

Chapter 1

The History of Austrian Economics and Marginal Thinking

... man, with his needs and his command of the means to satisfy them, is himself the point at which human economic life both begins and ends.

—Carl Menger (1871/1981), *Principles of Economics*: 108.

The origin of the Austrian School of economics is the publication of Carl Menger's *Principles of Economics* in 1871. Menger, based in Austria, along with William Stanley Jevons in England, and Léon Walras in Switzerland, are considered the co-founders of the “marginal revolution” in economics. The marginal revolution was a paradigm shift from the established labour theory of value to the marginal utility theory of value. The labour theory of value held that the value of a commodity is a function of the labour required to produce the item. The marginal revolutionists, in contrast, argued that value is not based on the amount of labour expended, but rather reflects how useful people perceive the commodity to be in satisfying their ends.

This revolution had radical implications for the way economists understood the world. A computer does not command a high price because it took a certain number of hours to produce. Instead, it is that consumers value the computer for its usefulness in achieving their goals that determines its high price. The consumer valuation of the final computer, in turn, is what drives the demand for the inputs—labour and resources—used to produce it. Consumer valuations, and not the amount of effort, is what determines prices. But what determines consumer valuations?

This is a question that had long perplexed social scientists. It is captured by what is known as the water-diamond paradox. At the core of this paradox

is the following question: Why do consumers value diamonds, which are a luxury item, more than water, which is essential for life? By introducing the concept of marginal utility, Menger and his co-revolutionaries were able to resolve this paradox.

In most contexts, people do not make either-or decisions. That is, people do not typically choose between having only water, and nothing else, or only diamonds. Instead, they are engaged in choosing among various quantities of water and diamonds. Instead of treating the choice as either-or, the proper way to frame the choice is as a marginal decision in which the individual chooses whether to consume an additional unit of water or an additional diamond.

Think about how you use water. Certainly, you consume some water—which is essential to human life—to quench your thirst. But water is so abundant that we also use it to bathe, water our lawns, and wash our automobiles. Water’s abundance means that the additional (that is, marginal) use value is low, which is reflected in the price we are willing to pay for a marginal unit of water. If water suddenly became much more scarce, perhaps as a result of a drought, we would reduce our use on the lowest-valued margin—likely watering our lawns or washing our cars—before reducing our personal consumption of water as a means to quench our thirst. This increased scarcity would be reflected in a higher price of water which would, in turn, induce people to refrain from pursuing its lowest-valued use.

Now consider diamonds. Diamonds tend to be scarce, and their main use is ornamental. As such, the price that most people are willing to pay for a marginal diamond is high. Think about what would happen if diamonds were as plentiful as dirt: the use value of diamonds would be low as would the price of the marginal diamond. As illustrated by its power to resolve the water-diamond paradox, marginal utility became the foundation of a new approach to understanding social action.

The labour theory of value, however, was not Menger’s only target in his *Principles*. He also was engaging the German Historical School, which was the dominant source of economic thinking throughout the German-speaking world. The German Historical School held that economic science is incapable of producing universal principles that apply across time and geographic space. Because of this, they held that the best that economists can do is to engage in the historical study of particular circumstances, with the hope of identifying some particular patterns that are specific to the context being studied.

In contrast to this view, Menger argued that universal economic laws apply across contexts, and he did so using marginal utility analysis as a foundation. Those in the German Historical School took issue with the claims by Menger and his colleagues—Eugen Böhm-Bawerk and Friedrich Wieser—about the possibility of universal theory and labeled them the “Austrian School” because of their academic positions at the University of Vienna. The label stuck.

Subsequent generations of Austrian scholars built on the works of Menger, Böhm-Bawerk, and Wieser. Following World War I, Ludwig von Mises and F.A. Hayek assumed the intellectual leadership of the Austrian School. Mises (*Socialism: An Economic and Sociological Analysis*, 1922) and Hayek (*Individualism and Economic Order*, 1948) engaged in an important debate with socialist thinkers over the best means of organizing economic activity to produce wealth. Hayek also engaged in a scholarly debate with John Maynard Keynes over macroeconomic issues and the viability of the capitalist system absent significant government involvement.

Beyond these two episodes, both thinkers made a number of significant contributions. Mises contributed to monetary and business cycle theory (*The Theory of Money and Credit*, 1912); economic methodology (*Epistemological Problems of Economics*, 1933; *Theory and History*, 1957; *The Ultimate Foundations of Economic Science*, 1962); the economics of government bureaucracies (*Bureaucracy*, 1944); and government interventionism (*A Critique of Interventionism*, 1929; *Omnipotent Government*, 1944). His magnum opus, *Human Action* (1949), systematically integrated much of this work in a comprehensive treatise on economic analysis.

Hayek contributed to monetary theory, capital theory, and business cycle theory (*Prices and Production*, 1931; *Monetary Theory and the Trade Cycle*, 1933; *The Pure Theory of Capital*, 1941); politics and political theory (*The Road to Serfdom*, 1944; *The Constitution of Liberty*, 1960); and legal theory (*Law, Legislation and Liberty*, three volumes, 1973–1979). In 1974, Hayek was awarded the Nobel Prize (The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel) for his work on monetary economics and business cycles.

Since the 1930s, no economists from any Austrian university have become leading figures in the Austrian School of economics. Following the awarding of the Nobel Prize to Hayek in 1974, there was a revival of interest in the ideas of the Austrian School. The major figures in this revival were Israel Kirzner, Murray Rothbard, and Ludwig Lachmann. These scholars continued to advance the ideas first set forth by Menger.

Kirzner made important contributions to capital theory (*An Essay on Capital*, 1966) and the theory of the market process and entrepreneurship (*Market Theory and the Price System*, 1963; *Competition and Entrepreneurship*, 1973; *Perception, Opportunity and Profit Studies in the Theory of Entrepreneurship*, 1985; *The Meaning of Market Process: Essays in the Development of Modern Austrian Economics*, 1992).

Rothbard made contributions to market structure theory, public goods theory, monetary theory, welfare economics, and the dynamics of government intervention into the market (*Man, Economy, and State*, 1962; *Power and Market: Government and the Economy*, 1970; *The Logic of Action*, 1997). He also engaged in scholarship applying Austrian business cycle theory (*The Panic of 1819: Reactions and Policies*, 1962; *America's Great Depression*, 1973).

Lachmann developed Austrian capital theory by incorporating subjective expectations and an appreciation for the heterogeneous nature of capital (*Capital and Its Structure*, 1956; *Capital, Expectations and the Market Process*, 1977). He also analyzed the role that institutions play in coordinating people in economic and social life (*The Legacy of Max Weber*, 1971) and the importance of microfoundations for macroeconomic analysis (*Macro-economic Thinking and the Market Economy*, 1973).

Subsequent generations of Austrian scholars have further developed and extended the insights of these thinkers. The purpose of this book is to present an overview of the key tenets of Austrian economics. In order to do so we draw upon and synthesize the insights from the aforementioned thinkers to present and discuss a set of eight topics that capture the core elements of Austrian economics.