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Brief History of Pre-Misesian Economics

Outline

Mises invented his new science of economics on the foundations provided by the classical economists and the individualist economists. Mises divides the history of that science into two periods: (1) the classical period beginning in the 18th century and continuing until the mid 19th century and (2) the individualist period beginning in the mid to late 19th century and continuing until Mises's treatise. The aim of this essay is to briefly present that history. I discuss each period in turn.

1. THE CLASSICAL ECONOMISTS

Mises wrote that prior to the eighteenth century, insights that would ultimately become incorporated into economic science were "scattered and fragmentary."[1] The situation changed when the classical economists discovered the division of labor law.[2] According to this law, if the conditions of capitalism are fully present or even partly present, individuals interact in such a way that each of them, acting in his own interest as a consumer and potential contributor to production, tends to benefit other consumers and contributors to production. On this basis, they proposed that strengthening the conditions of capitalism would raise national wealth.[3]

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[1]EP: 3.

[2]Thus Mises writes that economics

> achieved scientific status only with the development of economics in the eighteenth century. When men realized that the phenomena of the market conform to laws, they began to develop catallactics and the theory of exchange, which constitutes the heart of economics. After the theory of the division of labor was elaborated, Ricardo's law of association enabled men to grasp its nature and significance, and thereby the nature and significance of the formation of society (EP: 3).

In HA, Mises uses the term "economics" and "catallactics" interchangeably, as indicated in his introduction (HA: 7) and in the title of his Part Four (HA: 232). He attributes the term to Richard Whately (HA: 3).

[3]Because the classical economists lived during an era of autocracy or semi-autocracy, they did not emphasize the benefits to ordinary people.

The practicality of this new knowledge was evident. The classicals observed that when the leaders of government used their coercive power to increase private property rights, increase free enterprise, and reduce fraud, they caused national wealth to rise. The classicals explained how this had occurred by referring to the expansion in trade and specialization that is achievable under the conditions of capitalism.

The classical economists did not, broadly speaking, think of their work as science in the Misesian sense. Nevertheless, they used the division of labor law to refute arguments that market intervention could achieve particular ends. Their work was at least a precursor of what Mises conceived as the new science.[4]

It is worthwhile to state these ideas in a different way since their significance, if not the ideas themselves, have been misunderstood by subsequent economists who have adopted the name "Austrian." I begin with the *fact*, illustrated in Ricardo's theorem of comparative advantage and in Adam Smith's pin-making factory, that work may be made more physically productive through specialization and the division of labor as among individuals. Based on their observations of this fact, the classical economists proceeded to advise governments to adopt economic policies that expand private property rights, free enterprise and international trade, while helping to maintain a stable money. In recommending these policies, the classical economists were, in effect though not explicitly, applying economic science.

2. THE INDIVIDUALIST ECONOMISTS

Carl Menger (1871) incorporated Smith's and Ricardo's ideas into a grand system of progressing market interaction in which market phenomena are caused by individual choices. First he defined progress as an increase in consumer goods, thereby disposing of the classical term "national wealth." He continued to use the classical term, however, due to convention.[5] Then he wrote that progress is caused by a combination of two distinctly human characteristics: (1) the desire for consumer utility and (2) the capacities of individuals to help produce consumer goods. As they apply their capacities, their choices cause progress as an outcome.[6]

Individualist economics: the system of theorems that traces progress and market phenomena back to the choices of individuals. Individuals' desires for consumer utility, combined with their capacities to help produce consumer goods for exchange, enable them to earn money to buy the consumer utility-yielding goods from others who possess a comparative advantage in producing them.

[4]Mises writes that their work "led to the program and policies of liberalism and thus unleashed human powers that, under capitalism, have transformed the world" (EP: 4).

[5]Menger 1981: 112-13. For his critique of previous concepts of wealth, see his Appendix B.

[6]A more complete description of Menger's contribution would refer to his incorporation of long supply chains into the classical theory. But the focus of this story is not Menger.

Consumer Utility Theory of Market Phenomena and Consumer Sovereignty

> **Consumer utility theory of market phenomena**: a set of theorems about interaction under the conditions of capitalism in which all market phenomena can be traced to the desires of individuals acting in the consumer role and to individuals' capacities to identify and take advantage of gains from the higher physical productivity of the division of labor.

The ultimate motivation for progress in Menger's theory is the desire for consumer utility. This desire motivates individuals to cause all of the production, exchanges, prices, quantities, qualities, incomes, and so on in market interaction (i.e., the market phenomena). Because of this, it is appropriate to call the theory that depicts the grand system that he developed the *consumer utility theory of market phenomena*.[7] It consists of a set of theorems about interaction under the conditions of capitalism. These theorems enable the economist to trace all market phenomena back to (1) the desires of individuals acting in the consumer role and (2) individuals' capacities to identify and take advantage of gains from the higher physical productivity of the division of labor.

In the latter part of the 19th century and early 20th century, economists sought a convenient way to describe the individual actions that, in Menger's theory, caused the market phenomena and progress. Ultimately, they hit upon the idea of identifying the functions performed in the attainment of the aim of taking the greatest advantage of the division of labor law and dealing with scarcity. Having identified these functions, the economists proceeded to assign roles to perform them. The central role was that of the entrepreneur. The most advanced of the thinkers, like Frank Knight (1921), regarded progress and market phenomena as the consequence of the driving force of the entrepreneur role.[8] The entrepreneur role is motivated exclusively by the profit incentive to cause consumer goods to be produced and sold. Other, passive roles consisted of the consumer-saver, the worker and the owner of capital goods.

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[7]Mises writes that this theory was produced by Menger, William Stanley Jevons, and Leon Walras (HA: 121). In HA, Mises favors the term "modern theory of value" (HA: 3). Another term he uses is the "elementary theory of value and prices" (HA: 201).

A close reader of HA can recognize that "value" means "prices" and, in addition, that prices is a shortcut way of referring to all market phenomena. An early observer of ambiguity in the language of the Austrian economists who preceded Mises was Herbert Davenport (1902).

[8]In his earliest work in 1921, Knight made the entrepreneur role the driving force of progress in economic theory. Later, he changed his definition of economic theory to exclude the entrepreneur role on the grounds that one could only speculate on the actions that the entrepreneur role would take and therefore that this role could not be part of a deductive economic theory. This was his ultimate point in an article he wrote on diminishing returns to investment in which he completely omits the term "entrepreneur" (Knight 1944).

Law of Consumer Sovereignty

W. H. Hutt adapted this theory of the entrepreneur role. He expressed it by introducing the phrase "consumer sovereignty." Hutt's doctrine, or law, of consumer sovereignty can be considered the last stage in the individualist economics invented by Menger. The labeling of the consumer utility theory of market phenomena can be considered the last stage in the development of the vocabulary instituted by the individualist economics. It remained for Mises to build the foundations and to make additional advances by applying the doctrine to the holding of money and to the satisfaction of wants through time.

Law of Consumer Sovereignty: Under pure capitalism, market phenomena tend to be determined by individuals acting in the entrepreneur role in accord with the demands for material consumer goods made by individuals in the consumer role.

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