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The Foundation and Procedure of Austrian Economics

Austrian economics refers to economists all over the world who trace their method of dealing with economic topics to Austrian economist Carl Menger, who wrote during the mid-19th century. Menger showed that in order to describe the facts of human history, a social scientist must have a theory of how those facts can be related to human choices. The social scientist must ask: "How can I explain the facts by referring to the choices of particular individuals." Since his own speciality was economics, Menger also showed how economic theory helped to explain historical facts. Economic theory, he pointed out, is a system of deductive logic based on the assumption that the behavior of all economic subjects is *purposeful*. In other words, the economic theorist assumes that all behavior is aimed at accomplishing some goal.

As Menger saw it, market interaction and the great benefits it bestows on individuals as consumers are the consequence of millions or billions of separate minds each with particular and specialized knowledge of his or her situation. Each of these plans her own way of earning money income. But, in order to earn the money, she must acquire specialized knowledge that she can use to provide some good or service to others. She has a special incentive to coordinate her plans with those of others in order to ultimate buy the consumer goods produced by the others. Later Austrian economists, like Ludwig von Mises and F. A. Hayek, recognized that such coordination is achievable by means of price signaling and the use of money to make calculations. Thus, the individuals in free market interaction produce enormous amounts of knowledge about how to contribute to the satisfaction of consumer wants. Free markets and the use of money enables each to coordinate his knowledge with that of every other knowledge producer.

Many of Menger's contemporaries advocated a socialist system or organization. These socialists believed that under such a system, wealth that is comparable to that of market interaction could be produced. The difference is that they could distribute in a way that they regarded as fairer. They thought that such a result could be achieved by means of a central grandiose central plan that would use the factors of production to produce consumer goods in the most technologically efficient ways.

Mises and Hayek pointed out that no single individual is capable of acquiring and utilizing the knowledge needed to produce the amounts and qualities of consumer goods that are produced in market interaction. Without a system of free markets and prices, the specialized knowledge that is needed to discover what consumers want and how to best satisfy those wants could not be produced and coordinated. The socialists merely assumed that central planners would possess knowledge that would never be produced in the absence of a profit incentive and a system of free markets and prices. Socialist planners could conceivable cause a more equal distribution of the pie; but the pie would be so much smaller that practically no one would be as satisfied with his piece of it as compared with the piece he could have under a system of free markets and prices.

The great potential of individual planning is exhibited best in the hypothetical free market economy. If individuals operate in a free market economy, their creativity tends to achieve its greatest expression. Except for cases in which property rights are especially costly to establish and enforce (such as property rights to clean air) and the monopoly price, individual creativity will be manifest in the satisfaction of consumer wants. Austrians have a special place for the role of the entrepreneur.

Entrepreneurship refers to distinctly human action under the conditions of the pure market economy. To understand the entrepreneur in the market economy, one must contrast an imaginary economy containing only robot factor-suppliers, robot producers, and robot consumers with a hypothetical free market economy containing these robots plus pure entrepreneurs. This enables one to see how the distinctly human characteristics get manifested in the role of the pure entrepreneur.

Once the role of the pure entrepreneur is identified and made clear, the Austrian economist proceeds to show how different actors in a more realistic market economy act entrepreneurially – i.e., how workers, owners of capital goods and land, consumers, and savers each act as entrepreneurs. Following this, the economist focuses specifically on those individuals who get into positions where they manage businesses and bear the uncertainty connected with profits and losses. Such individuals create firms, finance and/or manage corporations and other businesses, and become major players in the stock market and futures markets.

Once entrepreneurship is defined, the Austrian economist proceeds to describe: (1) economic interaction in the "real" market economy, (2) the concept of interest, and (3) the trade cycle of boom and recession. In doing this, he uses a combination of imaginary constructions containing robots in some roles and entrepreneurship in others. These constructions are complemented by examples of interaction. To give examples, the economist begins with what most economists have called the comparative static method. According to this method, robots begin in equilibrium, a change in the data is introduced, and then the behavior needed to reach some new equilibrium is modeled. This model of adjustment to a new equilibrium is supplemented by a discussion of the imagination, creativity, and inventiveness of real human actors who were in the positions described in the model. In other words, the model is used as a foundation for a further discussion of the entrepreneurship that would present under the assumed conditions.

The same method is used to trace the effects of a market intervention, such as a price control, a restriction on production or sales, or a tariff. Beginning with equilibrium, a change is introduced and the effects of the intervention on the production of goods that satisfy consumer wants are traced with a model of robot behavior. This model is than contrasted with an image that contains beings that exhibit the human characteristics of imagination, creativity, and inventiveness.

Many of today's professional and academic economists attempt to describe economic facts by means of mathematical and statistical models. Modern Austrians regard such models as too mechanical. They stress the fact that the subjects of such models are not purposeful, creative,

innovative, and shrewd human actors. The subjects are merely robots that are programmed by the model-builder to behave according to algorithms. Following the logic of Menger, modern Austrian economists criticize the model-builders for providing little help in interpreting, or understanding, how human beings are able to identify new factors of and methods of production and new products to satisfy consumer wants. The model-builders disregard the imagination, creativity, and inventiveness of human actors.

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