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Carl Menger and the Forerunners of the Austrian School

3.1. Introduction

It is generally agreed that the 1871 publication of *Principles of Economics* (Menger 1981), by Carl Menger (1840-1921), gave birth to the Austrian school of economics. Nevertheless, this author's chief virtue lay in his ability to adopt and encourage a tradition of thought which originated in continental European Catholicism and the precursors of which date back to the dawn of Greek philosophy and, even more clearly, to the long-established legal, philosophical, and political thought of classical Rome.

Indeed, in classical Rome it was discovered that law is essentially based on custom, and that juridical institutions (like linguistic and economic ones) emerge as a result of a long evolutionary process and incorporate a huge volume of information and knowledge, an amount which far exceeds the mental capacity of any ruler, however wise and good. Cicero (*De re publica* 2.1-2), expressing Cato's view, writes: "The reason our political system was superior to those of all other countries was that the political systems of other countries had been created by introducing laws and institutions according to the personal judgment of particular individuals, like Minos in Crete and Lycurgus in Sparta… In contrast, our Roman republic is not the personal creation of one man, but of many. It has not been founded during the lifetime of any specific individual, but over a number of centuries and generations. *For there has never*

been in the world a man intelligent enough to foresee everything, and even if we could concentrate all brainpower into the head of one man, it would be impossible for him to take everything into account at the same time, without having accumulated the experience which practice provides over the course of a long period in history." As we will see, the core of this fundamental idea would provide the basis for Ludwig von Mises's argument on the theoretical impossibility of socialist planning. During the Middle Ages, the notion was preserved and reinforced through Christian humanism and the Thomist philosophy of natural law, which is conceived as a body of ethical principles which transcends the power of any earthly government. Pedro Juan de Olivi, Saint Bernardine of Siena, and Saint Antoninus of Florence, among others, theorize about the leading role which human entrepreneurial and creative ability plays as the driving force behind the market economy and civilization (Rothbard 1995a). However, this line of thought was most ably picked up, fostered, and perfected by the great Scholastic theorists of the Spanish Golden Age, who should undoubtedly be regarded as the chief precursors of the Austrian school of economics.

3.2. The Scholastics of the Spanish Golden Age as Forerunners of the Austrian School

According to Friedrich A. Hayek, the theoretical principles of a market economy, like the basic elements of economic liberalism, were not designed, as is generally believed, by Scottish Calvinists and protestants, but instead sprang from the teachings of Dominicans and Jesuits who belonged to the School of Salamanca during the Spanish Golden Age (Hayek 1978b). Hayek went so far as to cite two Spanish Scholastics, Luis de Molina and Juan de Lugo, in the speech he delivered upon receiving the Nobel Prize in Economics in 1974 (Hayek 1989). In fact, in the 1950s, the Italian professor Bruno Leoni began to convince Hayek of the Catholic, Spanish origin

of Austrian economic analysis. Leoni persuaded Hayek that the roots of the dynamic, subjectivist conception of economics lay in the Continent, and that therefore, they should be sought in Mediterranean Europe and in Greek, Roman, and Thomist tradition, rather than in the tradition of the eighteenth-century Scottish philosophers (Leoni 1991). Moreover, fortunately for Hayek, one of his sharpest pupils, Marjorie Grice-Hutchinson, specialized during this period in Latin and Spanish literature and completed, under Hayek's supervision, a research paper on the contributions of the Spanish Scholastics in the sphere of economics, a work which over time has become a minor classic (Grice-Hutchinson 1952, 1978, 1993).

Who were these intellectual forerunners of the modern Austrian school of economics? Most were Dominican and Jesuit professors of moral doctrine and theology at universities which, like that of Salamanca and Coimbra, constituted the principal centers of thought during the Spanish Golden Age (Chafuen 1986). Now let us examine and synthesize their main contributions to what would later become the basic elements of Austrian economic analysis.

Perhaps we should begin by mentioning Diego de Covarrubias y Leyva. Covarrubias (1512-1577), the son of a famous architect, became the bishop of the city of Segovia (where he is buried in the cathedral) and was minister to King Philip II for several years. In 1555, Covarrubias expressed better than anyone before him the essence of the subjective theory of value, the pivot of the entire structure of Austrian economic analysis, when he stated: "The value of an article does not depend on its objective nature but on the subjective estimate of men, even when this estimate is foolish." To illustrate his point, he added: "In the Indies wheat is more expensive than in Spain, because there men value it more, even though the objective nature of wheat is the same in both places" (Covarrubias 1604, 131). Covarrubias also produced a study

of the historical evolution of the maravedi's decrease in purchasing power, and he foresaw many of the theoretical conclusions Martín de Azpilcueta and Juan de Mariana, among others, would later present concerning the quantity theory of money. Covarrubias's study incorporates many statistics regarding price movements in the century preceding the one in which he lived, and it was published in Latin as *Veterum collatio numismatum*. This work is highly significant, not only because the Italians Davanzati and Galiani praised it in the centuries that followed, but also, and especially, because it is one of the books Carl Menger cites in his *Principles of Economics* (Menger 1981).

The subjectivist tradition Covarrubias established was continued by another remarkable Scholastic, Luis Saravia de la Calle, who was the first to shed light on the true relationship between prices and costs in the market. Saravia de la Calle asserted that in any case, costs tend to follow prices and not vice versa. Thus, he was before his time in exposing the errors of the objective theory of value, which the theorists of the English classical school would later develop, and which would provide the foundation for the exploitation theory of Karl Marx and his socialist successors. In his work, *Instrucción de mercaderes* [Instruction to Merchants], published in Spanish in Medina del Campo around the year 1544, Saravia de la Calle writes: "Those who gauge the just price of an article by the labor, costs, and risks borne by the person who deals in or produces the merchandise are seriously mistaken; for the just price springs from the abundance or lack of goods, merchants, and money, and not from costs, labor, and risks" (Saravia de la Calle 1949, 53). Moreover, the entire book centers around the function of the entrepreneur (whom Saravia de la Calle refers to as a "merchant"), in keeping with the previously-mentioned Scholastic tradition of focusing on the stimulating role the entrepreneur plays, a tradition that dates back to Pedro Juan de

Olivi, Saint Antoninus of Florence, and especially, Saint Bernardine of Siena (Rothbard 1995a).

Another noteworthy contribution of the Spanish Scholastics is their introduction of the dynamic concept of competition (*concurrentium* in Latin), understood as the entrepreneurial process of rivalry which drives the market and furthers the development of society. This idea would lie at the heart of Austrian market theory, and it contrasts sharply with the neoclassical equilibrium models of perfect competition, monopolistic competition, and monopoly. The concept also led the Scholastics to conclude that the prices of the equilibrium model ("mathematical prices," in their terminology), which socialist neoclassical theorists have sought to use as justification for interventionism and market planning, could never be known. Thus, Raymond de Roover writes: "Molina even introduces the concept of competition by stating that concurrence or rivalry among buyers will enhance prices." This dynamic view of competition bears no resemblance to the static model of "perfect competition," which in the twentieth century "market-socialism theorists" have naively believed could be simulated in a system without private property (Raymond de Roover 1955, 169). Nevertheless, it was Jerónimo Castillo de Bovadilla who most clearly explained this dynamic conception of free competition between entrepreneurs, in his book, *Política para corregidores*, published in Salamanca in 1585, in which he indicates that the most positive aspect of competition, its essence, consists of the attempt to emulate the competitor (Popescu 1987, 141-159). In addition, Castillo de Bovadilla formulates the following economic law, which constitutes the basis for every Austrian economist's defense of the market: "prices of products will decrease as a result of the abundance, mutual emulation, and concurrence of sellers" (Castillo de Bovadilla 1985, 2, chap. 4, no. 49).

As for the impossibility of authorities' or analysts' coming to know equilibrium prices and the other data they need to intervene in the market, or to construct their models, the contributions of the Spanish Jesuit cardinals Juan de Lugo and Juan de Salas stand out. Juan de Lugo (1583-1660) wondered what the equilibrium price might be, and as early as 1643, he concluded that it depends on so many specific circumstances that only God can know it ("*pretium iustum mathematicum licet soli Deo notum*") (Lugo 1642, 2:312). For his part, in 1617, Juan de Salas considered the chances of a ruler coming to possess the specific information that is dynamically created, discovered, and handled in the market, and he asserted that "*quas exacte comprehendere et ponderare Dei est non hominum*." In other words, it is God alone, and not man, who can properly understand and ponder the information and knowledge economic agents handle in the market process, and who can take into account all of the particular circumstances of time and place (Salas 1617, 4, no. 6, 9). As we shall see, the work of both Juan de Lugo and Juan de Salas foreshadowed, over three centuries in advance, the finest scientific contributions of the leading Austrian thinkers (especially Mises and Hayek).

Another essential element of what would later become Austrian economic analysis is the principle of time preference, according to which, all other things being equal, present goods are always valued more highly than future goods. This doctrine was rediscovered in 1556 by Martín de Azpilcueta (the famous Doctor Navarro), who in turn took it from one of the brightest disciples of Saint Thomas Aquinas, Gilles de Lessines, who as early as 1285, stated: "Future goods are not valued so highly as the same goods available at an immediate moment of time, nor do they allow their owners to achieve the same utility. For this reason, it must be considered that they have a more reduced value in accordance with justice" (Dempsey 1943, 214).

The Scholastics also analyzed the distorting effects of inflation, understood as any state policy of growth in the money supply. In this area, the foremost work is that of Father Juan de Mariana, entitled *De monetae mutatione*, which the author later translated into Spanish under the title *Tratado y discurso sobre la moneda de vellón que al presente se labra en Castilla y de algunos desórdenes y abusos* (Mariana 1987). In this book, which first appeared in 1605, Mariana criticizes a policy the authorities of his era employed, that of deliberately reducing the assay value of old copper coins. Though Mariana does not use the term "inflation," which was then unknown, he explains that this phenomenon produces an increase in prices and the widespread disorganization of the real economy. Furthermore, Mariana criticizes the policy of establishing ceiling prices to counter the effects of inflation, and he considers this policy not only incapable of producing positive results, but also extremely harmful to the production process. Mariana's contribution was an improvement on the exclusively macroeconomic, and thus much more simplistic, analysis Martín de Azpilcueta had carried out in 1556, and the one Copernicus had offered before that in his book *Monetae cudendae ratio*. These two men were the first to present the typical, crudely simplified and mechanistic version of the quantity theory of money so prevalent today (Azpilcueta 1965, 74-75).

The Spanish Scholastics also contributed significantly to banking theory (Huerta de Soto 1996). For example, there is the perfectly clear criticism Doctor Saravia de la Calle directed toward the exercise of fractional-reserve banking, in the sense that the self-interested use, via the granting of loans to third parties, of money placed with bankers in demand deposits is illegitimate and constitutes a grave sin. This doctrine coincides fully with the one classical authors of Roman law originally established, a doctrine which follows naturally from the very essence, cause, and legal nature of the monetary irregular-deposit contract (Saravia de la Calle 1949, 180-181, 195-197).

Martín de Azpilcueta and Tomás de Mercado also carried out a rigorous and very demanding analysis of banking activity, and while their contribution does not reach the critical level of Saravia de la Calle, it includes an impeccable study of the requirements which, in terms of justice, must be met in the monetary bank-deposit contract. All of the above authors implicitly demand that banks operate with a 100 percent reserve, and this proposal would become a pivot of the Austrian analysis regarding the theory of credit and economic cycles (Huerta de Soto 1998). Less rigorous, and thus more understanding of fractional-reserve banking, is the analysis of Luis de Molina and Juan de Lugo, though Dempsey believes that if these authors had been acquainted with the details and theoretical implications of fractional-reserve banking, as Mises, Hayek, and the other Austrian theorists later revealed them, and with the process of credit expansion and fiduciary inflation which results from the practice, then even Molina, Lesio, and Lugo would have considered it a vast and illegitimate process of *institutional usury* (Dempsey 1943, 225-228).

Nevertheless, it is worth mentioning that Luis de Molina was the first theorist to point out that deposits and bank money in general, which he refers to with the Latin term *chirographis pecuniarum*, form part of the money supply, just as cash does. In fact, in 1597, Molina expressed the fundamental idea, long before Pennington did in 1826, that the total volume of monetary transactions conducted in a market could not be paid for with the amount of hard money which changes hands there, if it were not for the money banks *generate* by noting down their deposits and the issuance of *checks* against these by depositors. Hence, as a result of banks' financial activity, a new quantity of money is created from nothing in the form of deposits, and this money is used in transactions (Molina 1991, 147).

Finally, Father Juan de Mariana wrote another book entitled *Discurso sobre las enfermedades de la compañía*, which was published posthumously in 1625. In this book, Mariana plunges into a true Austrian-style analysis concerning the impossibility, due to a lack of information, that a government could organize civil society based on coercive commands. Indeed, it is impossible for the state to obtain the information it needs to give a coordinating quality to its commands, and therefore its intervention tends to cause disorder and chaos. Thus, with reference to government, Mariana states: "It is a grave mistake for the blind to wish to lead the sighted." He adds that the authorities "do not know the people, nor the events, at least in terms of all of their circumstances, upon which success depends. Inevitably they will commit many serious errors, and people will be troubled as a result and will scorn such a blind government." Mariana concludes that "power and command are mad" and when "there are too many laws, as they cannot all be followed, or even known, respect is lost for all of them" (Mariana 1768, 151-155, 216).

In short, the Scholastics of the Spanish Golden Age were able to articulate what would later become the key theoretical principles of the Austrian school of economics, specifically the following: *first*, the subjective theory of value (Diego de Covarrubias y Leyva); *second,* the correct relationship between prices and costs (Luis Saravia de la Calle); *third*, the dynamic nature of the market and the impossibility of realizing the equilibrium model (Juan de Lugo and Juan de Salas); *fourth*, the dynamic concept of competition understood as a process of rivalry between sellers (Castillo de Bovadilla and Luis de Molina); *fifth*, the principle of time preference (rediscovered by Martín de Azpilcueta); *sixth*, the profoundly distorting effect inflation exerts on the real economy (Juan de Mariana, Diego de Covarrubias, and Martín de Azpilcueta); *seventh*, the critical analysis of fractional-reserve banking (Luis Saravia de la Calla and Martín de

Azpilcueta); *eighth*, the recognition that bank deposits form part of the money supply (Luis de Molina and Juan de Lugo); *ninth*, the impossibility of organizing society via coercive commands, since the information necessary to give such commands a coordinating quality is lacking (Juan de Mariana); and *tenth*, the libertarian tradition that all unjustified intervention in the market constitutes a violation of natural law (Juan de Mariana).

Hence, there are well-founded reasons to conclude that though the dynamic, subjectivist conception of the market was taken up again and given a definitive boost by Menger in 1871, it originated in Spain. It is there, namely in the School of Salamanca, that we find the intellectual roots of the Austrian economic tradition. Like the modern Austrian school, and in stark contrast to the neoclassical paradigm, the School of Salamanca is above all characterized by the great realism and rigor of its analytical premises.

3.3. The Decline of the Scholastic Tradition and the Influence of Adam Smith

To understand the influence the Spanish Scholastics exerted on the subsequent development of the Austrian school of economics, we must especially remember that in the sixteenth century, the Emperor and King of Spain, Charles V, sent his brother, Ferdinand I, to be King of Austria. Etymologically, "Austria" means "eastern part of the empire," an empire which at that time encompassed practically all of continental Europe, with the only notable exception of France, which remained isolated and surrounded by Spanish forces. Therefore, it is easy to understand how the Spanish Scholastics came to intellectually influence the Austrian school, a situation which was not a mere coincidence or caprice of history, but which arose from the intimate historical, political, and cultural relations which developed between Spain and Austria

beginning in the sixteenth century (Bérenguer 1993, 133-335). These relations would be maintained for several centuries, and Italy also played a vital role, as a cultural bridge across which the intellectual exchange between the far points of the empire(Spain and Austria) flowed. Thus, there are strong arguments behind the thesis that, at least early on, the Austrian school embodied a Spanish tradition.

In fact, Carl Menger's chief virtue was to rediscover and encourage this continental, Spanish, Catholic tradition which had fallen into decline and had been practically forgotten due to the triumph of the Protestant Reformation and the Black Legend against everything Spanish, and especially due to the negative influence which the contributions of Adam Smith and his classical-school followers exerted on the history of economic thought. Indeed, as Murray N. Rothbard indicates, Adam Smith abandoned former contributions centered around the subjective theory of value, entrepreneurship, and a desire to explain the prices which emerge in the real market, and replaced them all with the labor theory of value, which Marx would later follow to its natural conclusion when he used it as a basis for his entire socialist exploitation theory. Moreover, Adam Smith focused on explaining the "natural," long-term equilibrium price, a model of equilibrium in which entrepreneurship is conspicuously absent and all necessary information is assumed to be currently available (and thus neoclassical equilibrium theorists would later use the model to criticize supposed "market failures" and justify socialism and state intervention in the economy and civil society). In addition, Adam Smith flooded economic science with Calvinism, for example by supporting usury prohibition and distinguishing between "productive" and "unproductive" occupations. Finally, Adam Smith broke with the radical *laissez-faire* outlook of his continental (Spanish, French, and Italian) iusnaturalist predecessors and introduced into the history of ideas a lukewarm "liberalism" which was so riddled with

exceptions and clarifications that even many of today's "social democratic" theorists could accept it (Rothbard 1995a).

Hence, from the Austrian perspective, the ideas of the English classical school had a harmful effect on economics, and this effect grew more pronounced with Adam Smith's successors, particularly Jeremy Bentham, who infected economics with the narrowest utilitarianism and thus promoted the development of an entire pseudoscientific analysis of costs and benefits (which he believed could be known) and the emergence of a tradition of "social engineers" who strive to shape society at whim using the coercive power of the state. In England, this tendency culminated in John Stuart Mill's apostasy from *laissez-faire* and his many concessions to socialism. In France, the triumph of Cartesian constructivist rationalism explains why interventionists from the École Polytechnique and the scientistic socialism of Saint-Simon and Comte prevailed (Hayek 1955, 105-188).

Fortunately, despite the overwhelming intellectual imperialism which the theorists of the English classical school brought to bear on the development of economics, the Catholic continental tradition fostered by the Scholastics of the Spanish Golden Age was never completely forgotten. Furthermore, this doctrinal trend influenced two notable economists: one Irish, Cantillon; and the other French, Turgot. These two can largely be considered the true founders of economic science. In fact, around the year 1730, Cantillon wrote his *Essay on the Nature of Trade in General*, which Jevons views as the first systematic economic treatise. In this book, Cantillon highlights the figure of the *entrepreneur* as the driving force behind the market process, and he explains that an increase in the quantity of money does not affect the general price level all at once, but instead always hits the real economy in stages, gradually, by a process which inevitably affects and distorts the relative prices that emerge in the

market. This is the famous Cantillon effect, which Hume later copied, and which Mises and Hayek would pick up in their analyses of the theory of capital and economic cycles (Cantillon 1959).

Long before Adam Smith, the Marquis d'Argenson (in 1751) and especially Turgot had already accurately described the dispersed nature of the knowledge which social institutions, understood as spontaneous orders, incorporate. The analysis of spontaneous orders would later become one of the essential elements of Hayek's research program. As early as 1759, Turgot concluded in his *Éloge de Gournay*: "It is not necessary to prove that each individual alone can determine, with knowledge of the basic facts involved, the most advantageous use of his lands and effort. Only he possesses the particular knowledge without which even the wisest man would be in the dark. He learns from his repeated attempts, from his successes and from his losses, and in this way, he gradually acquires a special sense for business which is much more ingenious than the theoretical knowledge an indifferent observer can acquire, since it is motivated by necessity." Following Father Juan de Mariana, Turgot also refers to "the utter impossibility of directing, via rigid rules and continuous supervision, the multitude of transactions which, if only due to their abundance, cannot be fully known, and which furthermore depend constantly on a vast number of ever-changing circumstances that cannot be controlled, much less foreseen" (Turgot 1844, 275, 288).

Even in Spain, during the long decline of the eighteenth and nineteenth centuries, the Scholastic tradition did not disappear altogether, despite the huge inferiority complex so typical of the era with respect to the Anglo-Saxon intellectual world. The survival of this tradition is evidenced by the fact that another Spanish Catholic writer was able to solve the paradox of value and to clearly formulate the law of marginal utility twenty-seven years before Carl Menger published his *Principles of*

Economics. This writer was the Catalonian Jaime Balmes (1810-1848), who during his short life became the leading Thomist philosopher in the Spain of his day. In 1844, he published an article entitled "True Idea of Value or Thoughts on the Origin, Nature, and Variety of Prices," in which he not only resolved the paradox of value, but he also clearly set out the law of marginal utility. Balmes asks: "Why is a precious stone worth more than a piece of bread, some comfortable clothes, or perhaps even a healthy and pleasant home?" He answers: "It is not difficult to explain. Since the value of an article is determined by its utility or capacity to satisfy our needs, the more necessary it is for satisfying them, the more valuable it will be. *We must also bear in mind that if the number of means increases, then the need for any one of them in particular decreases; for if we can choose from among many, no particular means is indispensable*. Hence, there is a necessary connection, a sort of proportion, between the increase or decrease in value, and the scarcity or abundance of something. A piece of bread is worth little, but this is explained by its necessary relationship to the satisfaction of our needs; for there is an abundance of bread. However, if the quantity diminishes, the value will rapidly go up and will reach any level, a phenomenon which can be observed in times of shortages, and which is especially obvious with respect to all types of goods in a town long under siege during a war" (Balmes 1949, 615-624). With his contribution, Balmes brought the continental tradition full circle and paved the way for the work of Carl Menger and his Austrian disciples, who, a few decades later, would complete, perfect, and uphold that tradition.

3.4. Menger and the Subjectivist Perspective of the Austrian School: the Conception of Action as a Set of Subjective Stages, the Subjective Theory of Value, and the Law of Marginal Utility

Very early on, the young Menger realized that the classical theory of price determination, as Adam Smith and his Anglo-Saxon followers had formulated it, left much to be desired. Menger's personal observations of the functioning of the stock market (during one period he was a stock-market correspondent for the *Wiener Zeitung*), along with his own research, led him to write at thirty-one years of age, in, according to Hayek, "a state of morbid excitement" (Hayek 1992), the book which would officially give birth to the Austrian school of economics. In this book, the author strove to establish the new foundations upon which he believed it was necessary to rebuild all economic science. These principles essentially included the development of an economic science which would always rest on man, viewed as a creative actor and the protagonist of all social processes and events (subjectivism), as well as, for the first time in the history of economic thought, the formulation, based on subjectivism, of an entire formal theory on the spontaneous emergence and evolution of all social (economic, legal, and linguistic) institutions, understood as established behavior patterns. All of these ideas are incorporated in the book, *Principles of Economics*, which Menger published in 1871, and which would become one of the most influential works in the history of economic thought.

Menger's most original and consequential idea consists in an attempt to construct all of economics based on man, viewed as a creative actor and the protagonist of all social processes. Menger believes it essential that we abandon the sterile "objectivism" of the English classical school, and its obsession with the supposed existence of objective, outside entities (social *classes*, *aggregates*, *material* factors of production, etc.). He asserts that economic scientists should always adopt the subjective perspective of the acting human being, and that this perspective should exert a decisive influence on the way in which all economic theories are formulated. Hayek, in

reference to this new subjectivist conception Menger proposes, even writes: "It is probably no exaggeration to say that every important advance in economic theory during the last hundred years was a further step in the consistent application of subjectivism." Hayek adds that this application of subjectivism "…is a development which has probably been carried out most consistently by Ludwig von Mises, and I believe that most peculiarities of his views which at first strike many readers as strange and unacceptable trace to the fact that in the consistent development of the subjectivist approach he has for a long time moved ahead of his contemporaries" (Hayek 1955, 31, 209-210).

Perhaps one of the most typical and original manifestations of this new subjectivist trend Menger proposes has been his "theory of economic goods of different orders." For Menger, "first-order economic goods" are consumer goods, i.e. those which subjectively and directly satisfy human needs, and thus, in the specific, subjective context of each action, constitute the *ultimate end* the actor seeks to achieve. To attain these ends, consumer goods, or first-order economic goods, one must first pass through a series of intermediate stages, which Menger terms "higher-order economic goods" (second, third, fourth, and so on), such that the higher the order of each stage, the further that stage is from the final consumer good. In Menger's words: "When we have the complementary goods of some particular higher order at our command, we must transform them first into goods of the next lower order, and then *by stages* into goods of successively still lower orders until they have been fashioned into goods of first order, which alone can be utilized directly for the satisfaction of our needs" (Menger 1981).

This seminal idea of Menger's is simply the logical conclusion of his subjectivist conception, in the sense that each human being tries to achieve an end to which he attaches a certain *subjective value*, and with a view to that end, and motivated by its

subjective value, he conceives and launches into a plan of action comprised of a series of stages which he deems necessary for the accomplishment of the end. Moreover, these stages acquire a subjective *utility*, depending on the value of the goal the actor expects to reach through the use of higher-order economic goods. In other words, the subjective utility of the means or higher-order economic goods will ultimately be determined by the subjective value of the end or final consumer good which those means enable one to attain. Hence, for the first time in economics, and through Menger's efforts, theory focuses on the subjective viewpoint of the actor and revolves around an *action process* comprised of a number of *intermediate stages*, which the actor initiates, employs, and tries to complete, a process which culminates in the achievement of the end or final consumer good (first-order economic good) he seeks.

In acting, each person attempts to reach certain *aims* he has discovered are important to him for some reason. The term *value* refers to the actor's subjective appraisal of his aim, and such appraisals vary in mental intensity. The *means* is anything the actor subjectively believes suitable for helping him to achieve his end. *Utility* refers to the actor's subjective *assessment* of the means, depending on the value of the aim the actor believes that means will enable him to accomplish. In this sense, value and utility are two sides of the same coin, since the subjective value the actor attaches to his goal is projected onto the means he deems useful for achieving it, precisely via the concept of utility.

Menger's most significant and original contribution to economic science was his subjectivist conception of all human action processes, and not, as has been believed up to this point, his discovery of the law of marginal utility, which occurred independently of, but in parallel with, that of Jevons and Walras. The subjective theory of value and the law of marginal utility are merely obvious corollaries of the subjective conception of

the action process, a perspective we owe entirely to Menger and have just presented. In fact, throughout a series of stages, the human actor assesses the means in terms of the end he believes they will enable him to accomplish, and this assessment is not exhaustive in nature, but varies with the different interchangeable units of means which are relevant within the context of any specific action. Therefore, the actor will tend to value each of the interchangeable units of means in terms of the place the last of them occupies on his value scale, for if the actor should lose or gain a unit of means, the corresponding utility lost or gained, respectively, would be determined by the position occupied on the individual value scale by the end which might be lost or gained as a result of that last unit. Hence, from the Austrian viewpoint, the law of marginal utility has nothing to do with the physiological satisfaction of needs, nor with psychology, but instead is a strictly praxeological law (to use Mises's terminology), i.e. it falls within the very logic of all human, entrepreneurial, and creative action.

Thus, it is essential that we distinguish between the theory of marginal utility as Menger naturally developed it and the laws of marginal utility which Jevons and Walras simultaneously formulated. Indeed, Jevons and Walras expressed marginal utility as a mere addition to a mathematical model of equilibrium (partial in the case of Jevons, and general in that of Walras) in which the human action process is conspicuously absent, and the incorporation or exclusion of the law of marginal utility changes nothing. In contrast, for Menger, the theory of marginal utility is an ontological necessity, or an essential consequence of his own conception of human action as a dynamic process (Jaffé 1976, 511-524).

Moreover, it is not surprising that the principal founder of the neoclassical Chicago school, Frank H. Knight, maintained that Menger's theory of first-order and higher-order economic goods was one of his less important contributions (Knight 1950).

With this assertion, Knight actually reveals the theoretical inadequacies of the neoclassical paradigm of equilibrium, and more precisely those of his own Chicago school, for which the production process is objective and instantaneous, time plays no role other than a purely parametric one, and the creativity and uncertainty typical of any entrepreneurial act are eradicated by the Ricardian equilibrium that is the focal point of research.

3.5. Menger and the Economic Theory of Social Institutions

Menger's *Principles of Economics* was a very advanced book for its time: in it, Menger not only introduced the substantial role played in the real economy by the concept of time, ignorance, entrepreneurial knowledge, error as inseparable from human action, complementary goods which are gradually combined in the market process, and the continual disequilibriums and changes which characterize any real market; he also included in the book a novel theory about the origin and evolution of social institutions, a theory Hayek would later develop further and carry to its logical conclusion.

Indeed, Menger's second most important fundamental contribution was his theoretical explanation of the spontaneous, evolutionary emergence of social institutions, based precisely on the subjective conception of human action and interaction. Thus, it is by no quirk or coincidence that Menger dedicated his *Principles of Economics* to one of the most distinguished German historicists: Wilhelm Roscher. For in the doctrinal controversy between supporters of an evolutionary, historical, and spontaneous conception of institutions (a position represented by Savigny in the field of law and Montesquieu, Hume, and Burke in the field of philosophy and political science) and supporters of the narrowly rationalist, Cartesian conception (represented by Thibaut in the field of law and Bentham and the English utilitarians in the field of economics),

Menger believed that, with his contribution, he had provided the former with the definitive theoretical backing they needed.

Menger's subjectivist conception, based on the human actor, explains, through the idea of an evolutionary process in which countless people act, each one equipped with his own small, exclusive store of subjective knowledge, practical experience, desires, feelings, etc., the spontaneous, evolutionary emergence of a series of behavior patterns (institutions) which in the spheres of law, economics, and language make life in society possible. Menger discovered that institutions emerge as a result of a social process which is comprised of a multiplicity of human actions and led by a number of specific, flesh-and-blood men and women who, in their own particular historical circumstances of time and place, discover ahead of the rest that they achieve their ends more easily when they adopt certain behavior patterns. In this way, they initiate a decentralized, trial-and-error process in which the behaviors that best coordinate social maladjustments tend to prevail, and through this unconscious process of learning and imitation, the lead taken by the most creative and successful human beings in their actions spreads and is followed by the rest of society's members. Though Menger develops his theory by applying it to a concrete economic institution, the emergence and evolution of money (Menger 1994), he mentions that the same essential theoretical framework can, without great difficulty, be applied to legal institutions as well as to the emergence and evolution of language. Menger himself impeccably frames the new question around which he seeks to formulate his entire new scientific research program in economics: "How can it be that institutions which serve the common welfare and are extremely significant for its development come into being without a common will directed toward establishing them?" (Menger 1985). The answer is paradoxical, for those institutions which are most vital to the life of man in society (linguistic, economic,

legal, and moral institutions) are "unintended consequences of individual actions" (or in Menger's terminology, *Unbeabsichtigte Resultante*, Menger 1883, 182). Man could not have deliberately created these institutions himself, since he lacks the necessary intellectual capacity to take in the huge volume of dispersed, dynamic information they incorporate. Instead, they have gradually emerged in a spontaneous, evolutionary manner from the social process of human interaction, and Menger and the rest of the Austrians believe this very field should constitute the main focus of economic research.

3.6. The *Methodenstreit,* or the Controversy over Method

Menger must have suffered great frustration when the professors of the German historical school not only failed to understand his contribution, but also considered it a dangerous challenge to historicism. In fact, instead of realizing that Menger's contribution offered the theoretical backing which the evolutionary conception of social processes required, they considered its theoretical and abstract analytical nature incompatible with the narrow historicism they advocated. In this way, the first and perhaps the most famous controversy involving the Austrians, the *Methodenstreit*, arose. It would occupy Menger's intellectual energies for several decades. The historicists of the German school headed by Schmoller were victims of *hyperrealism* (like the American institutionalists of the school of Thorstein Veblen were later), as they denied the existence of a universally valid economic theory and defended the thesis that the only valid knowledge was that which could be derived from empirical observation and from the collection of data in each historical case. To counter this view, Menger wrote his second important book, *Investigations into the Method of the Social Sciences with Special Reference to Economics* (Menger 1883), in which he drew on the writings of Aristotle to assert that knowledge of social reality requires two

equally important disciplines which are complementary but radically and epistemologically different. There is *theory*, which can be conceived as the "form" (in the Aristotelian sense) that captures the essence of economic phenomena. This theoretical form is discovered by introspection; that is, through the researcher's inner reflection, which in turn is made possible by the fact that in economics (like in no other science), the researcher enjoys the privilege of having the same nature as those observed, a situation which provides him with extremely valuable first-hand knowledge. In addition, theory is constructed in a logical-deductive manner, based on clear, axiomatic knowledge. In contrast to theory, there is *history*, which can be conceived as the "matter" (in the Aristotelian sense) which materializes in the empirical facts that pertain to each historical event. Menger regards both disciplines, theory and history, form and matter, as equally necessary for knowledge of reality, but he emphatically denies that theory can ever be derived from history. Instead, the relationship between the two is of the opposite nature, in the sense that history can only be interpreted, classified, and comprehended in light of a pre-existing economic theory. Thus, based on a methodological perspective which J. B. Say had already largely intuited, Menger established the foundations of what would later become the "official" methodology of the Austrian school of economics.

We should point out that the term "historicism" has at least three different meanings. The first, which is identified with the historical school of law (Savigny, Burke) and opposed to Cartesian rationalism, is the one the Austrian school defends in its theoretical analysis concerning the emergence of institutions. The second meaning is associated with the nineteenth-century German professors of the historical school of economics and with the twentieth-century American institutionalists, who deny the possibility of a universally valid abstract economic theory, like that Menger defended

and the other Austrian economists have developed after him. The third type of historicism provides the basis for the methodological positivism of the neoclassical school, which seeks to rely on empirical observation (in other words, ultimately, on history) to prove or disprove theories, an approach Hayek considers merely one more manifestation of the Cartesian rationalism the Austrians so often criticize (Cubeddu 1993).

It is curious to note that Menger and his followers, in their defense of theory against the German historicists, had temporary allies in the theorists of the neoclassical equilibrium paradigm, including Walras and Jevons, among the mathematical marginalists, and the neoclassicals Alfred Marshall in England and John Bates Clark in the United States. Even when the Austrian supporters of the dynamic, subjectivist tradition of the analysis of market processes were aware of the profound differences between their approach and that of these theorists of (general or partial) equilibrium, they often felt that the goal of defeating the historicists and defending the correct scientific status of economic theory justified their temporary alliance with the equilibrium theorists. The high cost of this strategy would not become evident until several decades later, when in the 1930s ("the years of high theory," to use Shackle's happy expression), the triumph of the advocates of theory over the historicists was interpreted by most economists as the triumph of mathematically formalized equilibrium theory, and not the theory of dynamic social processes, which from the beginning, Menger and his followers had striven to develop and encourage.

At any rate, contrary to the most standard, textbook accounts, which generally portray the *Methodenstreit*, or controversy over method, as a fruitless loss of effort, we believe it was the occasion for the conceptual refinement and clarification of the inevitable methodological differences between the sciences of human action and those

of the natural world. Consequently, the great confusion that remains in this area today is undoubtedly due to economists' failure to pay sufficient attention to the significant contributions Menger made during this controversy (Huerta de Soto 1982).