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**Working Paper — Digitized Version**

## How far is Vienna from Chicago? An essay on the methodology of two schools of dogmatic liberalism

Kiel Working Paper, No. 209

**Provided in Cooperation with:**

Kiel Institute for the World Economy – Leibniz Center for Research on Global Economic Challenges

*Suggested Citation:* Paqué, Karl-Heinz (1984) : How far is Vienna from Chicago? An essay on the methodology of two schools of dogmatic liberalism, Kiel Working Paper, No. 209, Kiel Institute of World Economics (IfW), Kiel

This Version is available at:

<https://hdl.handle.net/10419/46781>

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# Kieler Arbeitspapiere Kiel Working Papers

Working Paper No. 209

How Far Is Vienna from Chicago?

An Essay on the Methodology  
of Two Schools of Dogmatic Liberalism

by

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ISSN 0342 - 0787

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Ag 4032 / 84  
Weltwirtschaft  
Kiel

September 1984

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## 1. Introduction: The Reemergence of Dogmatic Liberalism<sup>+</sup>

From the 1940's until the late 1960's, the unchallenged ruler of the intellectual kingdom of economics was a paradigm which - for lack of a better name - we shall simply call mainstream economics. Broadly speaking, mainstream economics may be described as a well-composed menu of quite distinct analytical tool-boxes which are eclectically used to solve the relevant problems at hand: neoclassical theory in the microeconomic domain, keynesian theory in the macroeconomic domain, and paretian welfare theory in the domain of normative economics.

For a long time, this menu gave economists the unique comfort of grasping the best of all worlds, i.e. to favour private enterprise, free trade, active stabilization policy, public regulation of industries, and extensions of the welfare state all at the same time, without running into too obvious inconsistencies. Not surprisingly, the ideological gospel of mainstream economics turned out to be a kind of pragmatic (or soft) liberalism which found its political counterpart in the rise of a social democratic (or populist) consensus in Europe and, after J.F. Kennedy, something like a Great Society consensus in the U.S.

Since the early seventies, the intellectual climate among economists has changed significantly. There is now a widespread disillusionment with the (still) ruling orthodoxy which can neither adequately explain the secular unemployment and the slack of growth in many countries of the western world, nor indicate any clearcut direction of reform; even worse, the failure of the system has been partly ascribed

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<sup>+</sup>This paper was presented at the seminar of Professor Giersch on the methodology of economics in June 1984. Thanks are due to the participants of this seminar, above all Patrick Tanghe, for providing new ideas on the subject.

to the advice of mainstream economists who had, by and large, warmly welcomed or at least not staunchly opposed the rise of mixed economies along neoclassical/keynesian/paretian lines.

Naturally, competing paradigms have gained ground. On the progressive/radical side of the political spectrum, the so-called post-keynesian school has evolved as a serious threat to the keynesian/neoclassical orthodoxy.<sup>1</sup> On the liberal-conservative side, a modern form of dogmatic liberalism has emerged as a challenge to mainstream economics and pragmatic liberalism. In this paper, we shall call an economist a dogmatic liberal whenever his economic policy advice is strongly biased towards preserving or establishing

- a maximum (negative) freedom of choice and action for consumers, producers and entrepreneurs,
- a minimum tax-, welfare-, and interventionist state, and
- a stable, rule-bound institutional framework (including the monetary regime) which is not subject to any discretionary political decisions.

Needless to emphasize, these criteria are too vague to yield an operational definition of the term in question; instead, they should be regarded as necessary conditions which have to be met before somebody can sensibly be called a dogmatic liberal.<sup>2</sup> Historically, dogmatic liberalism has its roots in the ideas and writings of the classical British liberals of the 18./19. centuries from Adam Smith to John Stuart Mill; institutionally it is today represented by the Mont Pélerin Society (M.P.S.).

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<sup>1</sup>We shall not discuss the ideas of this school any further. For a valuable survey of post-keynesian economics, see Davidson (1981).

<sup>2</sup>Note that a dogmatic liberal in our sense is not identical to a "libertarian" if we confine the latter term to those economists - like David Friedman (see D. Friedman 1973) - who take an anarcho-capitalist stance. The main difference is that anarcho-capitalists even deny the need for a publicly provided institutional framework.

Clearly, dogmatic liberalism cannot be consistently advocated without acceptance of the premises of methodological individualism, i.e. the view that all phenomena should be traced back to their foundation in individual behaviour.<sup>1</sup> Naturally, methodological individualism fosters a deep suspicion of statistical aggregates (such as national income) which can only be reduced to the decisions of individual agents under very restrictive assumptions. Thus dogmatic liberals use to share a strong reluctance to accept any genuine macroeconomic analysis as long as it is not firmly rooted in microeconomic theory. Not surprisingly, then, dogmatic liberals turn out to be anti-marxians and anti-keynesians not only with respect to their policy prescriptions, but also with respect to methodology.

On the other hand, the aversion to "holistic" macroeconomics goes along with a stronger reliance on microeconomic tools. In fact, with respect to microeconomics, dogmatic liberals usually share a fair amount of methodological optimism, i.e. a belief that microeconomics is an exceptionally powerful tool-box for analyzing social phenomena, even if these phenomena are not obviously reducible to a straightforward cost-benefit-calculus on the part of the acting agents; many dogmatic liberals would be inclined to regard microeconomics as the uncrowned queen of the social sciences.<sup>2</sup>

Apart from this common methodological basis the camp of dogmatic liberals is thoroughly divided on methodological

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<sup>1</sup>Note that the reverse does not necessarily hold: Anti-liberal policy proposals may well be derived from models of society which are free of holistic notions.

<sup>2</sup>Incidentally, this pro-micro-view has been institutionalized in the form of the Institute of Economic Affairs (I.E.A.), London, which was founded in 1957 with the declared intention of featuring and promoting microeconomic analysis. The I.E.A.'s board of directors and its advisory council are clearly dominated by dogmatic liberals.

issues. Two schools of thought stand out both in quantitative and in qualitative importance: The Austrian School and the Chicago School. A glance at the 1983 membership list of the M.P.S. reveals that adherents to either school make up a significant number of the most prominent M.P.S.-members (living and deceased): Economists inclined to Austrian ideas include James Buchanan, Gerold O'Driscoll jr., John Egger, Friedrich Hayek, William H. Hutt, Isreal Kirzner, Frank Knight (†), Ludwig Lachmann, S.C. Littlechild, Fritz Machlup (†), Ludwig von Mises (†), Murray Rothbard, Louis Spadaro, Leland Yeager; economists inclined to Chicago ideas include Armen Alchian, Gary Becker, Karl Brunner, Ronald Coase, Harold Demsetz, David Friedman, Milton Friedman, Jack Hirshleifer, William Landes, David Meiselman, Sam Peltzman, Pascal Salin, George Stigler, Roland Vaubel.

It is the purpose of this paper to illuminate the differences of these schools with respect to three fundamental methodological issues, namely

- the status of the postulate of economic rationality (section 3),
- the scope and relevance of equilibrium economics (section 4), and
- the purpose and limits of empirical research in economics (section 5).

We shall argue that - despite their obvious ideological similarities - the two schools find themselves close to the opposite ends of an imaginary continuum of economists ordered according to their methodological views on these issues. In each of the sections 3-5 we shall juxtapose and evaluate the basic views of both schools on the issue at hand. Naturally, our account of the school's positions will be a stylized one which cannot and should not do justice to the subtleties of any individual scholar's views. The paper will close with a few remarks on how two schools so vastly different on methodological grounds end up with almost identical policy



prescriptions, namely a fervent plea for laissez-faire.

The paper does not contain any original research; it is merely a summary of what the author thinks to be the distinguishing methodological features of both schools.

Before moving to the discussion of the separate methodological issues, let us briefly circumscribe what we mean by 'Austrian School' and 'Chicago School'.

## 2. What is Meant by 'Austrian School' and 'Chicago School'?

Under the label 'Austrian School', we bind together the views of those economists whose methodological stance displays a common intellectual debt to the two Viennese economists Carl Menger (especially his famous "Untersuchungen über die Methode der Sozialwissenschaften", 1883) and Friedrich Wieser.<sup>1</sup> The immediate intellectual fathers of the modern Austrian School are Ludwig von Mises, a pupil of Friedrich Wieser, and Friedrich von Hayek, himself a pupil of von Mises, both native Austrians who later emigrated to England and the U.S. respectively.<sup>2</sup> The center of the modern Austrian school has become New York University, with Israel Kirzner, Ludwig Lachmann, Murray Rothbard and, to a lesser extent, Fritz Machlup as their main representatives. Significantly Austrian ideas can also be found in the work of Lionel Robbins, Frank Knight (above all, Knight 1956) despite the fact that he was professor at the University of Chicago - and James Buchanan (especially Buchanan 1979).

<sup>1</sup> Note that the father of Austrian capital theory, Eugen von Böhm-Bawerk, is not included here; from today's point of view, his ideas on methodology, where neither distinctive nor particularly Austrian in spirit (see Hutchison, 1981, pp. 203 ff).

<sup>2</sup> Note that Joseph A. Schumpeter cannot be regarded as a genuine Austrian economist since his views on methodology do not reflect an Austrian heritage.

Under the label 'Chicago School' we summarize the common methodological views of the Economics Faculty at the University of Chicago in the post-Frank-Knight-era, beginning in the late 1940's after the appointment of Milton Friedman as full professor. The post-Frank-Knight-era may be subdivided into two periods, namely the era of Milton Friedman spanning from his famous methodological essay (Friedman 1953) to the views of the first generation of monetarists (including non-faculty members, such as Karl Brunner and Alan Meltzer), and the post-Friedman-era starting sometime in the early seventies with the maturation of a distinct Chicago view in microeconomics (Becker 1976, Stigler & Becker 1977) and the emergence of the new classical macroeconomics through the work of Robert Lucas, Thomas Sargent, Neil Wallace, and Robert Barro at the Universities of Chicago, Minnesota, and Rochester.

When dealing with either school, we shall focus on the most modern views; quite frequently, however, we shall have to flash back on the older ideas in order to recognize how the particular paradigm has evolved and what the likely future path of it will be.

### 3. The Status of the Rationality Postulate

There is a broad consensus among economists that, to yield any meaningful propositions, economic analysis has to be based on some rationality postulate, i.e. on some minimum requirement of internal consistency of individual agents' choices. In modern microeconomic textbooks, these requirements are embodied in the standard optimization procedures: all economic agents are assumed to maximize some objective function subject to some resource constraint. In particular, it is assumed that consumers maximize a utility function subject to a budget (or time) constraint, and producers maximize profits subject to a technology constraint.

While the need for a rationality postulate is beyond question, its logical (or empirical) status remains a matter of dispute, with Austrian and Chicago economists taking virtually opposite positions.

### 3.1. The Austrian View: Apriorism

The most lucid expression of the Austrian view is still to be found in Lionel Robbins' classical methodological essay:

"The propositions of economic theory, like all scientific theory, are obviously deductions from a series of postulates. And the chief of these postulates are all assumptions involving in some way simple and indisputable facts of experience relating to the way in which the scarcity of goods which is the subject matter of our science actually shows itself in the world of reality. The main postulate of the theory of value is the fact that individuals can arrange their preferences in an order, and in fact do so." (Robbins, 1935, p. 78 f)

And:

"... in the last analysis it reduces to this, that we can judge whether different possible experiences are of equivalent or greater or less importance to us. From this elementary fact of experience we can derive the idea of the substitutability of different goods, of the demand for one good in terms of another, of an equilibrium distribution of goods between different uses, of equilibrium of exchange and the formation of prices." (Robbins, 1935, p. 75)

Thus the assumption of economic rationality is considered to be true by introspection, i.e. by the simple fact that, as human beings, we are able to recognize and verify that all our fellow human beings do value goods according to some implicit (and consistent) preference ordering. This position is usually called apriorism, a term which is only correctly applied if we define the act of introspection not as a part of experience (a posteriori), but as an act of non-empirical insight or understanding. In fact, the Austrian School adheres to the so-called Verstehen-doctrine which postulates a category of understanding outside the range of

(empirical) experience. Again, this is best brought out by Lionel Robbins when comparing the methods of social and natural sciences:

"In Economics, ... , the ultimate constituents of our fundamental generalisations are known to us by immediate acquaintance. In the natural sciences they are known only inferentially. There is much less reason to doubt the counterpart in reality of the assumptions of individual preferences than that of the assumption of the election. It is true that we deduce much from definitions. But it is not true that the definitions are arbitrary." (Robbins, 1935, p. 105)

As this quotation indicates, apriorism along Austrian lines leads straight on to a methodological demarcation line between natural and social sciences, with the latter having recourse to an additional reliable source of knowledge, "Verstehen", which is not open to the natural sciences; in fact, the category of "Verstehen" figures as the boundary between natural and social sciences.<sup>1</sup>

Austrian apriorism is most elaborated, albeit hardly clarified, in the somewhat esoteric writings of Ludwig von Mises who made it the basis of a new science called praxeology, i.e. a general theory of human action of which economics is only one branch.<sup>2</sup> In praxeology, human action is defined as

"purposive conduct ..., i.e. not simply behaviour, but behaviour begot by judgements of value, aiming at a definite end and guided by ideas concerning the suitability or unsuitability of definite means." (v. Mises 1977, p. 34)

Translated into ordinary economic language, this statement should come close to a standard definition of economic rationality. Again, the apriori truth of economic rationality (in Misesian terms: purposeful action) is gained by introspection:

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<sup>1</sup>This idea goes back to Carl Menger (1883), p. 157.

<sup>2</sup>v. Mises (1949), p. 3.

"The starting point of all praxeological thinking is not arbitrary chosen axioms, but a self-evident proposition, fully, clearly and necessarily present in every human mind" (v. Mises, 1977, p. 4), and:

"What we know about our own actions and about those of other people is conditioned by our familiarity with the category of action that we owe to a process of self-examination and introspection as well as of understanding of other peoples' conduct. To question this insight is no less impossible than to question the fact that we are alive". (v. Mises, 1977, p. 71)

Needless to emphasize, such a radical apriorist position implies a fervent rejection of any empirical approach to the rationality postulate:

"The ultimate yardstick of an economic theorem's correctness or incorrectness is solely reason unaided by experience." (v. Mises, 1949, p. 858)

Misean praxeology figures as the most extremist view among Austrians. Already von Hayek takes a much more moderate position on introspection and apriorism. This comes out most clearly in his series of papers "Scientism and the Study of Society" (1942-44): While he endorses introspection as a valuable starting-point for any analysis in the social sciences (Hayek, 1942, p. 286 f), he does so primarily to defend a social science which is exclusively concerned with subjective phenomena against a "scientistic" approach which refuses to accept subjective values as the ultimate objects of inquiry. Thus interpreted, his plea for introspection boils down to a mere case for subjectivism and not a case for apriorism. In fact, Popper (1979, pp. 107 ff) rightly refuses to accept Hayek's line of reasoning as a case for methodological dualism since - once accepted - a purely subjectivist social science may treat "values" just as physics treats, say, elections; incidentally, this is precisely the path modern (mainstream) microeconomics and general equilibrium theory have taken.<sup>1</sup>

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<sup>1</sup> Von Hayek has apparently accepted Popper's interpretation of his views. He now stresses that "the differences between the two groups of disciplines have... been greatly narrowed" (Hayek 1967, p. VIII). Hutchison (1981) goes as far as to distinguish between Hayek I (the pre-Popperian) and Hayek II (the Popperian).

Latter-day Austrians - with the notable exceptions of Murray Rothbard (Rothbard 1957, 1976) and Mario Rizzo (Rizzo 1978) - appear to be somewhat lukewarm about the strong aprioristic claims of (Misean) praxeology. While the validity of the concept of introspection and purposeful action is never questioned (see i.a. Kirzner 1978), there is no significant further elaboration on the Misesian idea of rationality, and topics related to it are rare on the agendas of the latest conferences on Austrian economics (see e.g. Dolan (ed.), 1976; Spadaro (ed.), 1978; Kirzner (ed.), 1982). A recent survey on Austrian methodology suggests that apriorism should not be considered as a distinguishing characteristic of the Austrian School (Egger 1978, p. 19 f). Another recent survey by one of the most prominent modern Austrian scholars does not even mention it in a list of "Austrian features" (Kirzner 1981, pp. 115 ff).

### 3.2. The Chicago View: Instrumentalism

The Chicago view on the rationality postulate and on assumptions in economic theory in general was first advanced by Milton Friedman:

"... the relevant question to ask about the assumptions of a theory is not whether they are descriptively "realistic", for they never are, but whether they are sufficiently good approximations for the purpose in hand. And this question can be answered only by seeing whether the theory works which means whether it yields sufficiently accurate predictions." (Friedman 1953, p. 15)

Thus Friedman - and the Chicago School in general - regard the assumption of rationality as a mere working hypothesis to generate predictions which can be set against empirical observations; testing a working hypothesis "directly", i.e. without any recourse to the predictions of a theory derived from it, is a futile, if not logically impossible exercise. Note that, in Friedman's language, the term "prediction" is

very broad: It covers ex-ante and ex-post forecasts as well as unconditional and conditional forecasts, i.e. - in the language of econometric time series analysis - all predictions of a dependent variable beyond the period of parameter estimation, no matter whether the values for all explanatory variables are known with certainty or not. (Friedman 1953, p. 9)

Naturally, Chicago economists consider introspection as empirically meaningless since what we "understand" (in the Austrian sense) of ourselves and of other human beings is of no more than incidental help for constructing theories with falsifiable predictions. In addition, economic agents - consumers as well as businessmen - may be quite unable to verbally describe or even to consciously recognize the rational pattern behind their economic behaviour, i.e. from the viewpoint of the observing economist, they may merely act as if they were consistently rational optimizers. In the case of businessmen, this as-if-principle can be rationalized by a kind of Darwinian survival argument going back to a paper by Armen Alchian (Alchian 1950)<sup>1</sup>: In the long-run, only those businessmen using least-cost production techniques will survive in the competitive struggle so that those remaining in business can confidently be assumed to maximize profits.<sup>2</sup>

Evidently, there is no scope for a methodological dualism in this view since theories are considered as mere instruments in all sciences. In fact, Milton Friedman (and other Chicago economists) are highly optimistic with respect to the convergence of methods: While Friedman recognizes some gradual differences between physical and social sciences - above all the impossibility of (almost) completely controlled experiments in the latter -, he does not see any essential methodological rift between them. (Friedman 1953, pp. 4 ff)

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<sup>1</sup>See also Friedman (1953), pp. 22 f; Becker (1962), p. 164.

<sup>2</sup>An analogous argument applies to consumers: those who persistently bend down to erratic impulses or inertia may not be able to reach any self-imposed target level of consumption and will not be fit for any long-term struggle for survival. Severe mental illness may be a good case in point.

While the Friedman essay has become the target of much well-pointed criticism on logical grounds<sup>1</sup>, its endorsement of Chicago-style-instrumentalism still stands: the assumption of rationality as a mere tool to generate meaningful predictions, or, even more concisely, a sufficient, but not a necessary condition for deducing the propositions of economic theory.<sup>2</sup>

This instrumentalist view has found a striking theoretical corroboration through a much neglected paper by another Chicago economist (Becker 1962). He showed that the fundamental law of microeconomics - income compensated demand curves for a single product are downward sloping - can be derived without any recourse to the assumption of individual rationality.

His main point is straightforward: Assuming that any single consumer acts irrationally (or better: arationally), i.e. given his budget constraint, he chooses his consumption bundle at random<sup>3</sup>, the average consumer (or precisely: the consumer with mean consumption of each good and mean income) will find himself very close to the middle of his budget line since the law of large numbers ensures that "extreme" choices cancel out up to a small residuum. Any income compensated relative price changes mean a rotation of the budget plane in goods space, i.e. a change in the relative scarcity of at least some goods; while any individual consumer continues

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<sup>1</sup>I.a. the outstanding critiques by Nagel (1963) and Melitz (1965). Following Melitz, I see the most striking ambiguity in Friedman's usage of the terms "indirect" vs. "direct" testing. Friedman apparently overlooks the fact that even a "direct" test such as asking businessmen whether they maximize profits is not direct in the (logical) sense that no auxiliary assumptions are involved.

<sup>2</sup>This is the main message of Boland (1979).

<sup>3</sup>Becker also proves his case for an extreme sort of inert behaviour, for arational producers, and for technically inefficient random choice.



to distribute his (unchanged) income randomly at the new relative prices, the average consumer (and thus the whole economy of arational consumers) will almost certainly consume more of the "cheaper" goods and less of the "more expensive" goods than before, simply because he remains very close to the middle of his resource constraint and thus cannot "escape" its rotation.

Clearly, then, individual rationality is a sufficient, but not a necessary condition for aggregate consumer demand to behave in the way the fundamental law of microeconomics predicts.<sup>1,2</sup> The Chicago-type conclusions are thoroughly instrumentalist: We could do without the assumption of individual rationality; on the other hand, we can be all the more confident in the assumption of individual rationality since, even if it is not met, the predictions made on basis of it still hold, and it is only the predictions of microeconomics (the fundamental law of demand) which are of interest. Not surprisingly, then, Chicago economists went on to base their theories on the rationality postulate.

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<sup>1</sup>Of course, the Becker-type arationality is itself an extreme case, but as long as nobody has supplied a more "realistic" model of a rational/irrational mixture, there is no point in questioning the power of Becker's results. The burden of proof now lies with the critics.

<sup>2</sup>Kirzner (1962) has criticized Becker for having neglected the equilibrium process of price formation which may well require at least some rationality on the part of the acting agents. While Kirzner's argument is correct in its own "Austrian" right, it mistakes the scope of Becker's analysis: Neoclassical microeconomics does not have a theory of the process of price formation and neither has Becker. Thus Kirzner's critique of Becker's analysis is much more a critique of neoclassical theory in general (see section 4.1.).

### 3.3. Evaluation

From a philosopher's perspective, the gap between the two schools' views on economic rationality is fundamental: Introspective apriorism and instrumentalism are and remain irreconcilable antitheses. To the economist, however, this gap may not matter much as long as he cannot discriminate between an Austrian- and a Chicago-type research agenda on basis of the rationality postulate alone. In this respect, the only real programmatic difference appears to be that instrumentalism does and introspective apriorism does not call rational all non-human or mere reflexive behaviour which turns out to be formally compatible with constrained maximization of some objective function; clearly, this is a practically irrelevant difference because the scope of economics is restricted to non-reflexive human behaviour anyway. On the other hand, there is even a common programmatic ground of the two schools: Both reject any behaviourist attempt to test the assumption of rationality in an experimental setting<sup>1</sup>; both schools have great confidence in the power and fruitfulness of the rationality postulate (and microeconomics in general) and go on to make extensive use of it. In any event, introspective apriorism is moving to the background of modern Austrian thinking, and thus we may dare the forecast that the point for sheer dogmatic debates between apriorists and instrumentalists (or for that matter: empiricists) will gradually fade away; today, a controversy such as Hutchison versus Machlup in the 1950's<sup>2</sup> would appear sterile and anachronistic.

We conclude that, at least from the economist's viewpoint, it is not the status of the rationality postulate which can give us a clue to the most relevant paradigmatic rift between Vienna and Chicago. As we shall see in the next sec-

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<sup>1</sup>See Caldwell (1982), pp. 149 ff.

<sup>2</sup>For a valuable discussion of this famous controversy, see Caldwell (1982), pp. 139 ff.

tion, the scope and relevance of equilibrium economics scores much better on this account.

#### 4. The Scope and Relevance of Equilibrium Economics

Standard economic textbooks define the term "general equilibrium"<sup>1</sup> as the state of an economy where no rational decision-maker has an incentive to change the allocation of the resources at his disposal. In terms of demand and supply notions, general equilibrium is the state of an economy where the system of relative prices of all commodities (including money) is such that there is no excess demand (excess supply) in any commodity market (including the money market). Note, that these standard definitions refer to a static equilibrium, with all decisions being taken at one point in time. This is true even if the economy contains future ("dated") goods which enter the economic agents' calculus at expected prices and appropriately discounted values; in that case, the decisions over the future consumption and production pattern are still taken simultaneously so that we must again speak of a static equilibrium.

While the need for some equilibrium concept in economics is beyond question, the theoretical and empirical relevance of static equilibria as defined above are a matter of dispute. Again, the Austrian and the Chicago School take virtually opposite views on this matter.

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<sup>1</sup>In the following, we shall take general and not partial equilibrium as the reference notion simply because it is the most sophisticated concept of equilibrium theorizing. In any event, the points of disagreement between Austrian and Chicago economists do not depend on the distinction between these two equilibrium concepts.

#### 4.1. The Austrian View: Process Towards Equilibrium

Austrians are highly critical of the exclusive preoccupation of mainstream economics with static equilibria. Their central line of reasoning goes back to the seminal paper by F.A. von Hayek "Economics and Knowledge" (1937).<sup>1</sup> He argues that the realization of a static equilibrium price vector at any point in time does not ensure that the expectations on which individual economic agents base their plans and decisions, are mutually compatible and/or borne out by the facts; within the passage of time, the static equilibrium may be - and most probably will be - endogenously disturbed by agents correcting their prior expectational errors and reallocating their resources accordingly.

Hence there is a second, and in Hayek's view, much more important concept of equilibrium defined as a state of complete compatibility of ex-ante plans.<sup>2</sup> In Hayek's words:

"... we can speak of a state of equilibrium at a point in time - but it means only that the different plans which the individuals composing it have made for action in time are mutually compatible. And equilibrium will continue, once it exists, so long as the external data correspond to the common expectations of all the members of the society."  
(v. Hayek, 1937, p. 41)

Of course, this Hayekian dynamic equilibrium describes a situation which will hardly ever be met in the real world. For Hayek and his Austrian followers it merely serves as the fictitious endstate to which an economy is perpetually moving without ever reaching it.

"... the only justification for [our concern with the fictitious state of equilibrium] is the supposed existence of a tendency toward equilibrium... [which] can hardly mean

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<sup>1</sup>Littlechild (1982) shows that the critique of static equilibrium analysis runs somewhat parallel in the work of von Mises and von Hayek. We shall exclusively focus on von Hayek's arguments since they have become the kernel of modern Austrian thinking.

<sup>2</sup>Egger (1976), p. 21.

anything but that, under certain conditions, the knowledge and intentions of the different members of society are supposed to come more and more into agreement, or ... that the expectations of the people and particularly of the entrepreneurs will become more and more correct." (v. Hayek, 1937, pp. 44 f)

The quoted passage points to the core of the Austrian deviation from mainstream equilibrium economics: While the latter is exclusively concerned with analyzing a static equilibrium or a timeless succession of static equilibria ("comparative statics"), Austrian economics focuses on the process of moving towards a dynamic equilibrium in the Hayekian sense. The market and the whole system of interdependent markets are not viewed as timeless adjustment mechanisms, but as social institutions which generate new information and thus allow market participants to gradually improve their knowledge, correct errors and move to a more satisfactory economic state of affairs. In fact, the market as a perpetual process of discovery has been a recurrent theme in von Hayek's writings.<sup>1</sup>

But what sort of errors are to be corrected and what sort of discoveries to be made? Or, to put it differently: In what sense are economic agents assumed to learn? These are the questions which modern Austrians, above all Israel Kirzner<sup>2</sup>, address. Clearly, the Austrian process of learning must be outside the realm of mainstream equilibrium theory:

"If, say, imperfection in knowledge resulted from deliberate unwillingness to incur the costs of search, it is not clear how we can be confident that, in the course of the market process such unwillingness will invariably dissipate, or that the necessary costs of search will invariably fall." (Kirzner, 1978, pp. 69 f).

To account for learning in a dynamic sense, Kirzner develops a theory of genuine error which contains the germ for a

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<sup>1</sup> See i.a. von Hayek (1945, 1946, 1968).

<sup>2</sup> See e.g. Kirzner (1973).

definition of entrepreneurship. To understand his main points, it is worthwhile to quote him at length:

"Surely our justification for asserting the existence of a tendency for the prices of identical articles to converge rests on our understanding that the imperfection of knowledge (on which one must rely in order to account for the initial multiplicity of prices) reflects, at least in part, sheer error. We understand ... that the initial imperfection in knowledge is to be attributed, not to lack of some needed resource, but to failure to notice opportunities ready at hand. The multiplicity of prices represented opportunities for pure entrepreneurial profit; that such multiplicity existed, means that many market participants (those who sold at the lower prices and those who bought at the higher prices) simply overlooked these opportunities. Since the opportunities were left unexploited, not because of unavailable needed resources, but because they were simply not noticed, we understand that, as time passes, the lure of available pure profits can be counted upon to alert at least some market participants to the existence of these opportunities. The law of indifference follows from our recognition that error exists, that it consists in available opportunities being overlooked, and that the market process is a process of the systematic discovery and correction of true error. The hypothetical state of equilibrium, it emerges, consists not so much in the perfection of knowledge (since costs of acquiring knowledge may well justify an equilibrium state of ignorance) as in the hypothetical absence of error." (Kirzner, 1978, p. 70)

Hence, in contrast to mainstream microeconomics, Austrian microeconomics explicitly allows for genuine errors in the sense of unexploited profit opportunities; accordingly, the entrepreneur is broadly defined as any economic agent (consumer or businessman) who is alert enough to discern and correct errors and inefficiencies, be it through mere arbitrage or through (Schumpeterian) innovative activities such as introducing new productive processes or new products.<sup>1</sup> Of course, neo-classical economists may define entrepreneurial alertness

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<sup>1</sup>In this sense the Schumpeterian innovator may be formally subsumed under the modern Austrians' broad concept of entrepreneurship. Needless to say, such a merely formal interpretation misses the spirit of the writings of Schumpeter who attached a much deeper sociological content to the concept of entrepreneurship. See Schumpeter (1912, 1943).

as just another economic resource and thus integrate it into static optimization procedures; to Austrian economists, such an approach is counterproductive because it sweeps away the most fertile ground for research:

"... alertness cannot be treated as a resource with respect to which decisions are made on how to use it, since, in order to make such a decision with respect to a resource one must already have been alert to its availability. 'Alertness' thus appears to possess a primordial role in the decision making which makes unhelpful for it to be treated, in the analysis of decisions, 'as any other resource'." (Kirzner, 1978, pp. 68 f).

In summary, Austrians place entrepreneurship outside the static equilibrium framework; hence Austrian economics is genuine disequilibrium theory in the sense that the focus of research is turned to the simultaneous learning process of economic agents and the spontaneous order resulting therefrom. In this respect, Austrians find themselves rather close to the modern post-keynesian school, above all to the work of G.S.L. Shackle<sup>1</sup>, which also regards information generating processes as the very essence of economics.

Of course, the dynamic nature of Austrian economics again raises the question of methodological dualism between natural and social sciences. An Austrian research programme cannot simply apply the methods of physics since the acquisition and processing of knowledge is a specifically human activity to which the methodology of physics should not be well suited. Instead an evolutionary approach borrowed from biology may better fit Austrian research needs.

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<sup>1</sup>See Shackle (1972).

#### 4.2. The Chicago View: Tight Prior Equilibrium

Chicago economists are inclined to see the world through the glasses of tight prior equilibrium<sup>1</sup>, i.e. they suggest that what we observe in the real world is, by and large, an economy in long-run equilibrium. In particular they regard

- prices at which individuals currently agree to transact as market clearing prices, i.e. as prices which are consistent with constrained optimization of all decision makers,
- marginal products and compensation of identical resources as to be approximately equal in all uses,
- most individuals as to be price takers, and
- information bearing on prices and quantities as to be acquired at an economically optimal level.

Chicago economists would not deny that there are many diverse factors which may disturb the postulated state of long-run equilibrium; however, they would also make the claim that these factors are either of minor empirical importance - and thus do not require more than some ad-hoc theorizing or case studying -, or they are rather easily incorporated into the main body of tight prior equilibrium analysis. According to the typical Chicago judgement, monopolies and other market failures belong to the first category while price stickiness, government intervention and all sorts of random disturbances belong to the more important second category. Price stickiness is explained through the existence of long-term contracts which can be rationalized as expected value maximization on the part of private economic agents; government intervention is accounted for by equilibrium models of compe-

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<sup>1</sup>The following summary of the Chicago position partly follows the excellent survey by Melvin Reder (Reder, 1982, pp. 11 ff).



tition among pressure groups for political influence<sup>1</sup> which eventually will have to supplement the conventional economic models to yield a general politico-economic equilibrium theory; random disturbances require stochastic versions of the general equilibrium models which are expected to reveal basically the same economic properties as their deterministic counterparts.<sup>2</sup>

Hence, whenever a Chicago economist approaches some economic, social or political phenomenon to be explained, he invariably starts out from the assumption that he observes a state of (prior) equilibrium, with all profitable opportunities seized and no further adjustments required. He does not tautologically deny the existence of any other state, but he does shift the burden of proof to those who pretend to recognize some state of disequilibrium in the real world.

While tight prior equilibrium has always been a major ingredient of what is today called the Chicago school, the scope of equilibrium analysis has significantly widened in recent years. In fact, there is a marked gap between the older Chicago School around Milton Friedman who made extensive use of the Marshallian toolbox of partial equilibrium analysis, and the younger school around Gary Becker in microeconomics and Robert Lucas/Thomas Sargent in macroeconomics who devote most of their efforts to Walrasian general equilibrium problems.<sup>3</sup> An obvious example for this difference can be found in the treatment of institutional rigidities: While Friedman was still ready to accept price stickiness as an exogenous constraint without asking whether it was, in the last resort, compatible with rationality and overall tight prior equilibrium, the modern Chicago School

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<sup>1</sup>See Becker (1983). This line of research is still in its infancy.

<sup>2</sup>See Reder (1982), pp. 11 f.

<sup>3</sup>See the well-pointed argument of Hoover (1984).

feels obliged to 'go behind any rigidity' and to ask how it can be reconciled with successful constrained optimization on the part of all economic (and even political) agents.<sup>1</sup> The usual procedures to accomplish this reconciliation are to redefine the variables and/or to add new variables in the equilibrium model; so far, these new variables have always been either new objects of choice or new resource constraints which could help to account for observed anomalies.

To see how this research strategy works in practice, we shall briefly sketch the central ideas of two modern branches of Chicago economics: Becker's new theory of consumer behaviour and the new classical macroeconomics.

#### 4.2.1. Becker's New Theory of Consumer Behaviour<sup>2</sup>

The starting point for the modern Chicago reformulation of microeconomics is the limited scope of traditional demand theory. Whenever some observed phenomenon appears to be incompatible with constrained optimization and prior equilibrium of all economic agents, mainstream microeconomists are inclined to explain it by resorting to changes in tastes or outright irrationality; of course, this catch-all strategy does not only protect the theory against falsification, but it also closes the formal apparatus in a way which is particularly fruitless for economists since tastes and irrationality are themselves outside the realm of economics. The only way to lock this analytical emergency exit is to assume, as Becker does, that all human beings are (or behave as if they were) successful rational optimizers, and that tastes are the same for all human beings at all times. As empirical propositions, these are bold claims, but they must be made if a thoroughly economic approach to human behaviour

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<sup>1</sup>In this sense, the Chicago view described at the beginning of section 4.2. is the modern one.

<sup>2</sup>This subsection draws heavily on Becker & Michael (1973), the introduction to Becker (1976, 1) and Stigler & Becker (1977).

- and not a theory amalgam with some economic and some catch-all variables - is to be achieved.

Of course, tastes in the common sense meaning of the term, i.e. tastes for goods available in the market, are manifestly not identical across individuals so that the traditional formulation of demand theory cannot do the required job. Instead, Becker develops a new theory which he aptly calls the Household Production Function Approach<sup>1</sup>: He assumes that consumers gain utility out of commodities which they themselves produce via a household production function, and that goods available in the market are only one set of factors entering this production function, along with the household's time (i.e. the time left for consumption) and some other variables representing the environment in which production takes place. Hence the act of consumption is conceptually split off into buying market goods (subject to an income constraint), and transforming these goods along with other production inputs (above all time) into final commodities to be consumed. These final commodities are presumed to be just a few rather abstract entities such as nutrition, entertainment, and social distinction. It is only the preferences for these basic commodities which are assumed to be equal for all individuals at all times; thus, all differences in the consumption pattern of market goods must be reducible to the genuine economic observation that "... households respond to changes in the prices and productivities of factors, to changes in the relative shadow prices of commodities and to changes in their full real income as they attempt to minimize their cost of production and to maximize their utility." (Becker & Michael 1973 , p. 139).

A few examples may clarify how Becker's new microeconomics works in practice.

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<sup>1</sup>Becker & Michael (1973), p. 134. For a formal exposition of this approach, see Becker & Michael (1973), pp. 134 ff.

While the traditional theory cannot explain the simple fact that cross-price-elasticities differ between different pairs of market goods, Becker's theory can: As market goods are mere factors used in the production of basic commodities, we shall expect two market goods to have a relatively high cross-price-elasticity whenever they are used as substitutes in the same household production process (e.g. beef and chicken in the production of nutrition versus pianos in the production of entertainment).<sup>1</sup>

Traditional theory interprets fashions and fads as changes in tastes which cannot satisfactorily be explained by mere economic factors, even with the ad-hoc-support of 'band-wagon effects'; Becker's theory regards them as the necessarily fluctuating expression of a constant taste for social distinction which is periodically produced with different market goods simply because some 'newness' is technologically required to hold up the marginal productivities of the factors in use.<sup>2</sup>

Traditional theory cannot explain the existence of altruism or charity except in the non-economic sense that, to some extent, economic agents have an odd preference for helping others.<sup>3</sup> Becker, in turn, accounts for charity through his 'rotten-kid-theorem' which states that economic agents behave altruistically whenever the expected returns from such seemingly unselfish behaviour exceed its costs; not surprisingly, the returns depend on how strong the social interdependence between donor and donee happens to be so that a high level of altruism can be predicted to prevail in

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<sup>1</sup>Becker & Michael (1973), p. 140.

<sup>2</sup>Stigler & Becker (1977), pp. 87 ff.

<sup>3</sup>The public good aspects of these tastes form the core of the non-Chicago (mainstream) economics of charity.

small social units such as the family.<sup>1</sup>

In summary, Becker's theory is the microeconomic approach to human behaviour par excellence: It excludes - probably to the largest possible logical degree - all non-economic factors. In microeconomics, it is the peak of what can be reached with a firm belief in the power of equilibrium analysis.

#### 4.2.2. The New Classical Macroeconomics<sup>2</sup>

A similar peak has been reached in the macroeconomic domain with the elaboration of the new classical macroeconomics. The self-set task of the new classicals runs parallel to Becker's: They want to explain the observed phenomena, above all the business cycle, within a general equilibrium setting based on the three Chicago-style assumptions that

- all decisions of economic agents are based on real, not nominal factors,
- all economic agents are, to the limits of their information, consistent and successful optimizers, i.e. they are continuously in equilibrium, and
- economic agents make no systematic errors in evaluating their economic environment, i.e. they hold rational expectations.<sup>3</sup>

To build a theory of the business cycle on these three tenants is considered to be the prime, if not the only task of macroeconomics. In Lucas' words:

"... one would like a theory which accounts for the observed movements in quantities (employment, consumption, investment) as an optimizing response to observed movements in prices."  
(Lucas, 1976, p. 222)

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<sup>1</sup>For the details of this model, see Becker (1976, 2), p. 284.

<sup>2</sup>This brief subsection draws on Hoover (1984) and Lucas (1976).

<sup>3</sup>See Hoover (1984), p. 59.

Again, any resort to irrationality, inefficiency or disequilibria is regarded as an emergency exist which should be closed to economists; in this sense, keynesian macrotheory was a fatal analytical error which, for more than thirty years, detracted economists from their real task of elaborating a consistent general equilibrium model with no place for exogenous, i.e. unexplained, price rigidities.

#### 4.2.3. Evaluation

The distance between Vienna and Chicago with respect to the scope and relevance of equilibrium economics is large and important, not only to the philosophically oriented methodologist, but also to the practically minded economist. It is the wide gap between two schools which have for years moved into opposite paradigmatic directions.

For their own purposes, the Austrians have redefined the scope of economics. In Austrian eyes, economics is not the science of choice, but the science of action, or, more precisely, the science of adjustment to a hypothetical state of informational equilibrium. The central question for economics then is whether, how, and how quickly individuals become successful entrepreneurs by discerning past errors and inefficiencies and correcting their resource allocation accordingly. The answers to these questions may bear on the ageless controversy over the endogeneous stability of the private sector, i.e. the question whether private economic agents learn fast enough to prevent the economy from drifting into serious crisis after some unanticipated exogeneous shock.

Unfortunately, Austrian economics at its present stage of development looks very much like a 'programme without research'. While the fundamental points of departure from

mainstream economics have been repeatedly formulated<sup>1</sup>, there has so far been no serious attempt to operationalize the ideas in a full scale empirical research project. The Austrian reluctance to plunge into research on informational processes is probably due to two facts: the traditional Austrian scepticism concerning empirical research, and the nature of the required research project itself which would have to fall into the no man's land between social psychology, sociology, and economics. Until the Austrians overcome this reluctance, their programme is stuck.

In the form of tight prior equilibrium theorizing, the Chicago School has pushed traditional economics (i.e. the science of choice) up to the limits of its potential. A single analytical tool, constrained optimization, is presumed to explain virtually everything, from altruism down to the business cycle.

A clue to this striking performance may lie in a logical peculiarity of the Chicago-type-theories: All explanatory variables which are introduced to drive the machinery of constrained optimization (such as basic wants, shadow prices, costly information), and all phenomena which are supposed to be explained by this machinery are exclusively defined in terms of the theory itself; there is no independent specification of the terms in question, neither through another theory nor through pre-theoretical common sense.<sup>2</sup>

With respect to the explanatory variables, this procedure - albeit vulnerable on the grounds of the philosophy of

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<sup>1</sup>See i.a. the three conference volumes Dolan (ed., 1976), Spadaro (ed., 1978), and Kirzner (ed., 1982).

<sup>2</sup>Of course, the meaning of the terms in common sense and in the theory may, by accident, coincide. Still then, it is only the theoretical meaning which counts.

science<sup>1</sup> - is in line with instrumentalist philosophy to which, by and large, Chicago economists still subscribe. With respect to the phenomena to be explained, however, the procedure is simply curious. Take Stigler & Becker's account of fashions and fads: By defining them as "short episodes or cycles in the consumption habits of people" (Stigler & Becker, 1977, p. 87), they eliminate any common sense or sociological meaning of genuine waves in tastes and values which may even be "felt" if people cannot materialize them (such as a fashion of western clothing in the Soviet Union). Or take Becker's account of altruism: Common sense and philosophical usage point to a definition in terms of genuine unselfishness, but Becker must define it in terms of mere observed behaviour. Or take Lucas' important critique of the concept of (keynesian) involuntary unemployment:

"Sentences like 'more labour, as a rule, would be forthcoming at the existing money wage if it were demanded' are used again and again, as though, from the point of view of a jobless worker, it is unambiguous what is meant by 'the existing money wage'. Unless we define an individual's wage rate as the price someone else is willing to pay him for his labor (in which case Keynes' assertion above is defined to be false), what is it? The wage at which he would like to work more hours? Then it is true by definition and equally empty." (Lucas 1978, p. 242)

Lucas is right: In a world of rational optimizers, there is no such thing as involuntary unemployment, simply because there cannot be anything involuntary. (If, e.g., non-unionized workers remain unemployed simply because they do not dare to undercut de-facto minimum wages set by unions, they voluntarily accept a constraint on their choice set; of course, they may not be "happy" - whatever that means -, but they behave rationally.) And after getting rid of involuntary unemployment, Lucas proceeds to analyze the phenomenon of business and employment cycles on the basis of tight prior equilibrium theory, just as Becker does with fashions, fads and altruism.

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<sup>1</sup>For a thorough discussion of this point, see Rosenberg (1979), pp. 522.



Clearly, the whole procedure has a tautological flavour, and both scholars apparently recognize this as is indicated by Becker's plea for a useful closed system:

"Of course, postulating the existence of costs closes or 'completes' the economic approach in the same, almost tautological, way that postulating the existence of (sometimes unobserved) uses of energy completes the energy system, and preserves the law of the conservation of energy... The critical question is whether a system is completed in a useful way: the important theorems derived from the economic approach indicate that it has been completed in a way that yields much more than a bundle of empty tautologies in good part because the assumption of stable preferences provides a foundation for predicting the responses to various changes." (Becker 1976, 1, p. 7),

and Lucas' plea for a good analogue system:

"... a theory is not a collection of assertions about the behaviour of the actual economy but rather an explicit set of instructions for building a parallel or analogue system - a mechanical, imitation economy. A 'good' model, from this point of view, will not be exactly more 'real' than a poor one, but will provide better imitations. Of course, what one means by a 'better imitation' will depend on the particular question to which one wishes answers." (Lucas, 1980, p. 272)

Thus the modern Chicago School has come a long way from its positivist tenants in Friedman's methodology to its latest elaboration of axiomatic systems which satisfy some vague criteria of usefulness and goodness. Of course, predictive power still figures prominently in Chicago rhetoric, but the research emphasis has clearly shifted towards preserving the consistency of a theoretical construction solely based on overall equilibrium. In this sense, Chicago economics has become a mere interpretation rather than a theory of the world; or more polemically: an exercise in hermeneutics rather than a genuine effort to explain observed phenomena. Whether this interpretation yields any insight in a meta-economic sense is simply beyond the concern of Chicago economists.

This "lack of meta-economic concern" appears to be a central problem for non-Chicagoans when they try to evaluate some extreme Chicago-style research programmes: for Blaug (Blaug 1980,

240 ff), e.g., the common sense absurdity of the terms used in Becker's economics of the family is reason enough to discard the theory as a trivial ex-post rationalization of observed phenomena. Of course, such a judgement shifts the problem to the question whether and to what extent common sense can really help us to evaluate economic theories. Or, more fundamentally: What is the point in an observed phenomenon like, say, marriage which makes it unaccessible to economic analysis? Some criteria like "explicitness" of the rational calculus, i.e. some business-like attitude on the part of the acting agents may be indispensable if we want to draw a sensible line between economic and non-economic fields. If non-Chicagoans are not able to develop a set of criteria for this line, there will be no point in criticizing the methodological imperialism of Chicago economics.

## 5. The Purpose and Limits of Empirical Research

Given the attitude of the two schools with respect to equilibrium economics, their views on empirical research, notably econometrics, can hardly be regarded as independent methodological tenants. This is why we shall be brief on this subject.

### 5.1. The Austrian School: Vague Scepticism

As econometrics at its present stage of development could be defined as the estimation of parameters of structural or reduced-form equations which are derived from static equilibrium theory<sup>1</sup>, we should expect Austrians to reject econometrics on the ground that mainstream equilibrium economics

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<sup>1</sup>This ad-hoc definition excludes statistical time series analysis to the extent that it contains no terms derived from economic theory.

itself is deficient: estimating structural parameters of an economy which is supposed to be in a "perpetual Austrian disequilibrium process" is a futile exercise, simply because, in such an economy, there are no static, time invariant relations.

In fact, this appears to be the actual Austrian position although the few pointed statements addressing the scope of econometric research in Austrian writings are not unambiguous.

To quote von Mises:

"... 'correlations' and 'functions' do not describe anything else than what happened at a definite instant of time in a definite geographical area as the outcome of the actions of a definite number of people." (v. Mises, 1977, p. 63)

A similar argument is made by Mario Rizzo in a recent paper on the role of econometrics:

"... it is important not to interpret econometrically derived relations as great constants applicable to all situations at all times. These relations are not theoretical but merely historical. To extrapolate the latter to the former requires an inductive leap that we are not prepared to take." (Rizzo 1978, p. 53)

As far as these statements can be interpreted in the above sense, they certainly contain the germ for a sensible Austrian critique of quantitative methods. However, taken at face value, they apparently point to a view of econometrics as just another pseudo-science of historicism, i.e. another futile attempt to reveal some eternal laws in the quantitative pattern of history. By all means, such a critique grossly mistakes the scope of econometrics. While the seduction to make careless use of econometric models for forecasting and simulation purposes cannot be denied, there is certainly no "inductive leap" involved; to the contrary, econometrics is and has to be based on the hypothetico-deductive models of economic theory; it cannot simply draw on the pool of available data to form ad-hoc variables and

correlate them in theoretically empty regressions. But if econometrics is not theoretically empty, then a critique of econometrics must begin with a critique of current economic theory.

## 5.2. The Chicago School: Sophisticated Econometrics

Clearly, the firm reliance on tight prior equilibrium theorizing does not foster any anti-empirical attitude. To the contrary, there has always been a fair amount of (positivist) Chicago optimism with respect to the performance of empirical research. Again, Milton Friedman's methodological essay yields a good case in point:

"... differences about economic policy among disinterested citizens derive predominantly from different predictions about the economic consequences of taking action - differences that in principle can be eliminated by the progress of positive economics - rather than from fundamental differences in basic values, differences about which men can ultimately only fight." (Friedman 1953, p. 5)

However, with the shift from the older Chicago School around Milton Friedman to the modern School (notably Robert E. Lucas), this optimism has been somewhat shaken; it is now replaced by a critical - albeit not at all anti-empirical - attitude which has found its most intriguing expression in Lucas' fundamental critique of the performance of econometric macro models:

"... given that the structure of an econometric model consists of optimal decision rules of economic agents, and that optimal decision rules vary systematically with changes in the structure of series relevant to the decision maker, it follows that any change in policy will systematically alter the structure of econometric models." (Lucas 1976 (I), p. 126)

The consequences for policy evaluation on basis of traditional econometric models are devastating:

"... comparisons of the effects of alternative policy rules using current macroeconomic models are invalid regardless of the performance of these models over the sample period or in ex ante short-term forecasting." (Lucas 1976 (I), p. 126)

Note that this critique is, at base, a theoretical critique, i.e. a critique of those theoretical models which do not assume that economic agents use available information efficiently. Or, to put it positively: It is a plea for theoretical expectations. Any econometric work based on tight prior equilibrium theorizing (which includes the assumption of rational expectations) is exempted from Lucas' objections. Thus his argument is not directed against econometric research as such, but rather against 'naive' econometric model building along the keynesian lines in the 1950's and 1960's.

## 6. Final Remarks

We are left with the challenging question of why two schools so vastly different on methodological grounds arrive at virtually identical economic policy prescriptions. Without discussing the interesting details of this question, we may venture to say that the clue to the answer will lie in the views of both schools on equilibrium economics.

In the Austrian view of the market as a ceaseless process of discovery and information dissemination, there is no single individual and no board of directors who knows how the relative scarcity of goods will look like in the future. Granted this premise, it must be unwise to put the power of resource allocation into the hands of some committee, even if it is a democratically elected one; instead, it is much better to rely on the independent efforts of all private economic agents who are likely to have access to the best feasible - albeit still far from perfect - information in the small sector of society in which they live, work and make decisions. As pri-

vate agents are bound to search for new information on the changing pattern of relative prices in an optimizing fashion, a decentralized system will ensure the most rapid possible growth of knowledge. Hence setting up a stable institutional framework and letting the simultaneous adjustment of all private economic agents proceed on its own is the best way to promote progress in the sense of daring leaps into the unknown.

Tight prior equilibrium theorizing along Chicago lines has similar consequences for policy making: If markets can rightly be assumed to work efficiently (including the efficient use of available information), there is simply no rationale for government intervention apart from setting up a stable institutional framework (including an unambiguous definition of property rights).<sup>1</sup>

In summary, we see dynamic optimality behind the Austrian-, and static optimality behind the Chicago-plea for laissez-faire and negative freedom in general. A glance over the ideological 'bibles' of the two schools, von Hayek's "The Constitution of Liberty" (1960) and Milton Friedman's "Capitalism and Freedom" (1962), supports this conjecture: While Friedman is mostly concerned with demonstrating the allocative efficiency of free capitalism, von Hayek's emphasis lies much more on the informational dynamics of the system. Still then: While both authors like to underline their case for freedom by distinct welfare economic arguments, they would probably not consider either of these arguments as being necessary and/or sufficient conditions for negative freedom to be desirable. It would be most revealing to ask both authors whether they would still favour a maximum possible degree of negative freedom if it were 'proved' that freedom does not

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<sup>1</sup>It is unclear what normative significance should be attached to the recent Chicago research on political equilibria. So far, it seems, the normative stance of the Chicago School has not been shattered by this new strand of positive economics.

promote either static allocative efficiency or the growth of knowledge. I guess that both would cling to freedom, and thus implicitly declare their books as "essays in persuasion" which are intended to convince the world that freedom is not only desirable as an end in itself, but also as a means to achieve a lot of other nice things. Hence, as an ideological pillar of dogmatic liberalism, methodology may well play a minor part.

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