The Public Interest
special Ed. 1980, p. 111-22

The "Austrian" perspective on the crisis

ISRAEL M. KIRZNER

THE tragedy of "mainstream" economic theory is that its present crisis-like situation appears as the natural outcome of an intellectual process that was, perversely, set in motion by a series of significant theoretical advances. Somehow the dynamics of this history has produced, out of basically sound insights, an elaborate structure of theory, dazzling in its technical sophistication, inspiring in the architectonic quality of its intellectual edifice—but seriously deficient in any genuine understanding of the workings of market capitalism. Such, at any rate, is the "Austrian" perspective on the current state of the dominant Anglo-American "neoclassical" orthodoxy in economic theory.*

Several important aspects of this unique Austrian perspective need to be noted. First, this perspective sees the edifice of modern neoclassical economics as built upon essentially sound foundations. (This is certainly the case insofar as these foundations are compared with the general world view expressed in the classical economics

* The term "Austrian" economics has been used with a number of different meanings. For our purposes the term refers to the work now being done in this country by a group of younger economists who have rediscovered, especially through the work of Mises and Hayek, the value and fruitfulness of certain insights basic to the earlier school of Austrian economics, originating in the 1870's with Carl Menger in Vienna.

which neoclassical economics replaced.) The required task of reconstruction does not, in the Austrian view, call for a radically different set of *fundamental* insights (as would be required, for example, by a Marxist view). On the contrary, the task of reconstruction calls, in part, for consistent attention to precisely those fundamental insights to which the dominant neoclassical tradition owes its beginnings—insights to which its proponents still, on occasion, pay lip service. Indeed, part of the difficulty encountered by Austrians in persuading their colleagues of the need for reconstruction arises out of the circumstance that many of these orthodox colleagues believe themselves to be *already* thoroughly in sympathy with what (to Austrians at least) appear to be the revolutionary insights which form the basis for Austrian economics.

Second, the task of Austrian reconstruction is one which calls for a good deal of attention to the history of economic ideas, especially in the early years of modern economics. If the essentially healthy elements in modern neoclassical economics are to be preserved, if the basically sound ideas fundamental to it are to serve as the inspiration for a hoped-for reconstruction of the edifice, reconstruction dare not be undertaken without thorough familiarity with the sources of earlier mistakes. It is necessary to know where, in its earliest development, neoclassical economics went wrong. Only in this way may we hope to make over the shape of modern economics in a radical manner—yet without sacrificing its positive features.

Third, despite our remarks on the healthy roots of modern neoclassical economics, there should be no doubt about the gulf which separates the mainstream view of market capitalism from that with which Austrian economics proposes to replace it. *In the Austrian view, a thorough training in neoclassical economics simply does not equip one with a sensitive understanding of how the market economy works.* It is this very disturbing circumstance which has spurred the current resurgence of interest in the Austrian tradition.

The emergence of neoclassical economics

During the last three decades of the 19th century, mainstream economics underwent a series of drastic alterations. In 1870 a frayed and battered classical orthodoxy, represented typically by John Stuart Mill's *Principles of Political Economy* (1848), still struggled—in the face of widespread undercurrents of skepticism and incipient rebellion—to maintain its position of dominance. By 1900 fresh winds had conclusively swept out the old orthodoxy and had

firmly installed its successor—a body of thought by no means homogeneous or monolithic, but one nonetheless often referred to generically as "neoclassical economics," in the broadest possible interpretation of that term. Mainstream historians of economic thought tend to see the various separate schools which made up the neoclassical revolution as having made their separate contributions within a broadly shared consensus. Before World War I, the various schools pursued their work with relatively little international crossfertilization. Marshall in Cambridge, England; Walras, and later Pareto, in Lausanne, Switzerland; Menger and Böhm-Bawerk in Vienna, Austria; J. B. Clark in the United States, carried on their work, each in his own way, within the broadly-shared neoclassical world view. It has come to be held that between the two World Wars the various strands of neoclassicism merged naturally, as a result of more vigorous international flows of ideas, into the body of thought which has, since World War II, dominated Anglo-American thought. Thus, in this view, the current orthodoxy has beneficially absorbed the special strengths of all these various schools. The "subjectivism" of the early Austrians, the "general equilibrium" system of Lausanne, joined the mainline of Marshallian and Clarkian economics to produce what is today taught on both sides of the Atlantic. From this historical perspective the Keynesian attack on neoclassical orthodoxy appears now, in retrospect, to have had relatively little permanent *revolutionary* impact. Although Keynesian macroeconomics successfully dominated the stage during the immediate postwar decades, it has since then come to be significantly assimilated to neoclassical orthodoxy, first through Samuelson's "neoclassical synthesis," and more recently as a result of sustained growth of interest in the "micro-foundations" of macro theory.

The Austrian perspective on the same historical period in the development of modern economics sees the picture somewhat differently. Careful study of the various schools at work before World War I reveals that the differences which separated them probably exceed in significance the elements generally held to justify grouping these schools together under the neoclassical umbrella. It is true that all the great post-1870 economists were attempting to recast economics along lines which (in contrast to classical economics) recognized the role of the consumer, of marginal utility, and of the demand side of markets. But, except for the Austrians in Vienna, this emphasis came to be subordinated to other, more dominant, themes. For both the Walrasians and the Marshallians, economic theory came more and more to point primarily towards the deri-

vation of the conditions for market equilibrium. In these treatments the role of the entrepreneur came to be lost sight of, the dynamics of the market process came to be overlooked or misunderstood, and the role of competition came to be recast until its meaning for technical economics was almost the exact opposite of what it had meant to Adam Smith (and still means to the layman).

From this Austrian historical perspective, the absorption into Anglo-American orthodoxy of the ideas developed by the various separate pre-World War I schools assumes a different aspect. It was not that the various schools made their contributions to the development of an already commonly-shared body of understanding. Rather it was a case of the dominant Marshallian neoclassical strand assimilating important features of Walrasian economics, as well as, in some degree, certain insights from other traditions. The confluence of Walrasian and Marshallian traditions had the consequence, it is now clear in retrospect, of decisively turning modern economics away from an appreciation of capitalism as a market *process*. It is in a number of respects ironic that the very injection of certain fundamental Austrian ideas into the Anglo-American orthodoxy (as occurred, for example, in 1932 with the appearance of Lord Robbins' justly celebrated *Nature and Significance of Economic Science*) seems to have helped crystallize the new direction taken by neoclassical thought.

As a result of the dominance achieved by this new direction, the older Austrian tradition came to be almost completely submerged. By the mid-1940's the dynamic view of the competitive market process shared (despite their differences!) by Austrians, such as Schumpeter, Mises, and Hayek, had become a view completely alien to the mainstream perspective. The success achieved during this period by Keynesianism contributed still further to the eclipse of the Austrian tradition. To an observer of the profession in the mid-1950's, the Misesian view appeared as one thoroughly discredited—or at least ignominiously ignored—by the mainstream of economic thought. That mainstream, by constrast, was enormously busy in developing sophisticated mathematical models, elaborate econometric techniques, and massive programs of empirical studies.

It is only in recent years that the younger members of the economics profession, in the United States, in Great Britain, and elsewhere, are finding it no longer possible to ignore the major flaws in the dominant view. A small but growing group of scholars has rediscovered the Austrian tradition and are engaged in a broad effort toward the restatement of economics along lines embodying

the brilliant, neglected insights developed by the modern exponents of that tradition, Mises and Hayek. In what follows, I examine briefly the nature of the principal flaws in modern economics as seen from the Austrian perspective. This perspective is that which particularly emphasizes: the purposefulness of individual action; the role of knowledge in economic choice; the subjectivity of the phenomena that interest economists; the competitive-entrepreneurial character of the market process; and the *ex ante* role in which time affects economic activity.

Some flaws in neoclassical economics

Although Austrian critics of the modern neoclassical tradition often refer critically to the excessive technical sophistication affected by the present-day exponents of that tradition, such criticism should not be misunderstood. It is not so much that Austrians are driven to question the relevance, even in principle, of the mathematics and the econometric techniques which today fill the pages of the professional economic journals, nor is it even the conviction (often shared by non-Austrians) that the sheer bulk of the technical baggage is too massive and too abstract to be fruitfully applied in explaining the real world with which we wish to deal. Rather, Austrian skepticism of the technical sophistication that pervades modern economics stems from painful awareness that the attention paid to the formal apparatus has been responsible for failure to appreciate a number of insights crucially important for economic understanding. As a result, modern mainstream economics displays a number of related features which, for Austrians, appear as serious flaws. These features include especially: a) an excessive preoccupation with the state of *equilibrium*; b) an unfortunate perspective on the nature and role of *competition* in markets; c) grossly insufficient attention to the role (and subjective character) of *knowledge, expectations,* and *learning* in market processes; and, d) a normative approach heavily dependent on questionable *aggregation* concepts and thus insensitive to the idea of *plan coordination* among market participants. Together these flaws represent very serious distortions, at best, in the understanding of the market process in capitalist economies which modern neoclassical economics is able to provide.

Equilibrium. Probably the central notion in modern neoclassical economics is that of market equilibrium. A very large part of economics is concerned with working out the mathematical condi-

tions which must be satisfied in order for particular markets to have achieved equilibrium—i.e., the state of affairs in which all plans are successfully carried out without disappointment and without reason for subsequent regret. A very large part of applied economic theory proceeds by assuming that market data can be treated as consistent with the hypothesis of markets being *already* in equilibrium. To a large extent the mathematicization of economics, as well as the disappearance of the entrepreneur from the theory of markets, can be attributed to the central role of equilibrium theory. For Austrians this preoccupation with equilibrium represents a serious shortcoming. Without in any way denying the usefulness of the equilibrium concept as a tool of analysis, Austrians see the neoclassical emphasis on equilibrium as a failure to recognize the really important aspects of a market economy—namely, those which relate to the nature of market *processes*. Equilibrium economics has tended simply to take these processes for granted, treating them in effect as working so rapidly, and as being so definitely equilibrating in their character, as to permit the analyst to assume instantaneous attainment of equilibrium. This is not only unrealistic; it leads to a totally false perception of the social usefulness of the market.

The inadequacies of equilibrium theory have not escaped the attention of contemporary theorists. I will a little later comment on the attempts being made, within the neoclassical framework, to address these inadequacies. For our present purpose it is sufficient to point out that, despite these well-meaning attempts, the corpus of mainstream economics is still heavily dependent on the equilibrium assumption. It is precisely the widespread awareness of this crippling handicap which contributes to the crisis-like atmosphere surrounding contemporary discussion of economic theory.

Competition. Economists have always emphasized the beneficial role of competition in market processes. Sad to say, neoclassical economics long ago developed a technical notion of *static* competition which is not only antithetical to that used in everyday layman's speech, but which, more seriously, fails entirely to appreciate the nature and enormous importance of dynamic competition. Not only did neoclassical economics introduce a meaning to the term "competition" which is almost the opposite of its ordinary meaning, but, in so doing, it diverted attention from market *processes.*

For neoclassical economics a "perfectly" competitive market means a market already in full equilibrium, in which individual buyers and sellers have no discretion with respect to price what-

soever—price having been already somehow set at the level such that utility-maximizing buyers and profit-maximizing sellers make the set of decisions which will clear the market. Competition is thus a state of affairs in which there is no need and no opportunity to "compete," in the everyday sense of striving to outdo one's competitors.

This notion of competition is so obviously bizarre, unrealistic, and unhelpful in understanding markets, that it long ago led to attempts within the neoclassical paradigm to replace it with more realistic models, notably that of "monopolistic competition." In the 1930's and 1940's Joseph A. Schumpeter (who in this respect, at least, was thoroughly Austrian) ridiculed the standard competitive models. Unfortunately, the attempts to replace the unrealistic economists' notion of competition by and large failed. On the one hand, the substitutes that were offered suffered from serious limitations of their own. On the other, the mainstream of economics still proceeded to use—almost without compunction—the standard, unrealistic, static concept of competition.

For Austrians, an economics built around this unfortunate notion of perfect competition is seriously inadequate. Not only does it reinforce the regrettable preoccupation with equilibrium, it has also been responsible for a disastrous failure to understand the requirements for, and benefits of, the dynamic kind of competition (in which the conditions of the economists' static view of perfect competition are in fact *necessarily violated*). The results of this failure include, among other matters, a misunderstanding of the role of advertising in modern economics, as well as an approach to the economics of anti-trust which has seriously threatened the efficiency and vitality of American industry. Instead of recognizing the critical importance for dynamic competition of *freedom of entry* (and of the harmfulness of all the well-meaning governmental regulatory actions which have eroded this freedom in modern times), mainstream economics has supported the view that sheer size is *per se* anti-competitive, and that the presence of any discretion to a firm, with respect to price, is essentially sinister.

The work of industrial-organization theorists has also come to recognize the harm wrought by the dominance of the perfectly competitive model in mainstream economics. A good portion of the widespread dissatisfaction with contemporary theory must indeed be laid at the door of this model.

Knowledge, Expectations, and Learning. The shortcomings associated with neoclassical preoccupation with equilibrium and "per-

fect" competition, can be traced to a deeper flaw—a failure to recognize the role of knowledge in the face of radical uncertainty, and of learning processes in dynamically competitive markets. For mainstream economics, objective data are viewed as somehow able instantly to determine the decisions of market participants. Until quite recently the main body of neoclassical theory was entirely comfortable with the assumption of perfect knowledge. No attention was paid to the extent to which buying and selling decisions must express the expectations being held with respect to *other* people's buying and selling decisions. No attention was paid to Hayek's demonstration that market equilibrium means the possession by market participants of sets of mutually-sustaining expectations with respect to one another's actions.

This neoclassical lack of appreciation for the role of knowledge and expectations has gone hand in hand with failure to recognize the nature and significance of *entrepreneurial discovery* in an uncertain world. In particular it has been responsible for misunderstanding the nature of competitive market processes, and for failure to ask the relevant questions with respect to whether or not the *learning* sequences, of which such processes consist, are likely to be equilibrating. For Austrians, sensitized to awareness of these matters, all this adds up to a powerful indictment of mainstream economics.

Allocation, Aggregation, and Social Welfare. Economic theory has always been pursued not only for the light of understanding which it promises, but also for the fruit of improvement in the well-being of society for which such understanding might be deployed. The neoclassical framework within which mainstream economics has pursued these latter ("normative") interests, contains certain key features which, in the opinion of Austrians, compound the faulty perception of market capitalism which that tradition represents.

First, normative economics is conducted in terms of a notion of *social allocational efficiency* which begs the very essence of the normative problem. Second, the economic well-being of society has (partly under the impact of macroeconomic thinking popularized by Lord Keynes) come to be identified with such deeply flawed *aggregate* notions as gross national product and the like.

For Austrians, to see the economic problem of society as one of efficiently allocating scarce social resources for the attainment of social goals, is not only to extend misleadingly the notion of choice from the level of the individual (where it properly belongs) to that

of society as a whole (where it can only apply as a metaphor). Far worse, it is in effect to assume away essential elements of the question. For the notion of social allocation of resources must assume that *somehow it can already be known* (how? to whom?) exactly what the available resources of society are, and exactly what is to be the relevant priority ranking of social goals. As Hayek has shown, it is the essence of the social-economic problem to grapple with the obvious circumstance that these matters are in fact *not* known to any single mind at all. Indeed, from the Austrian perspective the social relevance of the market process lies precisely in the extent to which it facilitates the way in which scattered (and even as yet entirely undiscovered) information is mobilized and brought to bear upon decision making.

Austrian criticisms of *aggregate* notions of social economic welfare derive both from the methodological individualism and from the subjectivism embedded in the Austrian tradition. Aggregate notions of welfare imply that there is some objective entity such as "output" which can be aggregated across individuals for purposes of welfare comparisons. For Austrians this raises well-nigh insuperable conceptual problems. The circumstance that such aggregates rely on market prices to achieve value homogenization of physically heterogeneous products only compounds Austrian unhappiness.

The truth, as seen by Austrians, is that economic welfare—consisting as it does of nothing but the subjective sense of well-being of separate *individuals*—displays an interpersonal incommensurability which simply defies aggregation. Moreover, market prices at any given time are sure to be *dis*equilibrium prices, and thus wholly inappropriate for purposes of aggregation (even if aggregation were unconcerned with welfare aspects of output). More fundamentally, perhaps, the Austrian emphasis on the individuality of choice and on the crucial significance of mutual expectations, on the basis of which choices are made in society, focuses attention on normative issues that have been wholly neglected by mainstream economics. For Austrians such questions as the coordination of plans, the extent to which decisions of different individuals can be systematically modified by market experience to more correctly anticipate each other's preferences, and the degree to which disequilibrium prices contribute to such improved anticipation through generating opportunities for entrepreneurial discovery, are all at the heart of normative discussion. But they are nowhere to be found in mainstream normative economics.

The monetary framework: further flaws

For market capitalism to work smoothly and effectively in the coordination of the plans of market participants, a reasonably stable monetary framework is an important requirement. For Austrians one of the gravest consequences of mainstream economics during the present century has been persistent mismanagement by governmental monetary authorities—mismanagement that has again and again brought in its train inflationary booms followed by bouts of depression. Mainstream Keynesian economics, it is now fairly widely felt (by non-Austrians as well as by Austrians), has failed miserably to live up to its presumptuous claims of having rendered economic instability obsolete. Contemporary disillusionment with the Keynesian mainstream has in large measure arisen from a shrewd suspicion that Keynesian policies are not only inadequate to ensure stability, but have in fact been to blame for its disappearance. For today's intelligent layman to put the mainstream economist in his place, it is only necessary for him to ask the now well-known and troublesome questions about inflation and stagnation.

To Austrians these mainstream failures appear as natural consequences of neoclassical misunderstanding of market processes and of its blindness towards the critical importance of plan coordination. The decades of Keynesian ascendancy emerge as a period during which it was somehow blithely believed possible to analyze the interaction of various "macro" variables without any examination of the micro-underpinnings of these aggregate entities. It was held possible, for example, to examine the impact of changes in the money supply without considering their structural consequences, as manifested through the market interplay of individual transactions. To put it somewhat differently, it was held possible to talk, say, of "price level" changes consequent upon increases in the supply of money, in a manner assuming that possible changes in *relative* prices (and the consequences of such changes) may be safely ignored. It was held possible to talk, say, of changes in aggregate "investment" without regard to the delicate web of plans governing the social structure of capital utilization, and the role of relative prices in achieving and modifying this structure of production. The insight that market forces—with all the scope they provide for action based on erroneous information, and for the incentives they offer for the entrepreneurial discovery of such errors—govern monetary phenomena as well as "real" phenomena, was missed. The tragic result of all this has been that mainstream economics has, to its shame, come to appear to endorse the popular and dangerous

folklore that in order to stimulate economic activity and to avoid depression, it is necessary merely to inflate the money supply. That such inflation may induce serious distortions in the economy, that it may systematically foster failures of coordination among the decisions of individual market participants, are concerns that have tended not to disturb mainstream economists.

Rescue and reconstruction

Contemporary mainstream theorists have not remained entirely unaware of all the shortcomings that have been briefly noted here. A good deal of work appearing in current journals is in fact directed at extending mainstream economics to deal with such matters as market processes during disequilibrium, the role of uncertainty, and the search for information. The need to provide "micro foundations" for macroeconomics is by now almost universally conceded, and considerable work in this direction has been achieved, much of it involving careful attention to the role of individual expectations in market responses to macro policy. These efforts are most encouraging, as far as they go. Nevertheless, to Austrians these efforts seem unlikely to effect the radical repairs so sorely needed by the leaky structure of contemporary neoclassical theory.

The fact is that these efforts at improvement are directed at specific perceived limitations of existing theory. Unfortunately, they appear generally not to recognize the extent to which the entire theoretical structure needs reconstruction. Instead of dismantling the elaborate equilibrium models of which neoclassical economics consists—and appreciating the subtle processes of spontaneous learning made possible by market interaction under imperfect knowledge—the new work seeks to address the problems by constructing even more complicated equilibrium models. Instead of recognizing the high price (in fundamental economic understanding) paid in order to deploy sophisticated technical tools of dubious practical value, the new work has largely taken the form of pouring still more intellectual investment into the technical tool kit. Instead of seeking to escape the mechanical quality which neoclassical theory has imparted to economic analysis, much of the new work (notably that centered around the "economics of search") has tended to extend that mechanical quality to areas (such as those of knowledge and discovery) which had, until recently, mercifully escaped it. The Austrian economist is compelled to conclude that the new work is

being conducted along lines that, unfortunately, simply do not point in the required direction.

For Austrians the present state of economics is seen to stem naturally from its historical development. Consideration of this background appears to identify very clearly the direction of required reconstruction. Neoclassical mainstream economics possesses great virtues. With all its faults, it does perceive the market economy as an interlocking array of individual decisions. It perceives the pattern in which decisions at the level of production are inextricably linked with expected decisions of resource suppliers and of prospective consumers. What is required is to retain these fundamental insights, and to begin to explore, with a humility which sophisticated model building is somehow unsuited to generate, the way in which individual decisions are likely to be modified by the discovery of error, by the awareness of radical uncertainty, and by the awareness of the *futurity* of the perceived time dimension within which decisions must be made. Economic theory needs to be reconstructed so as to recognize at each stage the manner in which changes in external phenomena modify economic activity strictly *through the filter of the human mind.* Economic consequences, that is, dare not be linked functionally and mechanically to external changes, as if the consequences emerge independently of the way in which the external changes are *perceived,* of the way in which these changes affect expectations, and of the way in which these changes are discovered at all.

Of course, these are very "Austrian" prescriptions. Contemporary Austrian economists indeed believe that the tradition which they have rediscovered offers the strongest hope for economics in its present time of crisis.