

INSTITUTIONAL ECONOMICS

Sponsored by a Grant TÁMOP-4.1.2-08/2/A/KMR-2009-0041

Course Material Developed by Department of Economics,
Faculty of Social Sciences, Eötvös Loránd University Budapest (ELTE)

Department of Economics, Eötvös Loránd University Budapest

Institute of Economics, Hungarian Academy of Sciences

Balassi Kiadó, Budapest



Author: János Mátyás Kovács
Supervised by János Mátyás Kovács

June 2011

Week 4

”Old“ Institutional Economics II The Austrian School and the ”Methodenstreit”

Contents

- Austrian School
- The “battle of methods“ (*Methodenstreit*)

Austrian School

- Is it institutionalist at all? Is it really that different from the German Historical School (*Intimfeind*)?
- The *Methodenstreit* may be conceived of as a debate between two schools that agree on institutional matters, and both differ from the emerging neoclassical thought (and attack the Marxists): but then, what is the crux of the debate?
- Family quarrel?

- To decide, let us characterize the Austrian School first:
- Despite its marginalist discoveries, the school seemed to enter a dead-end street between the two wars, and institutional thought seemed to disappear in modern economics for good (the German historicists having the same fate).
- Meanwhile, it developed a militant libertarian rhetoric (to ease its defeat by the neoclassical school?), and – paradoxically – approached Ordo-liberalism (see next presentation) that had been rejected before because of its roots in German historicism.
- Generational differences (like with the Germans):
 - Menger, Wieser, Böhm-Bawerk
 - Schumpeter, Mises, Hayek, Haberler, Morgenstern, Machlup
 - Neo-Austrians: Kirzner, Rothbard, Lachman and their disciples
- “Founding father”: Menger
- In a sense, his methodology does not differ from that of his opponents.
 - Searching for laws: defining “essence” in an Aristotelian way, suggesting historical arguments (emergence of money), rejecting formalization, etc.
 - “Analytically Menger was still pre-Gossen” (Niehans)
 - “While Menger was a fresh spring in the theoretical desert of the German-language economics of his day, in the international context his contribution was obsolete before it had been made”. (Niehans)
- Novelties:
 - Founding two major pillars of modern economics: methodological individualism and a general/philosophical theory of the market
 - Market process: *human action*, choice, knowledge, error, time, discovery, entrepreneurship, competition, property, information, incentives, uncertainty, bargaining, etc
 - Many of these notions are of institutional nature, and were co-opted by the mainstream.
 - Machlup: six main features of the school (methodological individualism, subjectivism, marginalism, preferences, opportunity costs, the time

structure of the economy)

- He adds two normative characteristics: consumer sovereignty, dependence of political liberties on economic ones
- Game theory as an Austrian invention?
- Institutions: Menger as a German-style historicist but he tells more complex stories; history of money: emphasis on spontaneity, non-intended consequences, private property (Böhm-Bawerk's analysis of property rights)
- Pragmatic and organic institution-building
- A variety of institutions are included in the analysis: law, language, markets, community, state
- Institutions emerge from rational (self-interest-based) decisions in an evolutionary way; the end result may be irrational, harmful
- Against aufklärism/reformism (Hayek: critique of social engineering)
- The national economy (and its spirit) is no institution, no independent organism
- Are the political institutions of economic liberalism necessarily liberal? Menger is Josephinist, Wieser flirts with fascism, Mises will be the first arch-libertarian

“Battle of methods“

- Neoclassical versus institutional economics – is this the main cleavage?
Presentist bias
 - 1883: Menger, *Untersuchungen über die Methode*, review by Schmoller
 - 1884: Menger, *Irrtümer des Historismus*
 - Does the debate last until Sombart's death?
 - In the center: Menger-Schmoller conflict
 - The issues of both marginalism and historical analysis are absent in the debate: Menger (later Schumpeter and Hayek) make historical research, and Schmoller does not challenge marginalist theory and examines institutional problems from a logical perspective (contractual costs – similar to transaction costs)

- Niehans: the debate is about the basics of scientific research: how does one discover economic laws? Casual explanation or the primacy of pure facts
- Hayek: power struggle; Schmoller excludes the “abstract economists“ from Germany
- Schumpeter: both parties are right but they represent two different professions: economics versus economic sociology
- Conventional dichotomies:
 - Germans against Austrians
 - Student revolt: all participants were disciples of the old German professors
 - Conflict of principles or power positions
 - Nationalism versus liberalism
 - State versus the market
 - Empirical or abstract analysis
 - Law/history-based or philosophy/psychology-based approach
- Did anyone win? A wrong question, nonetheless:
 - In the short run: German victory
 - In medium term: Austrian victory
 - In the long run: did both schools win?
- Wisdom of hindsight: the *Methodenstreit* was blown up; parochial quarrel; none of the groups master mathematics; both keep a distance from the classical and the neoclassical schools; the history versus theory issue seems less important today when the two schools come together under the aegis of NIE (like earlier under that of Ordo liberalism)
- The participants of the *Methodenstreit* make mutual concessions during the debate (Weber in the middle?)
- The British version: Marshall versus Cunningham; Marshall's ambiguities
- Whatever we think about the debate today, at the time, it was at least as crucial as the marginalist turn.
- An ironical consequence: the concepts of the historicists (property, state, development, etc) have been included in the mainstream almost a century later

with more than a little help from Austrian theories.

- Hayek: bridging the gap (first in the case of Ordo liberalism, then in that of new institutional economics) between the “Austrians“ and the “Germans”
- Moving away from neoclassical theory (equilibrium, perfect knowledge, etc); order and rule as key institutional concepts
- *The Constitution of Liberty* (1960)
- *Law, Legislation and Liberty* (1973/79)
- *The Fatal Conceit* (1988)
- Interested in similar institutions as Menger: language, money, morals, state, property, law
- Organized/constructed and spontaneous/evolutionary orders (*taxis* and *cosmos*); different rules belong to the two orders (*thesis és nomos*)
- Critique of rationalist constructivism

Readings

Mandatory

Mises: *The Historical Setting of the Austrian School of Economics*, 1984 (chapters)

Mäki: *Universals and the Methodenstreit*, 1997

Menger: *Investigations into the Method of Social Sciences*, 1985

Streissler and Weber: *The Menger Tradition*, 1973

Hayek: *The Constitution of Liberty*, 1960 (chapters)

Additional

Schumpeter, *History of Economic Analysis*, 1954 (chapters)

Hodgson, *How Economics Forgot History*, 2004 (chapters)

Annex

Biographical sketches

- Menger
- Mises
- Hayek

Final questions

- Predecessors/successors of the school
- Friends and foes
- Discoveries
- Changes in the research program