AUSTRIANS AND INSTITUTIONALISTS: THE HISTORICAL ORIGINS OF THEIR SHARED CHARACTERISTICS

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I. INTRODUCTION

In the papers by Pete Boettke and Warren Samuels that serve as a common point of reference for the articles in this collection, the Austrian and institutionalist schools are compared. Though profound differences separate the two camps, the emphasis in the articles is on similarities that exist between them. Given the traditional antagonism that has been present between members of these two groups, the number of characteristics they share in common is nothing less than extraordinary. In my contribution to this collection on the Austrians and institutionalists, I will first add to the list of their similarities. I then

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will turn to the more important task of explaining how the institutionalists and Austrians came to share so many common characteristics.[1]

II. THREE OVERLOOKED SIMILARITIES

Both Boettke and Samuels note a number of substantive theoretical and methodological similarities in the approaches of the Austrians and institutionalists. Samuels also points out certain similarities of a more sociological nature, having to do with the way that the programs are presented and the way in which certain protagonists behave. Not all of these characteristics are positive. Intellectual isolationism, extremism masquerading as purism, an unhealthy preoccupation with methodology and the articulation of programs rather than with the extension of substantive work, paranoia in dealings with others: these hardly constitute complimentary behavioral traits. But neither author mentions various other similarities that may help to explain the presence of these negative characteristics among certain members of each camp.

It should first be mentioned that both Austrian and institutionalist economics began as national movements, in the sense that their founders were identified with particular countries. Furthermore, neither of the countries involved (Austria and the United States) had yet developed its own school of economic thought. Indeed, each was dominated by the ideas of economists from other countries: England in the case of American thought, and Germany in the Austrian case. Finally, both schools began in part as a reaction against what might be perceived as the "mainstream" of economic thinking in their respective countries.

Another common characteristic is that the reception of the ideas of each school by their respective mainstream counterparts was roughly similar. After an initial flurry of interest, both schools experienced a period in which their influence waned, and once the denouement began it was rapid in both cases. The particular paths differed slightly. Both the growth and decline of institutionalism was gradual, spanning about three decades at the beginning of this century. The Austrian experience was more apocalyptic, and it happened twice. Menger's work was initially ignored in Germany. He went on the offensive, publishing a methodological critique of historicism which led to the famed *Methodenstreit* with Schmoller. This was when the term "Austrian Economics" was coined; it was used derisively by German economists to indicate the second class status of the doctrine. A more important result of the battle was that the teaching of Austrian ideas was effectively banned in German universities by the powerful Schmoller. The Austrian's second brief moment in the sun occurred in England in the early 1930s, when Hayek was brought by Lionel Robbins to teach at the LSE. By the end of the decade, however, Austrian thought had again been left behind.[2]

A final similarity is that members of both camps were reacting not only to the prevailing economic theory of the time, but also to the political and social milieu of the countries of their origins. Significantly, the environments they reacted against were quite different. The growth of the power of the state, initially under Bismarck and in a later generation under Hitler, provided powerful motivation for the Austrians to defend the market system and forms of government in which strong constitutional constraints on the power of the state were vigilantly enforced. Institutionalism was a more populist movement which arose in part as a reaction against the unbridled growth of big business in turn of the century America, and later to the profound (and not always salutary) effects of rapid technological change on the fabric of American society.

The commonalities of experience mentioned above are not offered as excuses for the extremes of rhetoric that can occasionally be found in certain of the writings of Austrians and institutionalists. But remembering the frustrations that led to such rhetorical excesses makes them a little easier to understand.

III. THE HISTORICAL ORIGINS OF SHARED CHARACTERISTICS

Let us turn now to an examination of how the institutionalists and the Austrians came to share so many similarities in their approach to economics. As Boettke mentions, certain of these common points may be found in the writings of the originators. For example, Menger emphasized the evolution of institutions, the importance of time in economic analysis, the changeability of individual tastes, and the non-passiveness of human action, all of which are themes that institutionalists considered significant. But other similarities exist that cannot be traced to the founders of these schools, and these common points warrant explanation.

My thesis can be briefly stated at the outset. As is well known, institutionalism began as an opposition movement. Theirs was a revolt

against formalism, and the opponent was the budding neoclassical research program that had its origins in the marginal revolution. Though the Austrians also began as an opposition movement (their opponent was historicism), they were co-founders of marginalism, and once that doctrine became more widely-accepted the Austrians could be considered as a part of the "orthodoxy." Their split with the mainstream was precipitated by their participation in the socialist calculation debate in the 1930s. From that time onwards, similarities between the two groups in terms of methodological critiques and in terms of positive recommendations concerning how economics should be done emerged. Just as the neoclassical program has gained coherence and unity in the subsequent decades, so have the analyses of its critics become increasingly homogenous.[3]

The marginal revolution has its origins in the independent work of Jevons, Menger and Walras in the 1870s. But it was not until the 1920s and 1930s that the work of the Austrian and Lausanne schools began to become more widely known in England. In the 1920s, visits by English economists to Mises' *privatseminar* became more frequent. In 1931 Hayek accepted the Tooke Chair at LSE, and the publication of his *Prices and Production* (1931) and the translation of *Monetary Theory and the Trade Cycle* (1933) followed in rapid succession. Significantly, Austrians at this time did not view themselves as all that different from their counterparts in other countries, as evidenced by the following statement made by von Mises in the early 1930s.

> Within modern subjectivist economics it has become customary to distinguish several schools. We usually speak of the Austrian and the Anglo-American Schools and the School of Lausanne. . . . [The fact is] that these three schools of thought differ only in their mode of expressing the same fundamental idea and that they are divided more by their terminology and by peculiarities of presentation than by the substance of their teaching (Mises 1933, 214).[4]

Indeed, as Israel Kirzner points out in a paper in which this quotation is mentioned, "the major opponents of Austrian economic theory were, in 1932, perceived by Mises not as being the followers of Walras or of Marshall, but as being the historical and institutionalist writers (as well as a sprinkling of economic theorists) who rejected marginal utility theory" (Kirzner 1988, 9–10). All of this was to be changed by the socialist calculation debate.

The debate began in the 1920s with the publication of a provocative paper by von Mises. Mises claimed that the absence of a price mechanism in a socialist economy made rational calculation under socialism "impossible." As Kirzner notes in his recent reexamination of the debate, the initial response by proponents of socialism to Mises' challenge was anything but sophisticated (ibid, 5 ff.). Most seemed unaware of the implications of the problem of scarcity for questions of choice, or of how a price system provides an allocation mechanism in the face of that problem. As a result, the initial Austrian counterattack consisted in pointing out this benefit of a market system. Such a response could as easily have been made by any neoclassical.

Later in the 1930s a more sophisticated defense of socialism was crafted by such economists as Abba Lerner, Oskar Lange and H.D. Dickinson. These authors were able to show that a general equilibrium model of the economy could be used to describe either a competitive or a socialist institutional framework. The long run equilibrium conditions obtained under competition could be duplicated in a socialist world in which managers are directed to behave in appropriate ways, e.g. to price at marginal costs. Thus Mises' claim that calculation under socialism is impossible is refuted.

It was in formulating a response to this later socialist challenge that Hayek and Mises were to alter the direction of Austrian economics. Their answer to the socialists involved a radical departure from the usual approach to economics: they rejected the usefulness of the equilibrium construct for understanding the workings of a dynamic competitive economy. In its place they put the notion of a dynamic market process.

Their rationale may be explained in the following way. Both the socialist and neoclassical camps suffered from, in Hayek's words, "an excessive preoccupation with problems of the pure theory of stationary equilibrium" (Hayek 1940, 188). By focusing on questions of equilibrium, members of both groups failed to appreciate certain essential characteristics of the market system.

One of those characteristics is the ability of markets to efficiently convey information, to coordinate the actions of many agents, all of whom hold different knowledge. The ability of a market system to solve the coordination problem became a major theme in Hayek's work, beginning with his famous article "Economics and Knowledge" and continuing in various later publications.[5] The reason that the equilibrium approach was inadequate to capture this phenomenon had to do with its assumptions concerning knowledge. Simply put, in a world in which it is assumed that all agents have perfect information, the coordination problem doesn't exist. It can be mentioned that even in the more recent literature on the economics of information no account is taken of the facts that information is dispersed (that is, different agents have different, and sometimes incompatible, information) and subjectively-held.

Mises' contribution (which was later extended in Kirzner's work on the entrepreneur) was to recognize the entrepreneurial-discovery function of markets. In a dynamic world, new knowledge is constantly coming into existence. In a world in which knowledge is dispersed, arbitrage opportunities also exist. The profit motive drives the entrepreneur to discover new knowledge, to exploit its existence, and to seek out arbitrage opportunities when disparities in knowledge occur. Only a dynamic account of a rivalrous market process is capable of identifying this important function of markets. There is no entrepreneur in the standard general equilibrium model. Either prices are assumed always to be in equilibrium, or some fictional agent (like a Walrasian auctioneer) is postulated to explain the adjustment process.

In developing a positive account of how a market process works, the Austrians began to use concepts that had much in common with those used by institutionalists. Equilibrium analysis was rejected and a dynamic, rivalrous process view was advocated. The passive, purposeless agent of neoclassical theory was replaced by the acting, purposeful, future-oriented agent described in *Human Action*. The entrepreneur became identified as a critical agent of change. The dispersion of knowledge and its importance for problems of coordination was emphasized. Recognition of the subjectivity of things like costs led Austrians to harbor suspicions about the efficacy of cost-benefit analysis in particular and welfare economics in general. And Hayek, in seeking those institutions that were most likely to lead to coordination of plans, turned away from economics proper towards the study of philosophy, law, sociology and other fields in which the evolution of institutional forms, their change and their growth, became a major focus of his work. All of these are similarities with the institutionalist approach mentioned by Boettke and Samuels, and all had their origins in the socialist calculation debate.

IV. SIMILARITIES IN THE CRITIQUE OF MAINSTREAM METHODOLOGY

The authors also note various similarities in the methodological critiques of the mainstream offered by both groups and in particular their mutual rejection of certain tenets of "positivism." The story here is a bit more complicated. First of all, the philosophical doctrine of positivism is not monolithic. It changed dramatically as it evolved over the course of a century from the writings of classical positivists like Auguste Comte to the work of logical empiricists like Carl Hempel and Ernest Nagel. Next, though various positivist ideas dominated the rhetoric of mainstream economists writing in the 1950s and 1960s, the actual practice of economists was at best a bowlderized version of the philosophical doctrines. During the same period, the methodological critiques of opponents like the Austrians and institutionalists were often kept at the philosophical level, with the result that many mainstream economists found them unintelligible. Finally, philosophy aside, the actual practice of mainstream economics was in fact quite different from the approaches recommended by the heterodoxy. The primary difference was the growth in the use of mathematically expressed theoretical models and the development and use of econometric estimation techniques among practitioners of mainstream economics. So to state that neoclassical economics embraced positivism, while its opponents rejected it, is really to oversimplify matters. Again, a closer look at history will help us sort the issues out.

As Professor Kirzner points out in a passage quoted earlier, in the beginning of the 1930s the Austrians viewed their enemies as being historicists and institutionalists. The Austrians rejected what they took to be an anti-theoretical bias in the methodological approaches of these groups. There were historical antecedents for their attitude towards historicism. In Menger's debate with Schmoller, the Austrian argued for the primacy of "exact theoretical" laws over "realistic-empirical" ones.[6] In a like manner, Hayek in *Monetary Theory and the Trade Cycle* stated that purely empirical explanations of the business cycle are wrong-headed. Empirical work cannot produce any new theories; standard economic theory already exists and is well-verified. All that empirical work can do is to reveal to us areas that standard theory has yet to explain fully, and to help us to make forecasts (Hayek 1933, Ch. 1). Such beliefs were in direct opposition to those of the more empirically-oriented institutionalists like Wesley Mitchell. So if we examine the methodological literature of the interwar years, the institutionalists (at least those following Mitchell) and the Austrians were indeed at loggerheads, the former group advocating a form of measurement without theory and the latter giving minimal weight to empirical work. In the intervening years, a number of changes took place that pushed the two groups closer together and separated them from the mainstream.

Recall that the transformation of mainstream thought took place on two fronts, consisting of growth in the use of mathematical modelling techniques for theoretical work and of econometric estimation technique for empirical work. The Austrians would presumably favor the former development but oppose the latter, while the institutionalists would presumably take the opposite view. But this was not the case.

The Austrians, as we have seen, rejected the use of the standard equilibrium model because they felt it did not adequately capture the dynamic aspects of the market process. As a result, though the Austrians have continued to claim that their approach is theoretical, they have consistently attacked the use of mathemtical equilibrium models by mainstream economists. The institutionalists who embraced empiricism were happy to find the growing use of empirical methods in the economic profession, but they also found themselves being criticized by econometricians like Koopmans who railed against "measurement without theory." The "institutionalist approach" in fields like labor or agricultural economics increasingly took a back seat to the neoclassical approach, which emphasized the use of formal theoretical models that were tested against data. The institutionalists responded that such an approach missed the rich diversity of economic phenomena, that such mathemtical formalism produced an "unrealistic" vision of phenomenal reality. Just as the Austrians insisted that their non-mathematical approach was actually "theoretical," the institutionalists claimed that their more holistic, pattern-modelling approach was truly "empirical" because it more accurately reflected reality. Mainstream economists who equated the term "theory" with mathematical modelling techniques and "empiricism" with econometric estimation techniques found such claims rather bizarre. But more to the point, such claims could be dismissed as "unscientific" by mainstream practitioners who thought (wrongly, as it turned out) that they were positivists and that positivism was an unimpeachable (wrong again) philosophical foundation for the practice of science. Meanwhile the attacks of Austrians and institutionalists against the positivist pretensions of their orthodox counterparts came to sound more and more alike. Though they began as methodological opposites, members of both groups found themselves united against a common ememy, and a formidable one, at that.

V. CONCLUSION—THE ROLE OF METHODOLOGICAL WORK

I have argued that an understanding of the historical origins of the similarities of the approaches of the institutionalists and Austrians, and of their methodological criticisms of mainstream theory, makes those similarities more intelligible. How does all of this reflect on the role of methodological work in the discipline?

It is clear from what has been said above that a knowledge of the history of methodology can be very useful in understanding the present positions of various groups in economics. Though not an explicit theme of this paper, it is also true that different methodological positions often reflect differences concerning fundamental epistemological issues: differences concerning what can be known about phenomenal reality and of the best ways to represent that knowledge. Finally, it has been shown that methodological positions rarely if ever develop in a vacuum. Rather they result from complex interactions involving philosophical, sociological and political considerations in addition to those that are internal to the development of a discipline. It is my belief that a knowledge of methodology, in this broadly defined sense of the term, is extremely useful in gaining an understanding of the dynamics of the development of a discipline. That is no small role to play.

NOTES

1. I am more familiar with the development of Austrian thought than I am with that of the institutionalists. A similar excercise by someone more familiar with institutionalism would be very useful.
2. This second episode is discussed in two papers by Ludwig Lachmann (1982), (1986).
3. This interpretation, particularly the emphasis on the significance of the socialist calculation debate for the later development of Austrian thought, extends ideas found in two previous papers. See Kirzner (1988) and Caldwell (1988) and references therein.
4. This quotation is mentioned in Kirzner (1988); the author notes that, given the subsequent development of Austrian ideas, "one is tempted to describe it as an astonishing statement" (p. 9).
5. The role of this article in the evolution of Hayek's thought is explicated in Caldwell (1988).
6. An excellent discussion of this debate, in which the thesis is advanced that Menger and Schmoller differed on fundamental epistemological issues, is contained in Bostaph (1978).

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