

# Austrian Economics in Transition

From Carl Menger to Friedrich Hayek

Edited by  
Harald Hagemann,  
Tamotsu Nishizawa  
and Yukihiro Ikeda



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# Introduction

This book investigates both consistent and changing elements in the Austrian School of Economics since its foundation in the late nineteenth century up to the off-springs of this School at the end of World War II. The Austrian School of Economics has experienced various phases of transition when the flourishing place of this school, the city of Vienna and Austria in general, saw drastic changes in politics and in the economy, leading to the emigration of the leading members of the School in the 1930s. Representative examples are Friedrich August Hayek, Ludwig von Mises, Fritz Machlup, Gottfried Haberler and Oskar Morgenstern. We investigate the dynamic metamorphosis of the school, mainly with reference to its contact with other ideas and representatives of history of economic thought.

Part 1 begins with Carl Menger, the founder of the Austrian School of Economics. First, Yukihiro Ikeda investigates the economic liberalism of Carl Menger. Although later Austrians are known to be radical supporters of economic liberalism, it is an open question whether the founder of the School shared the same kind of radicalism. Using various materials, his published works as well as his unpublished papers now located at Duke University, Ikeda tries to tackle this riddle in the earlier phase of the development of the Austrian School of Economics. In the following paper, Kiichiro Yagi deals with Menger's methodological turn soon after the publication of the *Principles* (1871). The *Investigation* (1883), in which the 'principle of efficiency' determinates economic process in the idealized world, was only the middle point of his quest for the rational economic man. Menger was not content with the idealized world. He was interested in the economic action in the indeterminate world. Yagi also mentions Schmoller's review article and its influence on Menger in this context.

Part 2 deals with the German Historical School, which is often thought of as diametrically opposed to the Austrian School, particularly due to Schmoller's dispute on method with Menger. However, reality has been more diverse. In the first chapter of Part 2, Jun Kobayashi deals with 'substantial rationality' and 'formal rationality', two concepts playing important roles in Max Weber's methodological argument.

This is followed by Keith Tribe's contribution in which he shows that Weber was not only familiar with contemporary economic thinking in the 1890s, but that he had a special indebtedness to 'Austrian Economics'. According to Tribe, there was a lengthy process of reception reaching from the 1870s to the 1920s during which a 'new economics' became increasingly accepted, but without displacing historical or institutionalist economics. Finally, Tamotsu Nishizawa traces how German and Austrian ideas on economic theory and economic sociology exerted influence in Japan through the work of Ichiro Nakayama who had studied with Schumpeter at the University of Bonn in the late 1920s.

Part 3 consists of three contributions by Arena, Cangiani and Milford on the methodological problems of the Austrian School of Economics, with special attention to Menger. First, Richard Arena scrutinizes a transition of methodology from Menger to Wieser, the successor of the chair. In particular, Arena focuses on some aspects of Wieser's economic and social theory which are often ignored when his contributions on methodological individualism, power and institutions are discussed. Thus, Arena emphasizes that Wieser is more Wicksellian than Walrasian, and argues that in his analysis of money and credit Wieser in important aspects has anticipated Keynes's finance motive although no elaborated speculative motive exists in his theory. Next Michele Cangiani investigates the motives and results of Menger's revision of his 1871 book, by comparison with the posthumous edition of 1923. As the title indicates, a starting-point of the chapter is Polanyi's work and its relationship with Menger's new statements in the 1923 version of the *Principles*. Finally, Karl Milford, in analyzing Menger's problem situation, challenges the standard interpretation of Menger defending an Aristotelian essentialist position as counterintuitive, and instead emphasizes Menger's non- or even anti-essentialist approach to economics. Milford convincingly shows that Menger's methodological individualism conflicts with an essentialist approach to economics.

Due to the political developments of the 1930s most Austrian economists had to leave Austria and exerted a major influence in the hosting countries, particularly in the United States. Part 4 deals with this 'Dissemination of the Austrian School of Economics'. First, Harald Hagemann discusses the developments at the University of Vienna and the political developments which caused an enormous emigration of Austrian economists. He then gives a bird's eye view of important contributions of Austrian economists in the interwar period. Next, Arash Molavi Vasséi gives a thorough interpretation of Ludwig von Mises's approach

with which the Austrian theory of business cycles takes its starting point. Then Hansjoerg Klausinger presents Hayek as a leading international researcher of business cycle theory, which had been the main economic issue in the interwar period. Klausinger also points at Hayek's odd position as the Director of an Institute mainly dedicated to the task of empirical research on business cycles, relevant to business people, to which he had severe reservations. Finally, Chikako Nakayama focuses on Oskar Morgenstern in her analysis of the impact and the experiences of emigrated Austrian economists in the United States. Morgenstern's discussions with Frank Knight can be seen as part of the dissemination of the Austrian School, but also as a new impact coming from outside.

The book is concluded by Part 5. First, Kurt Leube, deeply involved with the Austrian tradition, informs us about the concept of '*Verstehen*' and related methodological problems with special attention to Menger and Hayek. By examining Hayek's *Sensory Order*, Susumu Egashira links Hayek's psychological argument to modern economics. Egashira argues that the Hayekian perspective might lead to a new paradigm in microeconomics. In dealing with the so-called 'Transformation Problem' of Hayek, Makoto Nishibe claims that Hayek drastically transformed his vision of the market in the 1930s and that there should be another dividing line between 1945 and 1946. Lastly, Tsutomu Hashimoto tries to answer the following questions: How did Mises and Hayek succeed Menger's methodological principles? How did they transform or reform them?

All in all, the chapters shed some light on the new developments and find fruitful contributions of the Austrian School to the evolution of economics in an international perspective. At the same time, we try to answer the ambitious question of whether there can be a School of Economics in the definite sense of the word. Indeed this is a problem with which Schumpeter was seriously involved with when he wrote his *History of Economic Analysis*.

The volume originated from the conference 'Carl Menger and the Historical Aspects of Liberalism' held at Hitotsubashi University, 17–19 December, 2004, organized by the Center for Historical Social Science Literature at Hitotsubashi University.

Some of the chapters in the volume were papers read at the above conference, but have been revised in many ways considering responses from the participants. Furthermore, we have extended the scope of the volume by inviting other contributions by colleagues who are experts in the field. We are grateful to Hitotsubashi University for their generous

financial support, without which the conference would not have been made possible. Particular thanks go to Professor Koichi Yamazaki, who organized the conference. Finally, we would like to thank Niels Geiger and Johannes Schwarzer for their support in adapting the manuscript to the publisher's guidelines and in preparing the index.

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## **Part I**

# **Carl Menger: Towards a New Image of the Founder**



# 1

## Carl Menger's Liberalism Revisited

*Yukihiro Ikeda*

### 1. Menger's liberalism: A myth?

Was Carl Menger a radical supporter of economic liberalism like the later members of the Austrian School of Economics? This is still an open question, even among scholars deeply involved with the study of the Austrian School in general and Menger in particular. There are good reasons for this: Menger's main works were in the fields of economic theory and methodology, published in 1871 and 1883 respectively. Although we have some other small pamphlets and papers dealing with specific topics, Menger did not have many opportunities to publish his works on economic policy while he was alive. Historians of economic thought are compelled to garner assorted comments that are scattered throughout the various papers and books that Menger did publish during his lifetime.

Fortunately, we are left with some hints that can help us to identify and interpret Menger's liberalism. After scrutinizing Menger's monetary theory, we are now inclined to answer this question in the following way: Menger was a moderate protagonist of economic liberalism, making him the odd man out among the later players of the Austrian School of Economics, such as Ludwig Mises and Friedrich Hayek (for details see Ikeda, 2008; see also Campagnolo, 2004, 2005). Our analysis is highly specific, in that it deals only with his monetary theories; yet, this chapter examines other aspects of Menger's liberalism as well, in an attempt to answer the aforementioned query.

In the next section, we examine Menger's lectures on Crown Prince Rudolf, who died tragically in Mayerling in 1889 (these shall hereafter be referred to as the Rudolf Lectures). Menger taught his pupils fundamental principles of economic policies. What are the agendas and

non-agendas of government in a market economy? What is necessary to promote the well-being of the subjects of a monarchy? By reading the materials Menger taught to Rudolf, one can get a bird's eye view of Menger's economic policies. This examination is followed by Section 3, in which I address his lectures on public finance. The transcription of the lectures, now available, thanks to the efforts of Takeshi Mizobata, enables us to read the contents of the lectures that he gave at Vienna University. Since Menger did not offer a detailed account of the discipline in his published works, this offers us a good way to identify his position in the history of public finance. This section, together with the previous one, contributes to the basic understanding of Menger's economic policies. In Section 4, we turn to a newspaper article that was written by Menger to commemorate Adam Smith. Although it was addressed to general readers, it gives us a clue to his interpretation of Smith in comparison with those by other German scholars of that era, which is another way to identify Menger's liberalism. In Section 5, we demonstrate that there are important differences in opinion between Menger and Rudolf concerning the problem of how to deal with the Enlightenment. While Rudolf shared a basic political stance with his mentor, he was more optimistic in his belief in the further development of human beings. In the final section, some concluding remarks will be made. Although we have tried to extend the scope of this analysis to include aspects of Menger's ideas other than monetary theory, this is still a tentative answer to the abovementioned problem.

## 2. Economic liberalism in the Rudolf Lectures<sup>1</sup>

As is indicated by Erich Streissler, the Rudolf Lectures are heavily based on Heinrich Rau and Wilhelm Roscher, but another important source is Adam Smith (see Streissler, 1994, especially 6–22). In this section we will demonstrate that Menger had relied upon arguments in the English Classical School represented by Smith, as well as those traditional discourses of German economics beginning with *Cameralwissenschaften*, of which the dominant player in the first half of the nineteenth century was Rau. In fact, these lecture notes are good examples of the reception history of Smithian economics and of a still-surviving tradition of typically German economic discourse.

Menger used the following simple two-stage theory with respect to the necessity of governmental intervention:

When a people is still uncivilized, the head of state may attempt to activate the sluggish economy on his own initiative; but where trade and commerce flourish because of a people's industry and education, the state can greatly harm the citizens' interests by interfering too much, while it will most definitely promote the interest of the national economy by allowing scope for individual action and lending support only in cases where an individual's strength is insufficient.

(Streissler and Streissler, 1994: 109, 111)

In developing countries waiting for takeoff where 'a people is still uncivilized', one badly needs a kind of state intervention; however, after takeoff, governmental intervention is more or less a disturbing factor in a market economy. Thus, in developed countries, the state must stop playing a definitive role in order to orient the economy as a whole.<sup>2</sup>

Menger supports his arguments in a typically Smithian or Hayekian way. In his own words:

However carefully designed and well-meant institutions may be, they will never suit everybody, since only the individual himself knows exactly his interests and the means to promote them. Innumerable influences, different for everyone, dominate man's activities, and only the individual knows the means for gaining his ends; from unhampered individual development there results a wide range of activities that permit an advanced stage of civilization to be reached. The individual citizen knows best what is of use to him and he will be most industrious when working for his own personal ends.

(Ibid.: 113)

Each economic player knows his own interests and the surrounding situations better than anyone else, Menger argues (see Rosner, 2008: 138; Wilke, 2008: 155). Furthermore, he works harder when promoting his own interests than when serving others to promote theirs. Broadly speaking, this argument reminds us of the well-known explications in *The Wealth of Nations*, whose ideas Friedrich Hayek shares with the great thinkers of the Scottish Enlightenment. Menger's standing point can be neatly summarized as follows:

Freedom (*Freiheit*) and self-reliance (*Selbstverantwortlichkeit*) in the economic efforts of citizens are the foundation of the overall



development of a state; therefore the state has to realize and defend these fundamental principles.

(Streissler and Streissler, 1994: 115)

As the above quotes show, Menger was supportive of economic liberalism, with some careful reservations. Let us look at government agendas from Menger's point of view.

Important roads, railways and canals that improve the general well-being by improving traffic and communication are special examples of this kind of enterprise and lasting evidence of the concern of the state for the well-being of its parts and thereby its own power; at the same time, they are/constitute major prerequisites for the prosperity of a modern state. The building of schools, too, is a suitable field for government to prove its concern with the success of its citizens' economic efforts.

(Ibid.: 121)

As is well known, roads and canals are included in government agendas in *The Wealth of Nations*. Smith did not mention railways, simply because they did not exist in England or in any other part of the world when he wrote his grand oeuvre. On the other hand, Menger did not refer to bridges and harbours either. It is difficult to determine whether he skipped them on purpose or if the omission has any substantial meaning.

Beyond these agendas, Menger goes so far as to say that the protection of forests must be provided by the government. He explains why this is necessary:

Quite often a forest owner in the mountains who is temporarily short of money will want to clear his high-lying forests; this can easily cause irreparable damage, since the rainfall will then run off in torrents and wash out the humus layer; floods in springtime, droughts in summer, and other kinds of damage to agriculture in the plains result from such deforestation of the mountain sides and tend to worsen over time. The Southern Tyrol, Istria, Dalmatia are sad object lessons of the blind greed of individuals and thoughtless negligence of former governments.

(Ibid.: 131)