Episode 403: Austrian Microeconomics: Where the Critics Go Wrong

Guest: Jeff Herbener

WOODS: I've had many, many people say to me, "What do you say to Bryan Caplan in his famous article?" And I thought, well, I'm always badgering Bob Murphy to get on the show, and doggone it, the guy has other things to do also. He's not just on The Tom Woods Show. So who's my number two guy to badger? Well, Jeff Herbener, of course, Liberty Classroom faculty member and guy whom I have not stumped in 20 years of asking questions. So, you are the lucky man to help us go through this. We will link to it, of course, on the show notes page today, which is TomWoods.com/403, because, Jeff, this is Episode 403 of the show.

HERBENER: Wow, very impressive.

WOODS: How about that? Great...So people can read this article for themselves; it'll be linked at TomWoods.com/403, and we're actually going to do it in order, and so this means that maybe I'll badger you once a month for the next -- give you something to do over the summer.

HERBENER: (laughing) Yeah.

WOODS: Yeah. So we're going to start with "Foundations of Microeconomics." And do not turn off the podcast, all right? I am ordering you, as regular listeners of the show, do not be put off by this. I know you're tempted to turn the thing off, because you want to hear us talk about business cycles and traditional topics, but this foundational stuff is very important. And according to Caplan, Murray Rothbard just gets all of it wrong; he doesn't understand welfare economics; he doesn't understand all kinds of questions that are discussed in mainstream economics. So we want to evaluate all this. First of all, explain to the audience, when we use the terms "utility functions" and "value scales," what do these two things mean? The Austrians talk about value scales -- tell us what these two things mean.

HERBENER: Okay, well, let's start with "value scales." So the Austrian view is to take the human person as the starting point of economic analysis. And then we begin the analysis by gathering up all that we can know about human action, just by reflecting upon our own actions. And in that process we hit upon this notion of choice -- that in action we make choices -- to use our means to attain some ends and forego the attainment of other ends, and that we choose between competing sets of means to attain the same end. And this choice is based upon a preference that we have that's bound up in this choice, so we prefer one alternative to another. So that's what a value scale is: value scales just are analyses of the idea that we're choosing and valuing one alternative -- that we choose -- more highly than an alternative option that we forego in action. So this is all, from the Austrian viewpoint, grounded in the reality of the human person and the circumstances of action and the nature of choice.

Now, utility functions are entirely different. Utility functions are constructed as an arbitrary arrangement of utility or value that is embedded in fictitious agents. So all the neoclassical approaches to explaining the real world of economics begin with agents that are assumed to have particular ways of valuing things. And so it isn't the association of means and ends -- particular things that we're using as human beings to obtain particular ends -- but the neoclassical economist assumes that there are these economic agents that are able to place a value on all of the different combinations of things that exist in the world. And so the assumption is that these agents are able to make comparisons between the value that they would place upon all sorts of different combinations of goods, whether or not these combinations of goods are associated with particular actions that particular people would be taking.

It's a little bit hard to wrap your head around this distinction, but perhaps we can use a concrete illustration. With the Austrian approach, we would look at a human person who is in particular circumstances and then chooses an end. He's hungry, and so he wants to eat lunch, and so he chooses a chicken wrap for lunch. And the means that he chooses, the chicken wrap, he values with respect to the end that it attains. So there's this connection that the human person creates between the ends and the means. The agent, though, of the models of the neoclassical school would value the chicken wrap within a bundle of all the other goods that exist. This agent has the ability to value all the different combinations of different amounts of the good. Like half of a chicken wrap, with a bag of apples, with an automobile, with a house that the person owns, and so on and so forth. And then minutely changing each of these amounts -- so two chicken wraps, and two bags of apples, and six cars, and so on and so forth. And then decide whether or not each of the bundles of goods has more or less value than any other bundle. So fundamentally, these are two entirely different approaches to the whole question of valuing and choosing and acting.

WOODS: This is probably my Austrian prejudice coming in, but the value scale approach seems so much more commonsensical and seems to be more understandable from the point of view of ordinary life.

HERBENER: Right, that's an excellent point. Why go through all this rigmarole? And the answer to this, I think, is that it harkens back to what Milton Friedman claimed about

mathematical logic: if we can put, he thought, economic arguments in mathematical language, then it's possible to give strict, demonstrable proof of conclusions that flow within the mathematical structure of the model. And this is superior to merely verbal reasoning, where there are all sorts of difficulties and fallacies, and so on and so forth, that he thinks don't enter into mathematical logic. Now, whatever one might say about that kind of a claim, it still leaves open the question, as you suggest, of what all this mathematical treatment has to do with explaining real human action and real economies.

WOODS: Let's talk about what Caplan is saying with regard to Rothbard's criticism of utility functions and Rothbard's preference for value scales. So value scales are high on Rothbard's value scale, apparently. So he's saying that Rothbard is critical of utility functions, because he believes that economists using them are conceiving of utility in a cardinal sense, as there being units of utility; whereas Rothbard claims that utility is ordinal -- you can't say how much more, in terms of some fixed unit, you value an ice cream cone to a bottle of wine or something, but you can simply say that you prefer one to the other. And Caplan says this is a complete misunderstanding; there is no cardinal utility being used in these utility functions. So who's right?

HERBENER: Well, it might be that Caplan has a point here. But again, if we accept his view, which is the standard neoclassical position, that you can use mathematical techniques, called representation theorems, to show a mathematical function that does in fact have cardinal elements to it as merely a representation of an ordinal ranking system -- if you accept this claim, then Caplan is correct. Now whether or not one should accept this claim in a broader sense -- whether this is just kind of a narrow mathematical proof or whether it's acceptable philosophically -- well that, I think, is a different matter.

So Rothbard, I think here, is just taking the commonsensical view that if you say that we have utility functions, and utility is the dependent variable in the function, then it has to have cardinal numbers. Otherwise, the whole functional analysis is rather pointless. So from a kind of commonsensical view -- and again, from various philosophical positions one might take -- this seems to be a legitimate criticism.

Now, if we accept Caplan's argument that representation theorems sort of get around this problem by showing that, if I ordinally rank things, I can from that construct a mathematical function that preserve the ordinal ranks, and therefore I can use the mathematical function in analysis -- if one accepts all that, which again I don't think one has to -- then one still has this problem that I alluded to earlier, that there has to be, in order for this to work, a complete and continuous ordering of preferences behind the mathematical function, so that when you construct the mathematical function, it's completely and utterly continuous. And you need this kind of continuity in order to do calculus and other mathematical operations on these functions.

So that then becomes the telling point against this approach. Is it really reasonable that we can model human beings by agents who not only can rank every conceivable bundle of goods that they might possess, but can do so in infinitesimally small,

changing amounts across all of the goods that they own or potentially could own? This seems, again, quite remotely connected to real human beings.

WOODS: Before we go on, let me ask you, what are the real world – well, for economic theory, anyway -- implications of this difference of opinion that you would have with Caplan and with other economists? If they have this view, and they use this type of functional analysis, how does that affect the way that they do economics? Because this all seems like very abstract theory. What are the practical implications of this way of thinking?

HERBENER: Well, I think the practical implications come in the nature of what economic analysis becomes when you treat it as functional. So once you say that what we have are functions and we can use mathematical analysis, you're led then, inevitably, to the view that economic analysis is really doing empirical prediction and empirical hypothesis testing. And so you've reduced economics to just a practical kind of predictive device that would be, in fact, useful -- or even supplanting -- of the entrepreneur. Basically, economic analysis is now doing prediction of what the patterns of demands will be, what will be profitable, what will not. You could replace all political decision-making with predictions based on modeling, and so on and so forth. So that is a completely different conception of what the usefulness of economic theorizing and economic analysis is. The Austrians hold that economic analysis tells us, really, about the meaning of human action. It tells us about the underlying economic laws that govern the social order, and are not particularly useful -- at least on the theoretical level -- for making empirical predictions.

WOODS: I'm going to skip "Indifference," for the moment, because he has a section on "Continuity" -- and given that we just hit on that, we might as well touch that. He quotes Rothbard: "Human beings act on the basis of things that are relevant to their action. The human being cannot see the infinitely small step. It therefore has no meaning to him and no relevance to his action." And of course, with calculus, you're dealing with infinitely small steps. And then Caplan says, "Okay, but without continuous preferences, it's also highly unlikely that, for example, supply and demand can ever be equal. If you draw the supply and demand curves continuously, then they are almost bound to intersect. But if you draw them as a discreet set of points, supply and demand in general don't have to intersect. Thus, the argument against calculus based upon the rejection of continuity also argues against even the use of simple algebraic constructs, like the intersecting supply and demand lines that fill Rothbard's works."

HERBENER: Yeah, here I think Caplan's just made a mistake. I don't think it's correct to draw the conclusion from discrete demand and supply curves, non-continuous supply and demand curves, that they don't intersect, or that you wouldn't get analysis of market clearing that both the neoclassicals and the Austrians hold to. That just seems to me to be mistaken. You'd still have a law of demand; you'd still have a law of supply, even if you work, as the Austrians do, in discrete units. And the reason you don't have continuous curves -- the discrete patterns would intersect, and markets would, in fact, clear. And what we're trying to explain is the real world of prices that

we see. We're not trying to establish particular conditions of the analytical device; we're trying to explain the real world. So if we see prices in the real world, and we can analyze them as clearing -- just through the logic of what would happen if prices were higher, we'd get excess supply. Or what would happen if prices were lower, we'd get excess demand at that point. So markets clear, we see this just as a matter of logic, and this isn't relevant -- I don't think his point is relevant. The other thing is that Rothbard explicitly says that his view of smooth continuous curves is just a pedagogical device. So it's just a way of nicely illustrating the basic laws of economics.

WOODS: All right, let's talk about indifference curves. Very important to neoclassical theory. Rothbard rejects them, and he is quoted here as saying, "The crucial fallacy is that indifference cannot be a basis for action. If a man were really indifferent between two alternatives, he could not make any choice between them, and therefore the choice could not be revealed in action." And then Caplan goes on to say, "The crucial assumption shared by both Mises and Rothbard is that no preference can exist which cannot be revealed in action. But why assume this?" And then he goes on and on. Now I'm not sure -- correct me on this, Jeff -- but I'm not sure they're saying no preference can exist which cannot be revealed in action. I think they're saying that no preference that an economist can do anything with -- it would have to be revealed in action for an economist to find something that could be studied. To speculate on what may be floating around in my mind is not what economics is about.

HERBENER: Yeah, that's exactly right. So here again, I think Caplan's just made a mistake. There's an ambiguity in the way that he's using the word "preference." Rothbard and Mises use the word "preference," as you point out, to refer to the choice that a person makes in action -- so that's just the definition of the word "preference." Preference is what's revealed or demonstrated when a person chooses between two alternatives. Now, all the other aspects of the state of mind of the person who's making the choice, the economist can say nothing about. That would just be a psychological question.

Caplan goes on with an example where he says, "I may be indifferent between choosing a green sweater and a blue sweater, but I still choose one or the other." But this again is just using the word "preference" in a different way. So, sure, a thing can be only incidentally important or unimportant to the person -- which color sweater -- but the person chooses the sweater, and that's where the preference would be indicated. And if the person were psychologically indifferent toward green or blue, then that's just not part of economic analysis, because that's not part of choice.

WOODS: What is the purpose of indifference curves, and do you think that this argument -- that action demonstrates preference, not indifference -- is the key argument against indifference curves?

HERBENER: No, I think the key argument against indifference curves we mentioned before: it's that in order to construct them, we have to have agents who have this, we assume, ability to value all different bundles of goods, of all different infinitesimal amounts, in order to establish either a preference or an indifference. The bundle

ordering of value must be entirely complete. And I think that's where the basic flaw of the analysis comes in. Indifference is used only to show the maximum utility point of choice in the neoclassical system. So I don't think it's indifference curves, per se, that are the main problem; I think it's the whole notion that we can model real human beings in their choices and actions by using these fictitious agents.

WOODS: I think we'll skip welfare economics, because we should probably do a whole episode on welfare economics, given that you've written on it, and it's not an easy topic, and Caplan thinks that Rothbard's important article on the subject just gets everything all wrong. So I would definitely want to revisit this in the future, to do an episode on welfare economics. But just to finish up the section on micro-foundations, he has a little bit here on subjectivism. He says, "Innumerable Austrian essays and books use the word 'subjectivism' in the title. This leaves one with the impression that other economists fail to embrace subjectivism, an impression that is simply false. What neoclassical economist claims that the value of a good derives from its labor content or its intrinsic goodness or anything other than individuals' preferences? It is true that academic papers often abstract from the heterogeneity of preferences, but this is merely a simplifying assumption. To assume, e.g., that everyone has the same log-linear utility function is on par with assuming that the world only contains two people, Crusoe and Friday. It is not a statement about the world, but a method of focusing on one particular problem. Neoclassical economists' propensity to declare certain situations inefficient may superficially appear to violate subjectivism. As mentioned earlier, this is because efficiency has a technical definition somewhat different from its meaning in ordinary conversation." Does he score any points here?

HERBENER: No, I don't think he does. Again, the distinction between the Austrian and the neoclassical treatment of this idea of subjectivism rests on a different foundation. So when Austrians talk about subjectivism, they just mean that the valuing that a real human person does in choice resides in his mind, that he just makes a judgment in his mind. Whereas subjectivism in the neoclassical sense -- as you were reading -- just is an assumption about the utility functions between two different persons. So some assumption must be made about what the configuration of the utility one person has relative to another. So, for example, different individuals might have exactly the same utility functions, but subjectively, their marginal utility, as the neoclassicals would say, would be different if they had different amounts of goods. And that would be sufficient, in their view, for exchange to take place, let's say, between two people: one who had more of a good would value a unit of it less, and then another person who has a different good in greater supply would place less value on a unit of it, and then they would trade. But this is really just, as Caplan seems to say, an assumption that's made about the configuration of the agent's utility assessment. Whereas, in the Austrian view, we're talking about real human judgment. And this again is a fundamental difference that, I think, is a very sharp distinction between the Austrian view and the neoclassical functional analysis, because the one thing that Caplan doesn't mention through this article -- and the point that Mises stressed about functional analysis -- is functional analysis must assume that there are constants in the quantitative relationships of human action. And that's precisely what subjectivism does not permit, because subjectivism says that it takes human judgment to ascertain

the value of all the different elements of action, and this human judgment is changeable. And if that is so, then there can't be constants between different sets of data or quantitative magnitudes in the results of human action.

WOODS: This article covers so many topics that are particularly juicy for the audience, so when we get to it -- and I hope you will join me periodically to walk through it -- we're going to get to the topics that everybody wants to hear. There's a very – well, compared to the other sections -- a very lengthy discussion and criticism of Austrian theory of the business cycle. That will be very useful to go through. There is a criticism of the Austrian method, the praxeological method; that will be useful so that people first understand the Austrian method, and then see criticisms of it responded to. Economic calculation -- I'm actually having Matt Machaj on, who has an interesting take on the economic calculation argument of Mises against socialism -- I'm having him on next week to talk about that. So we'll look what Caplan has to say about that, monopoly theory, there's a lot of great stuff coming up. I'm tempted to jump into the socialist calculation thing, but I think we've spent enough time; I'll let you go. On the show notes page -- TomWoods.come/403 -- we will link to this article so that you can follow along, both in this episode and in the episodes to come. Also, of course, if you want to learn real economics, well then you'll want to learn it from Jeff Herbener, who can bat down every objection you could possibly raise, over at LibertyClassroom.com, where Jeff -- not only did you do the introductory course on Austrian economics, but you did a course that we did a whole episode on here, in which you went through the Samuelson-Nordhaus economics textbook, which is extremely widely used. And you went through and gave an Austrian critique, chapter by chapter. Nothing like that's ever been done, and all of mankind is grateful to you for that. Thanks so much.

HERBENER: Well, thank you, Tom, for providing the opportunity for these outlets.