

Schumpeter and the old Austrian school

Interpretations and influences

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Schumpeter is at the roots of the persistent historiographic practice consisting in classifying Menger along with Jevons and Walras together as the three actors of the so-called marginalist revolution. All three are presented as the independent discoverers of very much the same marginal utility principle.¹ To Schumpeter, the marginalist revolution boils down to the simultaneous and independent rediscovery of this principle. Schumpeter however acknowledges that it is not the idea of marginal utility *per se* which is revolutionary. Indeed, it was already formulated before by Gossen and, when expressed in basic terms, it seems to flow from mere introspection, revealing little more but a triviality. In fact, the ‘revolutionary’ label is awarded to the three authors not so much for the exposition they give of the idea that the evaluation of goods depends on the intensity of individual needs, but rather for the radical change in the orientation of economic theory this principle entails. It is a marginalist ‘revolution’ in the particular sense that totally new foundations were proposed to replace those of the classical tradition. In this sense, no doubt Menger is as much a path-breaker than Walras or Jevons.² What is essential to Schumpeter is the acknowledgement of the marginal utility principle as basement from which the whole economic phenomena may be analysed, the acknowledgement of the primary role of human needs as driving force of economic mechanisms.

In the 1970s, two articles were to mark the beginning of an alternative interpretation of the marginalist take off. Streissler (1972) explicitly asks ‘to what extent was the Austrian School Marginalist?’ and Jaffé (1976) proposes a ‘de-homogenization’ of Walras, Jevons and Menger. Jaffé insists on the fact that the unification of the three authors under a single

¹ Schumpeter (1954, p. 825) agrees with this ‘... familiar tradition from which it is convenient to start, [according to which] this revolution centred in the rise of the marginal utility theory of value is associated with the names of three leaders: Jevons, Menger and Walras’.

² ‘... Menger belongs to those who have demolished the existing structure of a science and put it on entirely new foundations’ (Schumpeter, 1951, p. 83).

appellation leads to overshadow the differences between the distinct traditions Walras, Menger and, to a lesser extent, Jevons, gave birth to. The objective of Streissler is to show that to many respects, the Austrian tradition cannot be considered as representative of the marginalist tradition, emphasising the tenets constituting Menger's originality.

There is no doubt that the works of Walras and Menger have been pursued according to different analytical paths and that nowadays, the Austrian tradition can legitimately claim to be a competitive and independent stream of thought. But then, how is it possible that Schumpeter, trained in the very depth of the Austrian tradition, does not mention the crucial differences opposing Menger to Walras and indistinctly takes them in one but single movement?

The fact that Schumpeter underrates the divergences between Menger and marginalists might lead to think that he does not recognise any originality at all to the early Austrian tradition. However, this interpretation does not hold anymore if one takes into account the nature of Schumpeter's analytical work in which the Austrian originality clearly shows through. Indeed, specific aspects of the Austrian tradition have been subsequently picked up again by Schumpeter in his own analytical work and it is precisely these aspects that have marked his originality as a theorist. Schumpeter develops a dynamic conception of the role of the entrepreneur, breaking with the static framework of general equilibrium he yet admires so much and providing a theory of economic evolution in which change comes from within the system.

We are thus facing a striking paradox: on one side, Schumpeter as an historian of thought gives an interpretation of early Austrians as mere marginalists bearing little originality with regard to the logic of Walras and Jevons, while on the other side, Schumpeter as a theorist uses precisely these elements defining the Austrian originality he previously ignored in order to build his theory of economic evolution. It is by solving this paradox that we intend to shed some light on the nature of the relationship between Schumpeter and the early Austrian tradition.

In order to figure out the foregoing, it is first necessary to come back to the analytical distinction Schumpeter makes between circular flow and economic evolution (*section 1*). The essence of this distinction stems from the different roles played respectively by consumers and entrepreneurs in these two analytical frameworks. It will then be clear that despite embryonic disturbing elements, Menger, Wieser and Böhm-Bawerk, in essence, position themselves in the circular flow logic, justifying the Schumpeterian history of thought interpretation (*section 2*). Schumpeter - as a theorist - builds upon these elements, organising them coherently into the qualitatively distinct framework of economic evolution. More precisely, the influence of early Austrians on Schumpeter's analysis manifests itself at three levels: the focus on the economic process, the nature of economic rationality and the role of institutions in economic dynamics (*section 3*).

Circular flow and economic evolution: a qualitative breaking

For a long time, Austrians have been struggling to assert their originality, first with respect to marginalism and later on to neoclassical economics. Basically, the problem stems from the ambiguity conveyed by the use of identical words bearing distinct meaning: the Austrian conceptions of competition, economic rationality, subjectivism are distinct from the neoclassical ones. It was only during the interwar period, as a consequence of the debate on planning, that Austrians progressively became fully aware of the conceptual differences

separating them from mainstream economics.³ On the contrary, the merit of Schumpeter was to clearly locate himself with respect to the Walrasian framework as soon as 1912, avoiding the ambiguity initiated by Menger and transmitted to two generations of authors. In the *Theory of economic development*, Schumpeter makes the distinction between circular flow and economic evolution.

The Walrasian theory enters the reality of *circular flow* but loses any relevance as soon as we switch to *economic evolution*. To a certain extent, general equilibrium theory is realistic: it is an abstraction from reality which captures the essence of circular flow.⁴ Indeed, it is realistic, according to Schumpeter, to consider human needs as the fundamental cause of explanation for economic phenomena, to take individual choices as the basic conceptual unit of analysis and to stress the existence of a general interdependence of plans emerging beyond the consciousness of individual agents.

It is clear that Schumpeter does not indistinctly assimilate the framework of the circular flow with the Walrasian theory. This is particularly evident when examining the assumption of individual behaviour. In 1908, the author identifies 'hedonistic egoism' with Walrasian rationality and uses this term to criticise the Austrian analysis of individual rationality, and Wieser's psychologism in particular.⁵ However, in the *Theory of economic development*, the Walrasian equilibrium framework is replaced by the circular flow and parallel to this, hedonistic rationality does not anymore bear up to explicit and conscious maximisation.⁶ Rather, choices are the result of past experience and refer to a kind of adaptive rationality in which the concepts of rule and routine are central.

'In this system of values a person's whole economy is expressed, all the relations of his life, his outlook, his wants, all his economic combinations. The individual is never equally conscious of all parts of this value system; rather at any moment the greater part of it lies beneath the threshold of consciousness. Also, when he makes his decisions concerning his economic conduct he does not pay attention to all the facts given expression to in this value system, but only to certain indices ready at hand. He acts in the ordinary daily round according to the general custom and experience.'

Schumpeter, 1912, 1934, p. 39.

Individuals automatically reproduce the actions that prove efficient in the past. Such behaviour is coherent in the circular flow framework because it concerns a stationary economy, free from endogenous disturbing factors. The term stationary does not mean that the economy is simply reproducing itself identical; it may grow, but growth is smooth, ruled by the progressive and exogenous modifications of fundamentals (endowments, preferences and techniques) to which individuals continuously adapt themselves. Circular flow corresponds to the analysis of the process of convergence toward a general equilibrium reference which is itself moving according to exogenous circumstances. It describes the process of adaptation of an economy whose dynamics is predetermined by extra-economic factors. Given specific circumstances, individuals know by experience which types of action are best suited to satisfy their needs.

³Cf. Vaughn (1994), Lavoie (1985), Gloria-Palermo (1999).

⁴'En décrivant une économie purement stationnaire, nous recourons à une abstraction, mais à seule fin d'exposer la substance de ce qui se passe réellement' (Schumpeter, 1912, p. 8).

⁵'We have good reasons to be suspicious about sentences we find everywhere in literature under the name of psychological assertions... Our examples show us clearly that the reference to psychology of crises does not mean anything but [banality]' (Our translation from Schumpeter, 1908, p. 545).

⁶ Notice however that in the first edition of the *Theory of economic development*, individual behaviours in the circular flow still reflects the Walrasian meaning. The replacement had been rather slow and is explicitly stated in the second edition only (1926).

The individual household or firm acts, then, according to empirically given data and in an equally empirically determined manner. Obviously this does not mean that no changes can take place in their economic activity. The data may change, and everyone will act accordingly as soon as it is noticed. But everyone will cling as tightly as possible to habitual economic methods and only submit to the pressure of circumstances as it becomes necessary. Thus the economic system will not change capriciously on its own initiative but will be at all times connected with the preceding state of affairs. This may be called Wieser's principle on continuity.

(Schumpeter, 1912, pp. 8-9).

What is important to notice is that even in case fundamentals spontaneously change (from exogenous circumstances), there is no qualitative breaking in the circular flow logic: agents simply react by a process of trial and error to this modification. Their present choices are backward-looking in the sense that they are determined by past experience. Economic growth is the result of successive quantitative changes smoothly crystallised into routinised behaviour.

... all knowledge and habit once acquired becomes as firmly rooted in ourselves as a railway embankment in the earth. It does not require to be continually renewed and consciously reproduced, but sinks into the strata of subconsciousness. It is normally transmitted almost without frictions by inheritance, teaching, upbringing, pressure of the environment. Everything we think, feel, or do often enough becomes automatic and our conscious life is unburdened of it.

(Schumpeter, 1912, p. 84)

Circular flow is not tantamount to general equilibrium theory. It is a more general framework, elaborated upon the central reference of Walrasian equilibrium but also compatible, it will be argued, with the analyses of early Austrians.

If the framework of circular flow allows to grasp the essential mechanisms of a stationary economy, it is unable to provide any insight as regards the alternative phenomenon of economic evolution. Economic evolution concerns a qualitatively different - endogenous - kind of dynamics: changes in the fundamentals are the result of the economic process itself.

The position of the ideal state of equilibrium in the economic system, never attained, continually "striven after" (of course not consciously), changes, because the data change... If the change occurs in the non-social data (natural conditions) or in non-economic social data (here belongs the effects of war, changes in commercial, social, or economic policy), or in consumers' tastes, then to this extent no fundamental overhaul of the theoretical tools seems to be required. These tools only fail ... where economic life itself changes its own data by fits and starts.

(Schumpeter 1912, p. 62)

Circular flow dynamics results from exogenous changes in the circumstances which determine the ideal state of equilibrium towards which the economic process converges (though unconsciously as far as individuals are concerned); evolution dynamics results from endogenous shocks, self-generated by the normal working of the economy. But then, what is this 'source of energy within the economic system which would of itself disrupt any equilibrium that might be attained'?⁷ A new kind of individual rationality enters the scene, namely, 'energetic rationality'; it is a forward-looking type of behaviour which can be assimilated to creation, '...doing something different from other conduct' (Schumpeter, 1912, p. 81, footnote 2). More precisely, it is necessary to introduce three new elements, absent from the stationary economy, in order to define this alternative type of rationality and catch in this way the essence of economic evolution: creative actions materialise through *innovations*;

⁷Preface of the Japanese edition of the 1912 book.

creation is impossible without the support of the *institution of credit*; the actor of change is the *entrepreneur*.

As it is well known, the concept of innovation is defined in a very broad sense as a *new combination of factors* leading to the production of a new product or the implementation of a new method of production or the creation of a new market or the reorganisation of sectors of the economy or the utilisation of a new kind of raw materials. Every inventions are not actually implemented: there is a selection process from banks which decide the new combination to finance. Credit is the typical source for financing new combinations (Schumpeter, 1912, p. 104). This stems from the fact that innovations disrupt the normal working of circular flow in which all means of production are employed and there are no profits and thus no possibility to form savings. If an entrepreneur finances an innovation by turning to saving it means that *past evolution* allowed him to make savings. Nevertheless, 'And this [credit] is the source from which new combinations *are* often financed, and from which they would have to be financed *always*, if results of previous development did not actually exist at any moment' (Schumpeter, 1912, p. 73).

The function of the entrepreneur is precisely to find financial resources and implement new combinations. Schumpeter does not follow the traditional definition of the entrepreneur as a risk bearer. Nor does he accept to identify the entrepreneur with profit for profit is only the consequence of the innovative function. The entrepreneur is an agent guided by energetic rationality, whose plan of action does not stem from the - unconscious and routinised - research of need satisfaction but from new intuitions about future. The entrepreneur is the disrupting force of circular flow who decides to abandon the mechanic adaptive answer to existing conditions in order to rather act upon these conditions. 'Carrying out a new plan [energetic rationality] and acting according to a customary one [hedonist rationality] are things as different as making a road and walking along it' (Schumpeter, 1912, p. 85).

It is important at this point to make more precise the essence of the qualitative distinction between circular flow and economic evolution for it is according to this criterion that Schumpeter as an historian of thought appraises the contributions of Menger and early Austrians.

Of course, as said above, the specificity of economic evolution directly flows from the introduction of innovation, credit and entrepreneurship. But what we need now is a much more radical criterion according to which it will be possible to roughly locate authors either in the logic of circular flow or in that of economic evolution. Do not forget that this is an exercise of logical reconstruction: we need to find a criterion that may help us to understand why, despite their original traits, Austrians are indistinctly included along with marginalists into the logic of circular flow. The criterion we put forward concerns the role of consumer sovereignty. In circular flow, the production structure adapts itself continuously to consumers' needs. Individual needs are the ultimate cause explaining all economic phenomena and individual behaviour is directed by the research of need satisfaction.

The given external conditions and the needs of the individual appear as the two decisive factors for the economic process, which cooperate in determining its result. Production follows needs; it is so to speak pulled after them.

(Schumpeter, 1912, p. 12)

The role of consumer sovereignty is seriously altered in the logic of economic evolution: an innovation does not consist in a better answer to needs satisfaction but gets ahead of a modification of tastes and preferences. An innovation is not a hedonist answer - adaptation to

the existing structure of preferences - but rather a real action which gives rise to adaptation on the consumer side.

Yet innovations in the economic system do not as a rule take place in such a way that first new wants arise spontaneously in consumers and then the productive apparatus swings round through their pressure. We do not deny the presence of this nexus. It is, however, the producer who as a rule initiates economic change, and consumers are educated by him if necessary.

(Schumpeter, 1912, p. 65)

To sum up, in circular flow, production structure adapts to consumers' needs, whereas in economic evolution, needs are endogenously modified by the creative action of entrepreneurs in the supply side.

Austrians and the logic of circular flow

At this stage, the objective is to deepen Schumpeter's interpretation indistinctively associating early Austrians with marginalism. According to this interpretation, Menger, Böhm-Bawerk and Wieser are part of marginalism for one clear-cut reason, they develop the principle of marginal utility, breaking in this with the classical objective theory of value. The marginalist revolution was above all a subjectivist revolution and the only originality Austrians are granted with regards their attitude towards the use of mathematical tools in economics. Their technical weakness prevented them from reaching the level of abstraction of Walras' model of general equilibrium: Menger is opposed to Walras about the relevance of the mathematical method in economics and the very reason for this lies, according to Schumpeter, in his 'defective technique...' that '... prevented [Menger] from climbing the top of it...mainly because [he] did not understand the meaning of a set of simultaneous equations' (Schumpeter, 1954, p. 918);⁸ Böhm-Bawerk '... was an architect, not an interior decorator' (Schumpeter, 1951, p. 159) leaving to his epigones the task of doing 'the necessary polishing' and adjusting all the technical imprecisions of his theory of capital and interest; Wieser '...was the worst technician of the three great Austrians' (Schumpeter, 1954, p. 913). However, on the whole, their technical weaknesses leads them to provide - literary - one of the most clear presentations of the marginalist principle.

This interpretation of Austrian economists is thus based on a very rough argument. Early Austrians are marginalists simply because they participate to '... the great reform of the theory of value...' (Schumpeter, 1951, p. 85) and contribute to replace the classical foundation of labour-value with the idea that human needs are the driving force of the economic mechanism. Such an argument however, might seem by far insufficient to justify the weak discernment Schumpeter shows in his interpretation of the Austrian tradition. Indeed, a deeper examination of Menger's principle of marginal utility leads to question the proximity with marginalists on this ground. The difference does not merely lies in the rejection of the mathematical methods: if the formal demonstrations of Walras and Jevons are compared with Menger's literary presentations, substantial differences appear.⁹

What is needed at this level of the analysis is another more subtle argument that may explain the reason why Schumpeter does not recognise any specificity to the Austrian

⁸This criticism is addressed to Jevons at the same time.

⁹Karl Menger (1973), the mathematician son of the economist, gives a mathematical translation of the Austrian definition of the marginalist principle which shows substantial differences with the marginalist definition of Walras and Jevons. In particular, the Austrian version does not use any implicit assumption of continuity or differentiability of functions. See Gloria-Palermo (1999) for the implications of these formal differences.

tradition with respect to marginalism. Such argument has to be related to the foregoing criterion of distinction between circular flow and economic evolution. It will be argued that according to this interpretative framework early Austrians are rooted together with marginalists in the logic of circular flow. Let's examine what the dominant elements of Austrian analysis are which allow to uphold this proposition. Priority is given to Menger's analysis.¹⁰ We provide in what follows a reconstruction of Schumpeter's interpretation of Menger at the light of his cutting out of economics into circular flow and economic evolution.

Menger's analysis is based on a precise methodological stance. The scientific approach, and economics in particular, is purely analytical and consists in breaking down complex phenomena into their most simple elements, a logical decomposition in terms of relations of causality. On a methodological level, Menger's objective is thus:

[...] to reduce the complex phenomena of human economic activity to the simplest elements that can still be subjected to accurate observation, to apply to these elements the measure corresponding to their nature, and constantly adhering to this measure, to investigate the manner in which more complex phenomena evolve from their elements according to definite principles.

(Menger, [1871] 1950, pp. 46-7)

Individual and his behaviour are the simplest elements from which Menger draws up universal laws and explains the most complex economic phenomena by finding out causal relationships. The author considers human behaviour which seeks to satisfy needs as the most simple premise upon which everything should be built. This is defined as the principle of 'economizing'.¹¹ This principle represents the paramount foundation of the whole Mengerian edifice, at the roots of any economic explanation.

The theory of imputation offers a particular instance of this quest for universalism. The general principle of imputation consists in evaluating production factors – higher order goods – by attributing to them the fraction of the value of the finished product – first order good – that they enable to produce. Schumpeter interprets it as Menger's most important contribution to economics because imputation theory allows to extend the marginalist principle – economizing in Menger's terms – to the sphere of production. This theory is the expression of Menger's attempt to offer a universal theory of value, valid for all types of economic goods and in particular to production goods.

The hierarchy between consumption and production structures clearly emerges from this theory: production goods are evaluated according to the knowledge of causal relationships relating goods (of different orders) with individual needs. The production structure follows the consumption structure, trying to adjust itself to individual needs. Moreover, economic progress in Menger, precisely stems from improvement in the knowledge of causal relationships between higher order goods and individual needs.

If it is generally correct that clarity about the objective of their endeavors is an essential factor in the success of every activity of men, it is also certain that knowledge of requirements for goods in future time periods is the first prerequisite for the planning of all human activity directed to the satisfaction of needs. [...]. The second factor that determines the success of human activity is the knowledge gained by men of the means available to them for the attainment of the desired ends. Wherever, therefore, men may be observed in activities directed to the satisfaction of their needs,

¹⁰ Such a choice may appear reasonable for various motives. First of all, from the point of view of history of thought, Menger is unanimously accepted as the founder of the Austrian movement. He is the sole point of reference common to all Austrian authors over several generations. Moreover, from an analytical viewpoint, Menger set out the principles and concepts which were to be continued and expanded by his successors.

¹¹The term used by Menger ([1871] 1950, p.116) is 'Bedürfnissbefriedigung', literally the satisfaction of needs and desires.

they are seen to be seriously concerned to obtain as exact a knowledge as possible of the quantities of goods available to them for this purpose.

(Menger, [1871] 1950, pp. 89-90)

Individual needs are the ultimate determinant of the whole economic structure. There is no room for innovation in Schumpeter's sense for the only possible improvements concern the acquisition of knowledge on causal relationships between goods and needs. In other words, economic progress flows from a better use of resources thanks to improved knowledge of production processes. Menger remains in the logic of circular flow, providing an accurate analysis of the process by which the economy develops towards a better satisfaction of consumer's needs.

Of course, this interpretation might encounter one serious criticism: the figure of the entrepreneur is not absent from Menger's theory, thereby pulling the author towards the logic of economic evolution. Given that our aim here is to reconstruct Schumpeter's view of Menger, the solution consists in examining how Schumpeter interprets the Mengerian producer. Basically, the above criticism is overcome by the fact that Schumpeter considers Menger's entrepreneur as a mere arbitragist with no ability for creation, shutting the door to innovation and confirming in this way the classification of the founding Austrian in the logic of circular flow. Let's get into more details here. Schumpeter's interpretation is made explicit on the occasion of a debate with Knight in their interpretation of Menger's theory of the entrepreneur.¹² According to Knight, Menger lacks a rigorous concept of the entrepreneur whereas to Schumpeter, not only Menger does develop a precise theory, but his analysis is very close to Knight's own view. In other words, Schumpeter (1954) identifies in Menger the bases of the Knightian theory of the entrepreneur. The figure of the entrepreneur emerges in the analyses of both Menger and Knight in consequence of the uncertain character of economic process. According to this interpretation, the entrepreneur is defined as the residual uncertainty bearer. In Menger, uncertainty flows from the fact that production takes time. Remember that in the theory of imputation, present value of higher order goods depends on the *expected* value of related first order goods. Profits stem from relevant expectations and are the manifestation of a well managed risk. Entrepreneur's remuneration depends on his ability in finding the best combinations between goods of different orders so as to satisfy future consumers wants as closely as possible, that is to say, on his ability to process information about causal relationship between higher order goods and individual needs and to foresee what these future needs actually will be. According to this view, the function of entrepreneurs is to *adapt* the production process to the future expected structure of consumption. Menger's following description of the functions of the entrepreneur cannot but confirm Schumpeter in his interpretation:

Entrepreneurial activity includes: (a) obtaining information about the economic situation, (b) economic calculation - all the various computations that must be made if a production process is to be efficient...; (c) the *act of will* by which goods of higher order ... are designed to a particular production process; and finally, (d) supervision of the execution of the production plan, so that it may be carried through as economically as possible.

(Menger [1871], 1950, p. 160)

It clearly comes out of this debate that to Schumpeter, the Mengerian entrepreneur is not an innovator.

¹²See Martin (1979) for a deeper analysis of the debate between Knight and Schumpeter on the theory of the entrepreneur and their interpretation of Menger's treatment.

Of course, it would be necessary for our demonstration to be exhaustive to proceed in the same way with a reconstruction of Schumpeter's interpretation of Böhm-Bawerk and Wieser. We give below a few insights of this argumentation, pointing out intuitively that these authors too are considered by Schumpeter as belonging to the circular flow.

No doubt that according to Schumpeter, Böhm-Bawerk's analysis falls into the logic of circular flow. We are not questioning here Böhm-Bawerk's originality with respect to marginalism, the analytical consequences of the temporal dimension of the production process being sufficient enough to set his specificity. However, it is not sufficient according to Schumpeter to classify him in the alternative framework of economic evolution. The main argument is that innovation – in the sense of new combinations – are absent from Böhm-Bawerk's analysis.

And what of the third, the 'roundabout method of production' ? If Böhm-Bawerk had kept strictly to his expression 'adoption of roundabout method of production' and if he had followed the indication that it contains, this would be an entrepreneurial act – one of the many subordinate cases of my concept of carrying out new combinations. He did not do this.

(Schumpeter, 1912, p. 159)

The only variable upon which producers can act is the temporal length of the production process in order to implement the most productive techniques under given conditions; the production structure remains static in Schumpeterian sense, that is, it only adapts to the given structure of consumers' needs. In his *Positive Theory of Capital*, Böhm-Bawerk gives a graphic representation of the concept of maturity classes of goods. The author (1889, pp. 106-7) depicts a cross section of processes through a series of concentric circles. Schumpeter points out the ambiguity attached to this representation and stemming from the fact that all the stages of production are placed within the same framework. It is thus possible to give a synchronic interpretation of production, in terms of simultaneity of the different stages of the process, laying stress in this way on the static character of Böhm-Bawerk's representation.¹³

Schumpeter's interpretation of Wieser is strictly centred around the theory of value. Schumpeter scrutinises Wieser's pure economic developments to the exclusion of his social analysis of power conflicts in terms of leaders-masses interactions, yet at the core of his analysis of social dynamics. The forces guiding the evolution of the realm of economics constitute, in Wieser's view, the most powerful engine within this dynamic. The theory of value is an indispensable theoretical element and the point of departure Wieser needs to reach his true goal which, as the title of the book of 1914 suggests, is to develop a normative social view of the economy. Indeed, according to Wieser, economic relationships are the most conspicuous social relationships and economics in turns cannot be understood without and understanding of value¹⁴. From this point on, the place occupied by the theory of value and the principle of marginal utility is quite clear. They are not the core of investigation but the point of departure for research indeed directed toward the understanding of the dynamics of social phenomena.

Schumpeter however strictly separates Wieser's contributions to pure economics from his work in sociology, although he recognises that "every element of [Wieser's work] formed part of an harmonious whole, which unfolded itself slowly and grew organically to an imposing

¹³ Cf. Egidi (1983) for a deeper analysis of Schumpeter's criticism of the static character of Böhm-Bawerk's representation.

¹⁴ Wieser 1926, translated from German by Hayek ([1926], 1952, pp.556).

height and breadth” (Schumpeter, 1951, p. 301). As a matter of fact, Schumpeter concentrates on Wieser’s contribution to pure economics, limited to the elaboration of the Austrian theory of costs and repartition already sketched out by Menger. The fact that Wieser himself was at the origin of the expressions ‘marginal utility’ and ‘imputation’ as well as the law of opportunity costs or ‘Wieser’s Law’ is, in that respect, emphasised.¹⁵ If the social theory of power developed by the author in parallel to his analyses of pure economics is put to one side, the analytical sphere of value comes to the forefront and the question of imputation takes the limelight, pulling definitely his work along with that of Menger, into the logic of circular flow.¹⁶

The Austrian influence

One can hardly denied the presence in the work of early Austrians of theoretical factors, even though at an embryonic stage, hardly compatible with the marginalist logic. Traditional interpretations usually pay little attention to these elements and consider them as ‘introductory remarks’ (Stigler, 1941) or the manifestation of mathematical weakness (Schumpeter, 1954). However, it is precisely these elements that have been picked up again and developed by later generations of Austrian authors, so as to constitute ultimately the hard core of the tradition. We are referring here mainly to three elements: a causal- genetic method, a radical conception of subjectivism and the role of institutions. Schumpeter’s writings are indeed stamped with these aspects of the old Austrian school, consequently organised coherently into the framework of economic evolution.

Schumpeter inherited a central distinctive feature from early Austrians, namely a dynamic vision of economic phenomena. Economic process comes to the forefront and replaces the concern with equilibrium state conditions. The focus on economic process is often presented as one distinctive feature of the Austrian tradition as compared with mainstream economics. However, if we take as a reference Schumpeter’s interpretative framework, it is not sufficient in order to position this tradition in the logic of economic evolution. Indeed, the interest for the process is not specific to the framework of economic evolution but to the whole Schumpeterian analysis. Even in circular flow, the author is less interested by the pre-determined final state of general equilibrium than by the process of convergence towards this reference.¹⁷ The framework of circular flow is a fruitful synthesis between Schumpeter’s primary concern for economic process and his admiration of Walrasian general equilibrium analysis:¹⁸ circular flow is an analysis of individual adjustments towards a pre-determined final state of equilibrium; it concerns the analysis of the process of convergence towards equilibrium. The Walrasian general equilibrium remains a central reference but the focus moved to the question of how this situation can be reached. In the framework of economic evolution Schumpeter questions the static vision of Walras and the process under examination breaks with the idea of passive adaptation to the equilibrium reference: ‘I felt very strongly that this was wrong, and that there was a source of energy within the economic system which

¹⁵ Schumpeter ([1954], 1983, t.3, p.139).

¹⁶ Cf. Schumpeter (1951, p. 300).

¹⁷ Remember the celebrated opening sentence of the *Theory of economic development*: ‘The social process is really one indivisible whole. Out of its great stream the classifying hand of the investigator artificially extracts economic facts.’

¹⁸ Schumpeter’s opinion is unconditional: ‘...as far as pure theory is concerned, Walras is in my opinion the greatest of all economists’ (Schumpeter, 1954, p. 827).

would of itself disrupt any equilibrium that might be attained' (Schumpeter, [1912], 1937, preface).

To recap, economic process is always at the centre of the analysis, be it the process of convergence towards equilibrium in circular flow, or the process of creative destruction in economic evolution; as shown below, the analysis of economic process is also from the outset at the centre of investigations of the Austrian tradition.

In the Austrian logic, focus on economic process stems from the adoption of a more general approach to economic phenomena, namely of a causal-genetic method. The first Austrian author to make explicit this approach was Mayer ([1932] 1995, p. 57) who distinguished between two types of theoretical approach to the question of the determination of prices: causal-genetic theories which, 'by explaining the formation of prices, aim to provide an understanding of price correlations via knowledge of the laws of their genesis', and functional theories which, 'by precisely determining the conditions of equilibrium, aim to describe the relation of correspondence between already existing prices in the equilibrium situation'. According to Mayer, functional theories do not increase our understanding of the economic system since formal relationships depict a particular situation – a state of equilibrium – in which the price formation process has already taken place implicitly. On the contrary, causal-genetic approaches emphasise the research of primary causes which originate an economic phenomenon. Understanding an economic event means identifying the forces which set in motion the temporal process the outcome of which is the phenomenon under analysis.¹⁹ In this perspective, Schumpeter (1912, p.3) defines the activity of the theorist as consisting in identifying causal relationships between economic variables until a primary extra-economic cause is reached: 'Always we are concerned with describing the general form of the causal links that connect economic with non-economic data'. Economic explanation should be based on causality rather than interdependence.

Causal-genetic thinking is undoubtedly part of early Austrians' specificity and shows evidence of their influence on Schumpeter's analysis. Founding Austrians do subscribe to such an approach: Mayer's article was a tribute to Wieser and Menger's theory of price is presented as a typical causal-genetic analysis;²⁰ the question whether Böhm-Bawerk developed a causal-genetic approach of capital and interest is more controversial. However, it is sufficient to note for our purpose that the aspect of his work which Schumpeter celebrates the most precisely concerns the emphasis on economic process. According to Schumpeter (1951, p. 147), Böhm-Bawerk's great achievement has been to combine '... his own ideas with Menger's teachings into a coherent structure, into a theory of the economic process. [...] ... he became one of the five or six great economists of all time. He gave us an all-embracing theory of the economic process – one of the great analyses of economic life on the scale of the Classics and of Marx – conceived on Mengerian foundations...'

Subjectivism is put forward as a key characteristic of the Austrian school. Such assertion requires further precisions for subjectivism seems at first glance to be the only feature undoubtedly shared with Walras and Jevons, at the core of the marginalist - or subjectivist - revolution. The main argument here is that Menger, Wieser and to a lesser extent Böhm-Bawerk, paved the way for a particular conception of subjectivism, more general and of dynamic nature. Indeed from the outset, subjectivism was not restricted to the demand side

¹⁹For an analysis of genetic-causal thinking in economics, see Cowan and Rizzo, 1996.

²⁰ It is interesting to notice that Schumpeter develops a similar theory of price determination; the author, like Menger, does not come up with the determination of a single equilibrium price but with an interval of potential values delimited by the respective subjectivity of traders. 'Il n'est tout d'abord pas fixé de relation d'échange précise. Elle dépendra surtout de l'habileté, de la puissance économique et de la sécurité des positions des deux co-échangistes' (Schumpeter, 1912, p. 52).

but enlarged, through Menger's theory of imputation and Wieser's concept of opportunity costs to the production side.²¹ Moreover, we can find in early Austrians the stuttering of a dynamic view of subjectivism, as O'Driscoll and Rizzo (1985, p.22) define it: '[dynamic subjectivism] views the mind as an active, creative entity in which decision-making bears no determinate relationship to what went before', whereas static subjectivism is characterised by the fact that '[...] the mind is viewed as a passive filter through which data of decision-making are perceived. To the extent that the filter can be understood, the whole process of decision-making is perfectly determinate'.

This peculiar conception of subjectivism has direct repercussions on individual rationality. Austrian subjectivism challenges the marginalist *Homo economicus* whose objective is limited to utility maximisation and whose choice results from the comparison within a closed set of alternatives of all available possibilities. The Austrian agent makes his decisions within a continuously changing environment, the passage of time being the cause for the evolution of his perceptions and knowledge at the origin of a continuous modification of his plans of action.

Notice however that we find in Menger, Wieser and Böhm-Bawerk only the premises of dynamic subjectivism. Menger insists on the role of the acquisition of knowledge of causal relations; Wieser is at the roots of the opportunity cost theory and Böhm-Bawerk develops the consequences of the temporal dimension of the production process upon individual choices. As argued above, this was not sufficient for the authors to go as far as Schumpeter and consider the creative role of the entrepreneur proper. It nevertheless remains that energetic rationality – entrepreneurial rationality – cannot but be associated with a dynamic conception of subjectivism, showing evidence of the Austrian influence in Schumpeter's theory of economic evolution. Moreover, we already find in the writings of Menger and Wieser the idea that economic progress – evolution – is the outcome of the interaction of two types of rationality corresponding to what Schumpeter was later to call hedonist and energetic rationality. We are referring here to Menger's and Wieser's theory of money and more generally of institutions: money emerges as the result of the interaction between two groups of agents granted with different behaviours; on one side we find Wieser's 'leaders' or Menger's 'innovators', endowed with superior natural abilities that allow them to find new processes or new tools, like the use of a unique commodity as intermediary of exchange; on the other side, we find Wieser's 'masses' or Menger's 'imitators' who simply adapt to the decisions of the other group as soon as they become aware of the positive impact, if any, of these new processes or tools.²²

Schumpeter's theory of economic evolution rests, among other things, on an analysis of the function of the institutional set-up of the economy. More precisely, credit is analysed by Schumpeter as an indispensable institution to the implementation of innovations by entrepreneurs.

The very theme of institution is not alien to the old Austrian tradition as it is the case with marginalism, and progressively becomes part and parcel of the Austrian research programme. Menger's analytical objective is not clarified before his 1883 book and is precisely centred on the process of emergence of organic institutions: 'How can it be that institutions which serve the common welfare and are extremely significant for its development come into being

²¹The subjective dimension of marginalist analysis is restricted to the introduction of subjective factors on the demand side, the aim being to counterbalance the importance of objective factors passed down from classical theory and still present on the supply side: objective production costs determine supply in the analysis of Jevons and Marshall rejects the theory of opportunity costs offered by Wicksteed and Davenport.

²²See Arena and Gloria-Palermo (1997) for a deeper comparison between Menger, Wieser and Schumpeter on institutions and rationality.

without a common will directed toward establishing them?' (Menger, [1883] 1963, p.146). Theoretically understanding the origin and change of organically created social structures is ultimately, according to Menger, the fundamental question any theorist of social sciences should aim to resolve. This focus on institution however does not alter the very basis of the Mengerian logic which remains attached to the circular flow: there is indeed a hierarchy between consumption, production and institutional structures of society: the institutional structure provides the underlying environment necessary to the viability of economic activity organised in the other two structures and individual well-being depends on the ability of the production structure to answer consumption needs.

Wieser's theory of the emergence of institutions is slightly more complex than that of Menger, a theory of power conflicts being added to the explanation in terms of interaction between two types of rationality. Institutions emerge from a process of interaction between masses and leaders. Masses however are not a passive reactor to leaders' decisions; their attitude is essential insofar as they can accept or reject leader's impulsions. Leaders initiate a social movement whose outcome, through masses' selection, goes well beyond the expected results: 'Only a part of the force that builds social institutions is directed by purposes; the final decisive mass-influence operates beyond the purpose' (Wieser, [1914] 1967, p.165).

If old Austrians - Menger and Wieser in that case - have the credit for bringing the theme of institutions to the limelight, a fundamental difference with Schumpeter's analysis should however be pointed out. If the concept is the same, it is embedded in a totally distinct perspective. Schumpeter is not at all interested in grasping the process of emergence of institutions but rather in identifying the capitalist function of institutions and the role they play in economic evolution.²³ In this way, Schumpeter does not investigate the circumstances explaining the development of credit; he takes it as historically given and focuses on its influence on the process of creative destruction: the function of credit is to select between innovative projects of entrepreneurs by deciding who will get the funding.

The essential function of credit in our sense consists in enabling the entrepreneur to withdraw the producers's goods which he needs from their previous employments, by exercising a demand for them, and thereby to force the economic system into new channels.

(Schumpeter, 1912, p. 106)

Conclusion

The similarities are too evident to deny any influence of early Austrians on Schumpeter's theory of economic evolution. The main difference however is that Schumpeter understood the pathbreaking nature of these elements whereas Austrians remain ambiguous with respect to marginalism. In Schumpeter's perspective, Menger, Wieser and Böhm-Bawerk are ultimately classified in the logic of circular flow despite the presence in their analyses of the disturbing elements presented in the last section. It seems indeed that to Schumpeter, these elements are not central to them: remember that Menger's theory of money and institutions, although already sketched out in the *Grundsätze*, is the main theme of the *Untersuchungen über die Methode*, and that Schumpeter does not consider this later book as a major contribution to economics as the *Grundsätze* may be;²⁴ as for Wieser's description of the figure of the leader and power conflicts, it is part of the overshadowed sociological aspect of his work, Schumpeter emphasising rather his contribution to the Austrian theory of value, of

²³See De Vecchi (1995).

²⁴'It would be unfair to his chief contribution to present this later work as equally important'. Schumpeter (1951, p. 88)

imputation and subjective cost; Böhm-Bawerk does not fully grasp the consequences of the temporal dimension of the production process to the extent that roundabout methods of production do not amount to new combinations in Schumpeter's sense.

The distinction made by Schumpeter between circular flow and economic evolution may still be useful today in order to classify the different versions of the Austrian revival. In particular, the theories of Kirzner and Lachmann may be respectively classified in the circular flow framework and in the logic of economic evolution: Kirzner's theory of entrepreneurship focuses on the equilibrating function of the entrepreneur, depicted as an arbitragist actor, whereas Lachmann's analysis of the market process emphasises the disrupting force of creation. Lachmann's analysis may then be regarded as a fruitful attempt of extending the Mengerian logic to the framework of economic evolution.

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