

THE ONGOING METHODENSTREIT OF THE AUSTRIAN SCHOOL*

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“What distinguishes the Austrian School and will lend it immortal fame is precisely the fact that it created a theory of economic action and not of economic equilibrium or non-action.”¹

1. Introduction

The fall of real socialism a few years ago and the crisis of the Welfare State has meant a heavy blow for the mainly neoclassical research program that has supported social engineering to date, at the same time as the conclusions of the Austrian theoretical analysis on the impossibility of socialism seems to be largely confirmed. In addition, 1996 has been the 125th anniversary of the Austrian School which, as we know, came into official existence in 1871 with the publication of Carl Menger's *Grundsätze*.² It seems, therefore, that this is the appropriate moment to return to an analysis of the differences between the two approaches, Austrian and neoclassical, together with their comparative advantages, in the light of both the latest events and the most recent evolution of economic thought.

This paper is divided into the following sections. Firstly, the characteristics that distinguish the two approaches (Austrian and neoclassical) will be explained and discussed in detail. Secondly, a summarized account of the *Methodenstreit* which the Austrian School has been maintaining since 1871 to date will be presented discussing its different “rounds” and implications. A reply to the most common criticisms made of the Austrian approach, together with an evaluation of the comparative advantages of the two points of view, will conclude the paper.

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¹ Mises-1978, p. 36.

2. The essential differences between the Austrian and neoclassical schools

Perhaps one of the main features which is lacking in the study programs of the schools of economics is that, to date, they have not given a complete integrated view of the essential elements of the modern Austrian paradigm vis-à-vis the mainstream neoclassical approach. In Chart No. 1 (pp. 78-79), I have tried to fill this gap in a way that is complete but, at the same time, clear and concise, so that it is possible to understand at a glance the different opposing points between the two approaches, which I then discuss briefly.

2.1. Theory of action (Austrians) versus theory of decision (neoclassicals)

For the Austrian theorists, economic science is conceived as a theory of action, rather than a theory of decision and this is one of the features that most clearly distinguishes them from their neoclassical colleagues. In fact, the concept of human action covers the concept of individual decision and much more. In the first place, for the Austrians, the relevant concept of action includes not only the hypothetical process of decision in an environment of "given" knowledge of the ends and means but, above all, and this is the most important point, "the very perception of the ends-means framework within which allocation and economizing is to take place".³ Moreover, the most important factor for the Austrians is not that a decision is taken, but that it is taken in the form of a human action in the *process* of which (that may or may not be culminated) there is a series of interactions and processes of coordination the study of which constitutes, for the Austrians, precisely the research subject of economic science. Therefore, for the Austrians, economics, far from being a theory on choice or decision, is a theory on the processes of social interaction, which may be coordinated to a greater or lesser extent depending on the alertness shown by the different actors involved in each entrepreneurial action.⁴

Consequently, the Austrians are especially critical with the narrow conception of economics that originates from Robbins and his well-known definition of it as a science which studies the utilization of scarce resources which may be put to alternative uses in order to satisfy human needs.⁵ Robbins' conception implies given knowledge on ends and means and, therefore, the economic problem is reduced to a mere technical problem of allocation, maximization or optimization, subject to known constraints. In other words, the conception of economics in Robbins corresponds to the core of the neoclassical paradigm and is completely

² Menger-1871.

³ Kirzner-1973, p. 33.

⁴ Kirzner-1991, pp. 201-208.

⁵ Robbins-1932 and 1972.

foreign to the methodology of the Austrian School as it is understood today. In fact, the Robbinsian man is an automaton or caricature of the human being, who merely reacts passively to events. As opposed to Robbins' conception, the position of Mises, Kirzner and the rest of the Austrians should be highlighted. They consider that what man really does, rather than allocating given means to given ends, is to constantly seek new ends and means, learning from the past and using his imagination to discover and create (by action) the future. Therefore, for the Austrians, economics is subsumed under or integrated into a much more general and broad science, a general theory of human *action* (not of human decision). According to Hayek, if, for this general science of human action "a name is needed, the term *praxeological sciences* now clearly defined and extensively used by Ludwig von Mises would appear to be most appropriate".⁶

2.2. Subjectivism (Austrians) versus objectivism (neoclassicals)

A second aspect which is of capital importance for the Austrians is *subjectivism*.⁷ For the Austrians, the subjectivist conception consists of the attempt to build economic science on the basis of the real human being of flesh and blood, considered as the creative and leading actor in all social processes. This is why, for Mises, "economics is not about things, tangible material objects. It is about men, their meanings and actions. Goods, commodities and wealth and all other elements of conduct are not elements of nature; they are elements of human meaning and conduct. He who wants to deal with them must not look at the external world. He must search for them in the meaning of acting men".⁸ Therefore, for the Austrians, and to a great extent unlike the neoclassicals, the constraints in economics are not imposed by objective phenomena or material factors of the external world (for example, the oil reserves), but by human entrepreneurial subjective knowledge (the discovery, for example, of a carburetor that doubles the efficiency of the internal combustion engine *has the same economic effect* as the duplication of all the physical oil reserves).

2.3. Entrepreneur (Austrians) versus Homo Oeconomicus (neoclassicals)

Entrepreneurship is the force which plays the leading role in Austrian economic theory while, on the contrary, it is conspicuous by its absence in neoclassical economic science. In fact, entrepreneurship is a typical phenomenon of the real world, which is always in disequilibrium and cannot play any part in the models of equilibrium that absorb the attention of the neoclassical authors. Furthermore, the neoclassicals consider entrepreneurship as simply one more production factor which may be allocated in accordance with its expected costs and benefits, without realizing that, when analyzing the entrepreneur in this way,

⁶ Hayek-1952, p. 209.

⁷ The Austrian subjectivist concept allows economics to be generalized into a science that deals with all human actions and has full *objective* validity, which is paradoxical only in appearance.

⁸ Mises-1996, p. 92.

CHART No 1
Essential Differences Between the Austrian and Neoclassical Schools

Points of Comparison	Austrian Paradigm	Neoclassical Paradigm
1. Concept of the economic point of view (essential principle):	Theory of human action understood as a dynamic process (<i>praxeology</i>).	Theory of <i>decision</i> : rational and based on constraint maximization.
2. Methodological starting point:	<i>Subjectivism</i> .	Stereotype of <i>methodological individualism</i> (objectivist).
3. Protagonist of the social processes:	Creative <i>entrepreneur</i> .	<i>Homo oeconomicus</i> .
4. Possibility that the actors err <i>a priori</i> and nature of entrepreneurial profit:	Pure or sheer entrepreneurial error and <i>ex post</i> regret exist. Pure entrepreneurial profits arise from alertness.	There are no regrettable errors because all past decisions are explicable in terms of cost-benefit analysis. Profits are considered the payment for the services of a factor of production.
5. Nature of information:	Knowledge and information are <i>subjective</i> , <i>disperse</i> and <i>change</i> constantly (entrepreneurial creativity). Radical distinction between scientific knowledge (objective) and practical knowledge (subjective).	Complete, objective and <i>constant</i> information on ends and means is assumed. There is no distinction between practical (entrepreneurial) knowledge and scientific knowledge.
6. Reference point:	General process with a coordinating tendency. There is no distinction between micro and macro: all economic problems are studied in relation to each other.	Model of <i>equilibrium</i> (general or partial). Separation between microeconomics and macroeconomics.
7. Concept of "competition":	Process of entrepreneurial rivalry.	Situation or model of "perfect competition".
8. Concept of cost:	<i>Subjective</i> (depends on the alertness of the entrepreneur for the discovery of new alternative ends).	Objective and constant (it may be known by a third party and measured).
9. Formalism:	<i>Verbal</i> logic (abstract and formal) which allows the integration of subjective time and human creativity.	<i>Mathematical</i> formalism (symbolic language typical of the analysis of constant atemporal phenomena).

10. Relation with the empirical world:	<i>Aprioristic-deductive</i> reasoning. Radical separation and, at the same time, coordination between theory (science) and history (art). History cannot prove theories.	<i>Empirical</i> falsation of hypotheses (at least rhetorically).
11. Possibilities of specific prediction:	Impossible, since what happens depends on future entrepreneurial knowledge which has not yet been created. Only qualitative and theoretical "pattern predictions" on the dis-coordinating consequences of interventionism may be made.	Prediction is a deliberately sought objective.
12. Who is responsible for the prediction:	The entrepreneur.	The economic analyst (social engineer).
13. Present situation of the paradigm:	Notable <i>re-emergence</i> over the last 20 years (especially after the crisis of Keynesianism and the fall of real socialism).	Situation of accelerated <i>crisis and change</i> .
14. Amount of "human capital" invested:	<i>Minoritary</i> , but growing.	<i>Majority</i> , although it shows signs of dispersal and division.
15. Type of "human capital" invested:	Multidisciplinary theorists and philosophers. Radical libertarians.	Specialists in economic intervention (piecemeal social engineering). Very variable degree of commitment to freedom.
16. Most recent contributions:	<ul style="list-style-type: none"> • Critical analysis of institutional coercion (socialism and interventionism) • Theory of free banking and economic cycles • Evolutionary theory of institutions (juridical, moral) • Theory of entrepreneurship • Critical analysis of "Social Justice" 	<ul style="list-style-type: none"> • Public Choice theory • Economic analysis of the family • Economic analysis of Law • New classical macroeconomics • Economics of "information"
17. Relative position of different authors:	ROTHBARD, MISES, HAYEK, KIRZNER	COASE DEMSETZ BLAUG SAMUELSON BUCHANAN STIGLITZ FRIEDMAN-BECKER

he makes an insoluble logical contradiction: to demand entrepreneurial resources in accordance with their expected benefits and costs implies the belief that some information is available today (the probable value of the future costs and benefits) *before it has been created* by entrepreneurship itself. In other words, the main function of the entrepreneur consists of creating and discovering new information that did not previously exist and cannot be known, meaning that it is humanly impossible to make any neoclassical prior decision on allocation on the basis of expected costs and benefits.

In addition, today there is unanimity among all Austrian economists in classifying the belief that entrepreneurial profit arises from the simple assumption of risks as a fallacy. Risk, to the contrary, merely gives rise to another cost of the production process, which has nothing to do with pure entrepreneurial profit.⁹

2.4. Entrepreneurial error (Austrian) versus ex post rationalization of all past decisions (neoclassical)

The very different role played by the concept of *error* in the Austrian and Neoclassical Schools is not usually appreciated. For the Austrians, it is possible to commit sheer entrepreneurial errors¹⁰ whenever an opportunity for gain remains undiscovered by the entrepreneurs in the market. It is precisely the existence of this type of error that give rise to pure entrepreneurial profit. On the contrary, for the neoclassicals, there are never pure entrepreneurial errors which may subsequently be regretted (*regrettable errors*). This is due to the fact that the neoclassicals rationalize all decisions taken in the past in terms of a supposed cost-benefit analysis made within the framework of a constrained maximization. Therefore, pure entrepreneurial profits have no reason to exist in the neoclassical world and, when they are mentioned, are considered merely as payment of the services of a production factor or as income arising from the assumption of a risk.

2.5. Subjective information (Austrians) versus objective information (neoclassicals)

Entrepreneurs are constantly generating new *information*, which is essentially subjective, practical, disperse and difficult to articulate.¹¹ Therefore, the subjective perception of information is an essential element in Austrian methodology that is absent in neoclassical economics, since the latter always tends to handle information objectively. In fact, most economists do not realize that, when Austrians and neoclassicals use the term *information*, they are referring to radically different things. In effect, for the neoclassicals, information, like commodities, is something that is objective and is bought and sold in the market as a result of a maximizing decision. This "information", which may be stored on different supports, is not in any way *information in the subjective sense* of the Austrians:

⁹ *Ibid.*, pp. 809-811

¹⁰ Kirzner-1994a, Vol. I, pp. 223-226

¹¹ See Huerta de Soto-1995.

relevant practical knowledge that is created, interpreted, known and used by the actor in the context of a specific action. This is why the Austrians criticize Stiglitz and other neoclassical theorists of information for not having been able to integrate their information theory with entrepreneurship, which is always its source protagonist, as the Austrians have done. Furthermore, for the Austrians, Stiglitz does not fully understand that *information* is always subjective and that the markets they call “imperfect”, rather than generating “inefficiencies” (in the neoclassical sense) give rise to the formation of potential opportunities of entrepreneurial gain, which tend to be discovered and made use of by the entrepreneurs in the coordination process that they are continually stimulating in the market.¹²

2.6. Entrepreneurial coordination (Austrian) versus general and/or partial equilibrium (neoclassical)

The models of equilibrium of the neoclassical economists usually ignore the coordinating force that entrepreneurship has for the Austrians. In fact, this force not only creates and transmits information but, more importantly, also drives the coordination between the unadjusted behaviors of agents in society. Effectively, all social discoordination materializes in an opportunity for gain which remains latent until it is discovered by the entrepreneurs. Once the entrepreneur realizes that the profit opportunity exists and acts to take advantage of it, it disappears and there is a *spontaneous process of coordination*, which explains the trend towards equilibrium that exists in any market economy. Moreover, the coordinating nature of entrepreneurship is the only factor which makes it possible for economic theory to exist as a science, understood as a theoretical *corpus* of laws of coordination which explain the social processes.¹³ This approach explains why the Austrian economists are interested in studying the *dynamic* concept of competition (understood as a process of *rivalry*), while the neoclassical economists concentrate exclusively on the models of equilibrium which are typical of the comparative *statics* (“perfect” competition, monopoly, “imperfect” or monopolistic competition).¹⁴ For Mises, as we see in the quotation at the beginning of this

¹² Regarding the Austrian criticism of Grossman-Stiglitz’s theory of information, see Thomsen-1992; and also Kirzner-1997, pp. 60-85.

¹³ Rothbard and Kirzner have criticized the extreme subjectivist position held by some theorists who, like Lachmann and Shackle, believe that there is no coordinating tendency in the market. This error originates from ignorance of the coordinating force of all entrepreneurial human action. See Rothbard-1995c, especially pp. 56-59; and Kirzner-1995, pp. 11-22.

¹⁴ My Austrian School colleagues usually refer to the fact that entrepreneurial processes tend to lead the system towards equilibrium, although they acknowledge that this is never reached. I prefer to talk about a different model, which I have described as the “social big bang”, that allows unlimited growth of knowledge and civilization in a way that is as adjusted and harmonious (*i.e.* coordinated) as is humanly possible in each historical situation. This is the case because the entrepreneurial process of social coordination never ceases or becomes exhausted. In other words, the entrepreneurial act consists basically of creating and transmitting new information that will inevitably modify the general perception of goals and means of all the actors involved in society. This in turn leads to the unlimited appearance of new disorders which imply new opportunities of entrepreneurial gain that tend to be discovered and coordinated by the entrepreneurs. This repeats itself successively, in a never-ending dynamic process that constantly makes civilization advance (model of the coordinated “social big bang”). See Huerta de Soto-1992, pp. 78-79.

paper, there is no sense in the construction of economic science based on the model of equilibrium, in which it is assumed that all the relevant information for drawing the corresponding functions of supply and demand is considered "given". The basic economic problem for the Austrians is quite different: to study the dynamic process of *social coordination* in which the different individuals are continually generating new information (which is never "given") when they seek the ends and means that they consider relevant in the context of each action in which they are involved. Thus establishing, without realizing it, a spontaneous process of coordination. For the Austrians, therefore, the basic economic problem is not technical or technological, as it is usually conceived by the theorists of the neoclassical paradigm when they assume that the ends and means are "given" and pose the economic problem as if it were a mere technical problem of maximization. In other words, for the Austrians, the basic economic problem does not consist of the maximization of a known target function subject to constraints that are also known. It is, on the contrary, strictly economic: *it emerges when there are many ends and means competing among themselves, when knowledge of them is neither given nor constant, but is dispersed over the minds of innumerable human beings who are continually creating and generating it ex novo and, therefore, all the possible alternatives which exist, all those which will be created in the future, and the relative intensity with which each of them will be pursued cannot even be known.*¹⁵

Moreover, it is necessary to realize that even what appear to be merely maximizing or optimizing human actions always have an entrepreneurial component, since the actor involved in them must have realized previously that this course of action, which is so automatic, mechanical and reactive, is the most advisable in the specific circumstances in which he has found himself. *In other words, the neoclassical approach is merely a specific case, of relatively minor importance, which is included and subsumed under the Austrian conception, which is much more general, richer and more explicative of the real world.*

Furthermore, for the Austrians, there is no sense in separating microeconomics and macroeconomics into two watertight compartments as the neoclassical economists do. On the contrary, economic problems should be studied together on an inter-related basis, without distinguishing between their micro and macro components. The radical separation between the "micro" and "macro" aspects of economic science is one of the most characteristic insufficiencies of modern introductory manuals and textbooks on political economy. Instead of providing a unified treatment of economic problems, as Mises and the Austrian economists try to do, they always present economic science as divided into two different disciplines ("microeconomics" and "macroeconomics") with no connection between them and which, therefore, can be studied separately. As Mises rightly says, this separation originates from the use of concepts which, like the *general price level*, ignore the application of the subjective and marginalist

¹⁵A.M. Endres even refers to the "Mengerian principle of non-maximization". See his article Endres-1991, pp. 275-295, especially footnote 5 on p. 281.

