economy. From this perspective the analysis receives its meaningfulness and their analytical concepts. Void of human action, economic terms tend to become empty and lose their connection with the practical issues. As Mises (1998, p. 40) points out:

“In asserting the a priori character of praxeology we are not drafting a plan for a future new science different from the traditional sciences of human action. We do not maintain that the theoretical science of human action should be aprioristic, but that it is an always has been so. Every attempt to reflect upon the problems raised by human action is necessarily bound to aprioristic reasoning. It does not make any difference in this regard whether the men discussing a problem are theorists aiming at pure knowledge only or statesmen, politicians, and regular citizens eager to comprehend occurring changes and to discover what kind of public policy or private conduct would best suit their own interests.”

While the history of the natural sciences is a record of theories and hypotheses discarded because they were disproved by experience, no such thing can be expected in economics. Here, whether an interpretation will be regarded as valid “depends on the appreciation of the theories in question established beforehand on the ground of aprioristic reasoning.” (Mises 1998, p. 41) In the Misesian theory, all economic terms must be tied to the actions of individuals in order to remain meaningful. Economic analysis of the Austrian kind requires a strict separation between theoretical, empirical and ethical analysis. It is marked by a deep distrust in averages and aggregates such as the price level and national output. Its focus of analysis is more directed towards erroneous action than equilibrium, more on imperfect knowledge than on perfect knowledge and more on the categorical elements than on quantification.

IX. Economic Policy

It is the fate of the Austrian approach to be unpopular. Austrian economics is unpopular because it pronounces unpopular truths. The political left rejects this approach, because of its strict free market-orientation; it is rejected by the conservatives because of its strict individualism; it is rejected by governments, because it stresses non-intervention; it is rejected by various belief-systems, because it holds on to the principle of subjectivity of values. The broad band of mainstream economists does not like this approach: neo-classicals disregard Austrian economics, because it does not use mathematical modelling; Keynesians reject it, because Austrians do not hold that aggregates are sensible means of investigation; econometricians must ignore the Austrians, because they disqualify econometric studies as mere historiography. When explaining unemployment, Austrian economics surely will not find support from trade unions. It comes as no surprise that Austrian economics is still confined to the fringes of the political spectrum albeit its recent gains in attention.⁴⁵

Austrian economics occupies a small place in the overall amount of economics papers. This has a rather peculiar reason: in contrast to the typical econometric study or compared to mathematical modelling, Austrian economics does not allow for easy scientific production. It offers none or only a very difficult paradigm for theses and papers – especially on the level of dissertations. Its rejection of mathematical modelling and econometrics reduces the scope of activity for academic economists who find an ample field for investigation in these areas.⁴⁶ Austrian economics does not fit into the web of publish or perish. On the other hand, most of the current output of economics as an academic discipline appears rather useless or misleading. When asked for the impact on the real world, on economic policy and business management, the relevance of modern mainstream economics has been meagre. Since Keynesianism has been exposed as being more alchemy than science, it was only Monetarism that had had some impact for short period of time. More recently, however, even monetary policy is largely being conducted without economic theory. The

⁴⁵ Candidacy of Ron Paul

⁴⁶ This has already been the feature of the German historical school with its amazing fecundity of “scientific production” and its success in conquering academic chairs. Like in its modern version, this approach delivers an effective “research program”.

need is widely felt, even among mainstream economist, that the currently dominant paradigm is deficient. By focusing on the short term, economics automatically becomes the serving maid of special interests – be it government, trade unions, political parties, or ideologies that are en vogue. Some tendencies in microeconomics are also disturbing with its interventionist bias towards “market failure” and the ongoing outreach of economic analysis into almost all areas of social life. This “imperialism of economics” seems to involve that, step after step, the premise of subjective valuation gets lost in favor of an authoritarian position. This all comes along with the substitution of substance by form and of relevance by elegance – often an early sign of decline in the arts and sciences.

As elaborated by Hayek in his later works⁴⁷, the Austrian approach ultimately leads to “*ordo*-economics“ or constitutional economics, i.e. it offers a set of principles for the constitutional elements of an economic order directed at attaining and preserving individual liberty and economic productivity.⁴⁸ Austrian economics, based on methodological individualism and subjectivity of valuations, provides a series of guiding-posts for economic policy that tend to be put aside by mainstream economics. Foremost among these principles, which can be deduced in a systematic way from the main principle of human action, ranks the principle of free markets along with a monetary order that is not subject to government or central bank intervention and that is not exposed to the volatilities of fiduciary money creation of the banking sector. Austrian economics rejects government ad hoc interventions in all of its forms yet there is difference between the anarcho-libertarian position which rejects any kind of government role and the *ordo*-libertarian position, which rejects ad hoc interventionism but accepts the state’s role as a guarantor of institutions that favor personal and economic liberty.

⁴⁷ Among others see *The Fortunes of Liberalism*, Vol. 4, *The Collected Works of F.A. Hayek*, ed. by Peter G. Klein, Chicago and London 1992

⁴⁸ In the modified given by Walter Eucken, *Grundsätze der Wirtschaftspolitik*, Tübingen 1952, the theory of “*ordo*-liberalism” was the dominant economic paradigm of economic policy during West Germany’s reconstruction years only to be substituted by Keynesian in the late 1960s.

X. Ordo-Libertarianism

The basic principle of ordo-libertarianism is most clearly expressed in a phrase by Ludwig von Mises

“All that good government can do to improve the material well-being of the masses is to establish and to preserve an institutional setting in which there are no obstacles to the progressive accumulation of new capital and its utilization for the improvement of technical methods of production.”⁴⁹

In praxeological terms, the goal of scientific investigation in the tradition of the Austrian school is not directed at determining the conditions of equilibrium (or non-action), but to determine the factors of human action as an endeavor to improve conditions. In other words: the focus of research in Austrian economics is directed at discovering the factors that to not hamper the individual's incentives to act towards the attainment of prosperity.

In this perspective, the research orientation of Austrian economics becomes mainly institutional. The basic question of inquiry thus becomes: Which institutions promote individual liberty such as to allow the attainment of individual prosperity and its diffusion to society as whole in the forms of capital accumulation and technological progress.

COMMENTS WELCOME

DIRECT YOUR CRITIQUE AND SUGGESTIONS TO

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⁴⁹ Mises, Planning for Freedom [Planning for Freedom](#)