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Divergent Approaches In Libertarian Economic Thought

THE WRITINGS of the great majority of economists over the past thirty years have supported the powerful currents that sweep the modern world toward centralized authority, interventionism, and statism. The teachings of these economists led generations of students and laymen to believe uncritically that an economy based on unhampered individual enterprise and the institution of private property must breed unemployment, instability, resource misallocation, stagnation and an unjust distribution of income. And yet, there has consistently been a dissenting minority whose voices are not completely drowned out by the teachings of their colleagues.

These economists, arguing on strictly technical grounds, defend the efficiency of the unhampered market economy, and point out again and again how measures put into effect by governments must lead to consequences worse than the evils that they seek to avoid. Apart from the strictly technical questions involved, these writers also point to the value judgments implicit in many of the conclusions of their colleagues. They show how many of the welfare proposals offered in the name of economics merely reflect arbitrary opinions concerning such matters as the ethical status of private property, the ability of an individual to choose for himself, and the like.

In recent years this minority view among economists has gained considerable strength. Our younger economists are no longer persuaded that the old interventionist dogmas

are beyond criticism. The benefits arising from the free interplay of market forces are more and more coming to be recognized. The views of free-market economists are becoming less and less easy for the still-dominant "mixed-economy" exponents to ignore.

This change in climate is being felt by the more inquiring of our undergraduate students around the country. Ten or fifteen years ago it was commonplace for an intelligent student to complete his undergraduate studies—often with even a major in economics—and yet gain no inkling of the very existence of a respectable minority free-market view in the contemporary economic literature. This has changed; the existence of an economic literature that formulates policy recommendations with full consciousness of the relevant market consequences and their implications for individual welfare and freedom of choice is now a matter of common knowledge.

THE ECONOMISTS who have contributed to this literature in the United States have written as individuals, not as members of a single "school," and there have been significant differences of opinion among them, both on theoretical questions and on policy issues. It is, of course, always a hazardous undertaking to classify independent writers. However, it seems widely recognized that most of the economists who have emphasized the efficiency and other advantages of the free market can be associated with either one or the other of two intellectual sources. On the one hand there is an academic tradition strongly associated with the University of Chicago, embracing in particular the work of the late Henry Simons, of F. H. Knight, and of younger scholars such as Milton Friedman, Yale Brozen, and George J. Stigler. On the other hand there has since

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the 1940's been felt in this country an expanding, well-articulated influence that clearly traces back to the Austrian subjectivist school. This influence is almost synonymous with the work of Ludwig von Mises, and has inspired significant similar work by others in the same tradition. It is idle to speculate on the appropriateness of the term "schools" to describe these two intellectual sources. While the term school is widely applied to Chicago economists¹, it would probably be inaccurate to refer to the writers most strongly influenced by Professor Mises as a "school."² Nonetheless, it remains a fact that there exist significant differences between the "Austrian" literature in which the works of Mises are the most important and influential, and the writings of the economists whom we will, for the sake of brevity and convenience, call the "Chicago" economists.

It is, of course, important not to exaggerate the differences between the two streams of writing, the Misesist and the "Chicago". While, as we shall discover, there exist sharp differences in methodology and in perspective between the two trends, there is an almost surprising coincidence between their views on most important policy questions. This is especially true with respect to issues having to do more narrowly with the operation of the price system. The truth is that whatever differences exist between the two approaches, both have basically the same sound understanding of how a market operates, and this is responsible for the healthy respect which both approaches share in common for its achievements. It is this common denominator which provides the rationale of this essay, the purpose of which is to describe clearly the more important points of distinction that set apart their two approaches to the market. And for this reason this essay does not take up some important differences between these two streams of thought that occur in monetary economics and business cycle policy—areas in which the basic denominator common to both trends has far less direct relevance.

But whatever the similarities displayed in these two approaches, it does seem a useful

1. For an academic discussion of this usage, see *Journal of Political Economy*, February, 1962.
2. And, despite the fact that Professor Mises teaches at New York University, it would be quite incorrect to talk of a Misesist "New York University School."

task to enunciate with some care the more fundamental matters of method and perspective upon which agreement is absent. In what follows the writer presents the controversial issues as he understands them; he makes no claim to represent the distilled "official" views of any particular writers.

ONE WAY of presenting the difference between the two approaches under consideration might be as follows: The price theory that underlies the contributions of the "Chicago" writers is not fundamentally different from that accepted by American economists generally, including those holding the efficiency and justice of the market system in deep mistrust. It is merely that the "Chicago" economists apply their price theory more consistently and more resolutely, assigning to it a scope of relevance far wider than that granted by others. On the other hand the Misesist approach involves a theory of price that differs in important respects from that taught and applied by others.

This admittedly oversimplified way of stating the difference between the two approaches, among other advantages, enables us to perceive the intellectual roots of their divergence from one another. "Chicago" price theory, like that taught in most United States economics departments, is solidly in the Anglo-American neoclassical tradition associated most importantly with Alfred Marshall. The profound influence exercised by Marshall upon American price theory, in



Ludwig von Mises

spite of its modification at the hands of Edward II. Chamberlin (a modification that is, from the point of view of this essay, yet on Marshallian lines), is clearly visible as the central thread in "Chicago"-type textbooks on price theory.³³

On the other hand the price theory associated with Mises, nourished from the stream of Austrian thought going back to Carl Menger, has entered American economics as a distinctly alien element. (The only comparable influence, and that a rather muted one, is that deriving from the writings of Philip H. Wicksteed.) While Walrasian general equilibrium ideas made their strong impact early on American economics in the 'thirties and 'forties with the growing vogue of mathematical economics, it was not until much later, when Mises' writings came to be known in their American editions, that his ideas were seriously discussed in this country.

While there are numerous smaller points of difference that separate the two approaches—the dominant neo-Marshallian microeconomics of "Chicago", and the Austrian-type theory of the Misesist—it will prove convenient to concentrate on three rather major sources of disagreement. We will discuss in turn the following: (1) the role of equilibrium; (2) the role of empirical investigations; and (3) the concept of monopoly. A clear understanding of these matters will go a long way towards an understanding of what sets the two approaches apart, and the degree of the separation.

The Role of Equilibrium

IN MARSHALLIAN economics, as in Walrasian, the concept of equilibrium plays a major, if not a permanent, role. Considering the various forces at work in a market, the price theorist asks himself what conditions would have to be fulfilled before one can pronounce these forces to be in balance. The initial data governing a situation determines the conditions needed to reach equilibrium. Since a situation in which these conditions are absent is not in balance, it cannot be assumed to be a lasting situation; market forces will bring about change. Because the

3. The dissatisfactions with the theory of monopolistic competition that have been voiced by "Chicago" economists do not affect the validity of the statements in the text.

direction of motion of a disequilibrium market was more or less uncritically assumed to lead toward the fulfillment of the conditions for equilibrium, the latter situation came to be looked upon as "the solution". In other words, whenever one is provided with a list of existing conditions, and is asked to use price theory to explain "what will happen" as a result of these initial conditions, the answer is seen to be provided by *the description of the equilibrium situation appropriate to the initial data*. This procedure of equilibrium analysis has become, through the method of "comparative statics," the principal means of analyzing the consequences of changes in the data. One simply compares the equilibrium conditions appropriate to the new set of data with those appropriate to the older set. The change in data can then be said to bring about a change in the market situation from the "old" equilibrium configuration to the new one.

The concept of equilibrium is one which has been applied, *mutatis mutandis*, to different market structures. In particular, the changes in neo-Marshallian price theory that resulted from the work of Harvard's Professor Chamberlin in the 'thirties did not affect the use of the equilibrium method. For Chamberlinian theory as for that of his predecessors, the important objective is the description of the equilibrium situation corresponding to the postulated data. Whereas pre-Chamberlinian theory had operated in a world in which only two patterns of market structure could occur, Chamberlin argued for a view of the market that should accommodate an entire spectrum of different structures. With respect to each kind of market structure there will then be sought the corresponding equilibrium configuration.

THE equilibrium notion as applied to the market refers to the particular pattern of decisions on the part of the market participants that permits all the decisions to be successfully carried out. The particular market structure prevailing in a given situation determines the range of possible decisions open to each participant. The theorist's insight into how an individual participant reaches his decisions enables explanation of which possible decision will be selected as the best opportunity in given circumstances. It is thus possible to list the set of decisions that will have to be made by the various participants in a given market situation if one

is to be able to say simultaneously (a) that each participant is making the best decision possible from his point of view; and (b) that all the decisions can be carried out at the same time.

As a result of this emphasis on the situation at equilibrium, consideration of the neo-Marshallian approach led naturally to a rather special view by economists of the method appropriate to their task, and this tendency was reinforced by the strong influences of Leon Walras. This methodological view emphasized the strictly formal character of the search for the equilibrium conditions. Given the structural conditions assumed for the market, the tastes of the consumers and the technological constraints governing production, we find that discovering the set of price offers and bids, the set of product quantities and qualities, and the set of inputs to be employed in production assumes a character amenable to mathematical attack. It became easy for price theorists to set up the appropriate equations that would have to be satisfied simultaneously in order to pronounce the market to be in equilibrium; it became easy to emphasize the task of examining the conditions under which a solution of these equations is formally possible.

In addition, the stress on equilibrium situations facilitated yet a further tendency (one that was reinforced by the work of Chamberlin), that is, a persistent pattern of analyzing markets on the assumption that *the structure of the market is a datum*. While this tendency has begun to wane in recent years, the more traditional approach, including that followed by "Chicago" economists, has been to specify the particular character of competition or monopoly believed to be relevant to a particular market, and to seek the corresponding equilibrium solution. Little attempt was made to understand how the relevant competitive structure of the market has been itself forged out of the dynamic process of the market, and how out of the continued operation of this process there may be expected, perhaps, an evolving market structure.⁴

Before turning to consider how different a role is assigned to the equilibrium notion in

the Misesist system, it will be useful to notice one further implication of the dominant neo-Marshallian approach shared by "Chicago" economists. This is the seriousness with which the perfectly competitive model is treated. In the 'thirties the hitherto widespread use of this model by economists generally came under sharp attack on the grounds it lacked realism, but not in terms of its internal formal adequacy. ("Chicago" economists, in fact, have tended to defend continued wide use of the perfectly competitive model, arguing that it provides a workable approximation to the real world.)

And yet, as F. A. Hayek has pointed out, the perfectly competitive model suffers from the severe defect that it is *restricted to a*



F. A. Hayek

*situation that already satisfies the conditions for equilibrium.*⁵ The perfectly competitive market is one in which conditions exist that by definition assume that no decision made need be disappointed. Each buyer and each seller in the perfectly competitive market is assured of being able to buy or to sell as much as he wishes at the going price; no possibility exists for analysis of a perfectly competitive market that is *not* in equilibrium. The astonishing willingness of economists to restrict so much of their work to analysis of a model that from the start rules out consideration of disequilibrium possibilities can

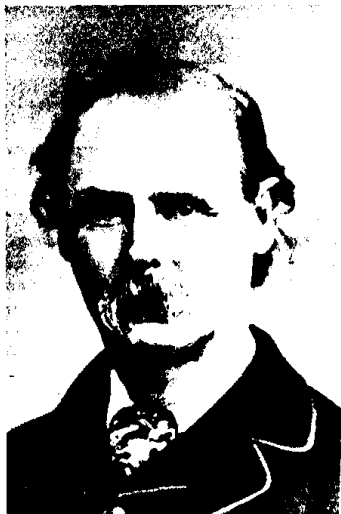
4. For an perceptive discussion of this point see J. M. Buchanan, "What Should Economists Do?", *Southern Economic Journal*, January, 1964.

5. Cf F. A. Hayek, *Individualism and Economic Order* (Chicago: Univ. of Chicago Press, 1948), pp. 92-106.

clearly be ascribed only to the prevalent exclusive concern with equilibrium situations. With little interest attached to any but equilibrium solutions, with no awareness of the dynamics of market structure, there need be little compunction in raising the perfectly competitive model to a paramount position.

All this contrasts very starkly indeed with the role assigned to the equilibrium notion in the Misesist system. Here the emphasis is *not* on the configuration of decisions necessary to ensure that all of them can be carried out. The emphasis is, instead, on the *process* generated by the forces of the market. The focus is not on the set of prices, output and input quantities, that must prevail if a market is to be in equilibrium. Instead it is upon the manner in which prices, outputs, and inputs *change* from one period to the next as the logic of the market forces adjustments to be made in the decisions of the participants.

To the Misesist the problem to be solved is not the specification of equilibrium conditions corresponding to different market structures. The economist is called for, instead, to understand how one disequilibrium situation generates the pressures that lead toward a new situation in which disequilibrium maladjustments have, to some degree, been corrected.



Alfred Marshall
(1842-1924)

Of course for Mises too the position of equilibrium is a unique one. But its uniqueness consists not in its providing the solution, the outcome determined by the data. Its uniqueness is simply that the equilibrium position, were it to prevail, would be characterized by the *cessation* of the market process, all relevant market forces having successfully spent themselves. Analysis of equilibrium conditions provides a useful *contrast* to the process of market agitation that marks a state of disequilibrium, but it is this agitation itself which is the focus of analytical attention.

It follows that for the Misesist view, the enumeration of the equations whose simultaneous solution is required for equilibrium, the examination of the possibilities for such a solution to exist, are activities of profoundly subsidiary importance. These activities do not provide the answers the Misesist economist is seeking. For this reason the elaborate techniques marshalled by the mathematical economists leave the Misesist totally unimpressed. Not only are they not addressing themselves to the problems the Misesist considers important, but they are confining themselves to analysis of conditions in which the market has nothing further to contribute.

For similar reasons the Misesist has little patience for the elaborate consideration of the perfectly competitive model. He objects to this model, not primarily on the Chamberlinian grounds of realism, but on account of the model's irrelevance to the market *process* set in motion by disequilibrium conditions. The perfectly competitive model has nothing to say about such a process; by definition such a process can occur only in the *absence* of perfectly competitive conditions.

In fact the entire concept of market structure has little relevance for the Misesist. From his point of view competition is not a condition of the market that indicates a certain pattern of decisions as being an equilibrium pattern. Rather, competition is seen as the driving force behind the adjustment process taking place in the market. Since only competition provides this driving force, analysis of different market structures boils down, in this view, to analysis of the strength of this drive. And since market structures are themselves *produced* by the process of market adjustment, it is hardly useful to take

them as given, as data that independently determine the course of the market process.

One further implication of the Misesist approach may be mentioned in concluding this section, and that is the role of the entrepreneur. For a theory of price concerned primarily with states of equilibrium, the entrepreneur is a somewhat peripheral figure. He has no role at all in the central scheme of things, at least until we are ready to postulate changes in the data. Despite the careful attention which so original a "Chicagoan" as Professor Knight has devoted to the theory of uncertainty and profit, the entrepreneur hardly occupies the center of attention in "Chicago" economics. It is otherwise in the Misesist approach. Here the entrepreneur, the initiator of change, searching for the profit opportunities spawned by disequilibrium conditions, performs the most essential role of all. It is his competitive pursuit of profits which sets the market process in motion. It is he who occupies the center of analytical attention.

The Role of Empirical Investigations

THE contemporary dominant view of economics is one in which important roles are assigned both to the theorist and to the empirical research worker. The general attitude is somewhat as follows: In earlier days, when economics was rather primitive, there was disagreement on the method appropriate to the discipline. At the close of the last century there were those who stressed theory to the exclusion of empirical investigation, and there were others who believed it possible to acquire economic knowledge only through the methods of historical research. In the enlightened present we have come to realize that both kinds of investigation are required and that they complement one another. Theory and empirical research, in this dominant view, are closely intertwined. One is willing to deplore contemporary institutionalist attacks on theory; one is equally willing to deprecate armchair theorists who disdain to muddy their hands with down-to-earth statistics.

"Chicago" economists are in general strongly in agreement with the mixed approach. While they vigorously emphasize the power and usefulness of theory, they subscribe to the requirement that theory be

"operational", and watch for "implications" of theory that can be tested against empirical data. Because "Chicago" economists have more faith in the power of theory than other (non-Misesist) economists, and because, as a result, they apply theory to many neglected facets of economic activity (e.g. many kinds of non-pecuniary motivations), they are in fact frequently engaged in a wider range of empirical investigations than other economists are. In this kind of approach a theory is a tentative "guess" whose validity must await confirmation by the evidence. While "Chicago" economists are probably more aware than other econometricians of the subtle difficulties of extracting watertight confirmations, or even refutations, of theories



Milton Friedman

from observational data, they nonetheless tend to look upon these difficulties as merely a need for more refined statistical, observational and computational techniques, rather than as a problem ineradicably inherent in the nature of the material under investigation.

In this view, the investigator writing down market prices, measuring output volume, or describing the degree of concentration in industry, may be engaged in exactly the same kind of activity—that of helping to acquire economic knowledge—as is the theorist whose models suggest the particular sets of statistics to be collected.

The view is rather different when considered from the Misesist perspective, however, and some of the most extreme literary disagreements between the two approaches have to do with this issue. In the Misesist

view the role of empirical investigation is an altogether different one, and knowledge obtained by the empirical investigator is of an altogether different character from that discovered by the theorist. In this view empirical confirmation of the theorems obtained by abstract logic is neither possible nor necessary. It is not possible, because there are no constants in the realm of human actions; it is therefore impossible to investigate the consequences of changes in one variable with assurance that no disturbance is at the same time being caused by changes in other variables. On the other hand confirmation of economic theorems is not necessary, because the theorems themselves describe relationships logically implied by hypothesized conditions. The validity of these relationships can be tested by examining the reasoning employed to establish them.

Empirical work, in the Misesist system, has the function of establishing the *applicability* of particular theorems, and thus of *illustrating* their operation. Factual measurement and description provide information which can be used in applying theory. Economic theory postulates certain relationships under specific conditions. Only concrete observation, therefore, can tell the applied economist which particular theorem is of relevance in a given situation. But the discovery that the facts fit perfectly with the predictions of a theory does not provide the economist with knowledge that he did not possess before; nor would the failure of the facts to fit with theory cause him to abandon a valid theorem—this might merely indicate inapplicability of the theorem. The world of facts is too complex to permit simple hypothetical relationships to be directly perceived or refuted; with only variables to be observed, the real world market can only be understood with the help of theory, not the reverse. Direct observation does indeed provide knowledge, possibly important knowledge, but of a different kind from that embodied in an economic theorem. Observation provides the material to be understood by applying the appropriate theory.

The skillful theorist well-acquainted with real market phenomena may be in an ideal position to illustrate the validity of theory by reference to well-chosen concrete facts. He may in this way convince laymen of the far-reaching truth of price theory far more powerfully than by direct teaching of the

theory itself. But this is a matter of pedagogy, not of establishing the substantive truth of the theory in a manner satisfactory for science.

It will be seen that we have here a fundamental and profound difference in outlook between the two approaches being examined in this essay.

The Concept of Monopoly

THE last example of disagreement between the "Chicago" and Misesist views we shall consider here concerns the notion of monopoly. We have had occasion earlier in this essay, to draw attention to the different concepts of competition that characterize the two approaches. The disagreement about monopoly that we shall consider here is not unconnected with the different outlooks noted earlier.

In the dominant Anglo-American tradition in price theory, monopoly is invariably associated with a particular pattern of decision possibilities seen facing the *firm*. In technical jargon the firm enjoying some degree of monopoly power faces a downward-sloping demand curve, i.e. it can sell any of a wide range of different volumes of output, but can sell the larger outputs only by charging lower prices. This is contrasted with the "perfectly competitive" firm, which is able to sell the amount it wishes, within reason, without having to lower its price.

This view of monopoly is the one upon which the Chamberlinian theory of monopolistic competition is predicated; it is the view upon which economic analysis of anti-trust policy is almost invariably based. The distinguishing features of this monopoly concept are first that monopoly power is possessed by the producing firm, and second, that it is evidenced by the power of the firm to raise its price by being willing to sell smaller quantities of output. This is the monopoly concept used as a matter of course by "Chicago" economists.

In the Misesist system, however, the term monopoly is used to denote a quite different concept. And there is in this system little significance attached altogether to the downward-sloping demand curve that faces a firm. In this system, with its utter disinterest in the perfectly competitive model mentioned earlier, the demand curve facing *any* firm is understood—at least in disequilibrium—to be more or less downward-sloping. This is not seen as in any way interfering

with the dynamic process of competition which we earlier found to be central to the Misesist view of the market.

Moreover, in the Misesist emphasis on the process rather than on the result, the concept of monopoly is inseparable from the explanation of the source of monopoly power. To contend that a firm enjoys monopoly power one must be able to account for the existence of this power. Since a firm is merely the interim resource complex assembled by the entrepreneur, its possession of exclusive selling power can only be ascribed to possession of unique resources. Entrepreneurship is viewed as being by definition competitive in a free unhampered market. With no restriction on buying or selling, no one entrepreneur is able, without having already captured unique resources, to control any one branch of production. Clearly in the long-run view, monopolistic control over production cannot be ascribed to firms as such, but only to the fortunate owners of unique resources.

This is not the occasion to examine more thoroughly the implications of this view of monopoly for judgments on the efficiency of resource allocation, or for one's opinions on antitrust policy. It is not difficult to see that these implications must be considerable. We return to appraise very briefly the signifi-

cance of the distinctions which we have drawn between the "Chicago" and Misesist approaches.

With such deep-seated differences separating the foundations of Misesist economics from that of "Chicago", it is, for the libertarian, reassuring to discover that so many policy questions seem to lead to the same answers in both approaches. Clearly there is some common ground possessed by the two, on which the cited differences do not make a great deal of direct practical difference. For the pragmatic policy-maker, less concerned with philosophical underpinnings than with ready-to-use conclusions, the distinctions setting apart the two approaches may not seem of great moment. On the other hand, for the student and scientist, these differences will seem of far greater importance. For the student of the history of ideas, the matters of disagreement are similarly of considerable interest. While there are, as we have seen, many policy questions on which both are in agreement, there can clearly be no guarantee that this will always be the case. Only careful, dispassionate study of both approaches can enable one to choose intelligently between them, and to be able to perceive the truth where the two views do in fact lead to divergent conclusions.

Our Son Wears Cap and Gown

I see myself a thousand years ago,
When rivers imaged trout instead of ships . . .
When she I thought I loved most loved my quips.
When war clouds roiled, but I was still at peace.

My view of black and white eschewed all gray;
Each thing I saw was either bad or good . . .
I looked at trees and never thought of wood.
Each dime I earned received a quick release.

My lack of height caused heartache on the way;
I didn't make the teams . . . but I could write.
And now I see those golden goals in sight.
Just as I did a thousand years ago.

CHOLM G. HOUGHTON