

# *Capitalism and Morality*

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Carl Menger and Milton Friedman:  
Two Men  
Two Methods  
Two Schools  
Two Paths to Free Markets

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**History of Economic Thought Class, Dr. Younkins, April 19, 2006**

Of the economists who defend the free market, there are two schools. One is the Austrian school and the other is the Chicago school. The two schools together rightly recognize the superiority of free market economy in both conforming to man's nature and promoting his well-being. While scholars in the two schools agree on the superiority of the free market they differ, sometimes greatly, on their choice of method and argument that they use to discern, promote and defend its principles. These similarities and differences show themselves in the works of two scholars, Carl Menger and Milton Friedman, whose works comprise two paths to liberty; each path having its strengths and weaknesses. In addition to the significance of these paths to those interested in defending the free market, an understanding of them is also important to anyone seriously interested in political economy.

## **Carl Menger: Solid Foundations of the Theoretical Austrian**

The Austrian school began with the works of economic philosopher Carl Menger in Vienna in the late Nineteenth century. His *Principles of Economics* broke new ground and laid the foundation for one of the most influential schools of economics ever founded when published in 1871. According to Younkins, Menger “destroyed the existing structure of economic science and, including both its theory and methodology, and put it on totally new foundations” (Younkins 2005, 17).

Menger published his *Principles* as his vision of reality and in this work he truly shows himself to be a philosopher of economics. The book was intended to “restore the theoretical soundness of Smith's ‘system of natural liberty’” (Skousen 2005, 25) by correcting what Menger saw as its theoretical errors. He believed that the economist must discern what he calls the universal principles of economics. Believing that cause and effect are both knowable and that they govern our economic motivations, he sought to set economics on the firm standing of the natural sciences by discerning its exact laws. His *Principles* and his later work *Investigations into the Method of the Social Sciences* contain the groundwork for a complete philosophy of economics and economic methodology. In them, we find metaphysics, epistemology, ethics as well as his controversial methodology by which he sought to develop an exact theory of economy.

Menger follows a tradition of Aristotelian realism, though he does not align himself directly with Aristotle nor is he totally an Aristotelian.<sup>1</sup> Opening his first chapter of *Principles* with “All things are subject to cause and effect” (Menger [1871]1994, 51), it is not hard to see his Aristotelian foundations. He also believed that things had essences which by their nature they conformed to; he says “what is in essence the thing, that strict typical phenomenon of a definite kind must always, and indeed in consideration of our laws of thinking, simply of necessity, be followed by phenomena of just as strict and definite a type” (Menger [1883]1996, 29). Like Aristotle, he believed that the essences are metaphysical and that we are able to know these essences in both a practical everyday sense and in a scientific and theoretical sense. The ability of people to know the essences of things along with the laws of reality to which they conform is what makes science possible. He believed that things conform to laws of behavior according to their essence. Believing that reality exists independently of our minds, he thought that by observing phenomena we can learn their essences and the laws they conform to using the process of logical induction. Menger saw that we could in this manner come to understand, by observation and induction, the individual motivations of economic actors. It is this understanding that comprises the universal principles of economics and from which he would derive his exact theory.

Using this metaphysical and epistemological framework, and with the aforementioned principle of cause and effect in hand, Menger looks at the relationships of causality involved in humans fulfilling their needs. He sees that the law of causality is present in the process of our fulfilling our needs “If, therefore, one passes from a state of need to a state in which the need is satisfied, sufficient causes for this change must exist.” (Menger [1871]1994, 51-52). The concept of needs, which Menger sees as largely being derived from his biological and physiological nature, is of utmost importance to his development of “the exact theory of political economy” (Menger [1883]1996, 60). Satisfying what man needs is the “final cause in Menger’s exact theory and the driving force of all economic activity” (Younkins 2005, 26). He believes that all economic activity is explainable by discerning the laws involved in the process of individual humans fulfilling their needs. He consequently focused his economic inquiry on these factors instead of things such as commodity costs and production like the classical economists.

### **The War Over Method**

This method, focusing individual actions and motivations rather than the general aspects of phenomenon, differed greatly from the method of the classical economists and most of his contemporaries. Where Menger advocated a theoretical approach to economics that attempted to understand the economic actions of individuals, most of his contemporaries advocated the historical approach that examined the general aspects of national, state or other spatiotemporally defined areas of economic activity. Menger became involved in what was known as the “*Methodenstreit*” or “war over method” with scholars of the German historicist school of economics. In some ways, this war still persists to this day and characterizes a large part of the relationship between Menger and Friedman and between the Austrians and the Chicagoans. This modern manifestation will be covered later on.

The German historicists believed that there were no stable laws of economics and that the task of the economist was to collect and analyze data. They used findings derived by this method to justify socialist and interventionist policies enacted by the German government. Menger rejected this notion of the impossibility of economic laws as well as the policies advocated by the historical school. He wrote his *Investigations* largely as a reaction to the method of the historicists and his ongoing battle with Gustav von Schmoller of the German historicist school. The orientation of the historicists was known as the historical-empirical whereas that of Menger was known as the abstract-theoretical. The Germans held that all laws were at best contingent to the circumstances—legal, political, and cultural—and that none could hold with certainty over time. Menger and later Austrians rejected this on the basis that any laws derived from this method held only in the spatial and temporal circumstances within which they were derived. Menger saw that the historicists could not deal with the reality of economics, only with what they had in

their data which could at no time be extensive enough to yield a complete picture. For Menger “the goal of scholarly research is not only the *cognition*, but also the *understanding* of phenomenon... We understand it when we have recognized the reason for its existence and for its characteristic quality (the reason for its being and for its being as it is)” (Menger 1996, 9). He correctly saw that historical method could yield only cognition of phenomenon but never understanding. Without understanding, the findings of economists would be anecdotal observations at best which describe only small slices of economic activity and leave economic reality outside of possible grasp. Only through abstract-theoretical economics could actual timeless understanding of phenomenon be obtained and for this reason abstract theoretical analysis is necessary in economics.

Menger, unlike the historicists, believed that there was room in economic science for both approaches and that both stood on equal footing in regard to importance and validity: “just as theoretical economics can never take the place of the history and statistics of economy in our striving for cognition... [neither could the historical science]... take the place of theoretical economics without leaving a gap in the system of economic sciences” (Menger [1883]1996, 8-9). He believed that because what we experience involves both an individual aspect and a general aspect there is room for both the theoretical-individual and the historical-general modes of inquiry. The historicists sought to discern the laws of particular economies, such as that of a nation. Such laws were short run and could not hold universally outside of the particular facility of that from which they are derived.<sup>2</sup> While Menger made room for both orientations the historicists, as mentioned above, denied that there were exact laws in economics; as Bostaph puts it “The historicists rejected universality in economic theory because they believed that theory should be empirically descriptive of a given social context” (Bostaph 2005, 125). Menger correctly saw that the empirical method of the historicists could only present the data but could never interpret it. In order to gain understanding of economic laws one must use the theoretical approach to examine the data provided by the empirical approach.

Bostaph observes the Methodenstreit had no clear victor.<sup>3</sup> The Mengerian theoretical approach is arguably superior to that of the historicists because it is able to yield laws that hold in all circumstances and enable us to understand economic phenomenon rather than merely know them. While Menger’s work—along with that of Mises, Hayek and Rothbard who use his method—is still read today, it is not the approach used by mainstream economists. In some ways, it could be said that the war over method continues today and manifests itself in the differences between the two free market schools of economics. The Austrian school still relies largely on the abstract-theoretical approach advocated by Menger and further developed by Mises. The Chicago school, on the other hand, relies largely on Keynesian methodology that resembles that of the German historicists. Milton Friedman is the quintessential figure of the Chicago school and a vocal supporter of empirical method in economics. The continuation of methodological conflict becomes apparent when Friedman’s theories are examined.

### **Milton Friedman: The Precarious Foundation of the Empirical Chicagoans**

The Chicago school of economic thought developed as a reaction to the popularity of Keynesian theory following the Great Depression. Keynes, like the historicists, believed that economic laws were all short-run and used his theories to justify government intervention in the economy. At the time that the arrogant Englishman developed his theory, the Austrians comprised the extent of serious free market economic schools. Mises, Hayek, Rothbard and Hazlitt offered criticism and response to Keynesian method and the policies supported by the Keynesians but unfortunately, as Skousen notes, “the Austrian counterattack on Keynesian economics was almost completely ineffectual” (2005, 60). The effective attack against Keynesianism came from Milton Friedman.

Friedman responded to the Keynesians by using their own theories against them to prove that their interventionist policies did not achieve the results they were intended to achieve. Friedman observed

that the problem with Keynesian theory was that it had made many predictions and presented many theories but had never tested these any of these theories to see if they worked. He proceeded to use empirical analysis of data to systematically break down the edifice of Keynesian economics. Friedman's insight was in his monetary theory and he sought to place his monetarism at the forefront of economics. Against the Keynesian belief that the best way to maintain consumption and with it economic growth was through government spending, Friedman showed that government expenditures to households do not increase consumption. After showing fiscal policy to be of little effect in terms of controlling business cycles, Friedman advocated the importance of the quantity of money and its effects on the economy. He uses his monetary theory and his statistical skills to demonstrate the importance of monetary policy throughout history. Friedman demonstrated that the cause of the onset and severity of the Great Depression was fouled monetary policy.

Friedman is to this day one of the most widely recognized figures in economic history. Today at ninety-six, he and his work continue to be highly influential in the areas of economics and politics. He is a vocal and quite effective advocate for free markets and limited government and a major figure in the shaping of US policy since at least the Nixon years. His method and his skill at using it have brought him to the forefront of the economic sciences today. His success has allowed him to steer much American policy toward more free markets and limited government.

Friedman's method is very different from that of Menger and the Austrians, so much so that it fuels again the fires of methodological debate over the best method for use in economic research. As observed by Younkins, Friedman preferred "not to be a system builder" (2006, 1) and instead focused on empirical and historical analysis in order to establish a basis for his ideas. He lays down no system of metaphysics or epistemology; the fundamental principle of his methodology is predictability. In his 1953 essay "The Methodology of Positive Economics" he says that "The ultimate goal of a positive science is the development of 'theory' or 'hypothesis' that yields valid and meaningful (i.e., not truistic) predictions about phenomena not yet observed" (Friedman 1953, 7). Again, unlike Menger and the Austrians, he is not concerned with understanding of phenomenon and their actions but simply with predicting future phenomenon. For Friedman, all a theory needs to be considered a good theory is to make accurate predictions about the future. All theories are merely constructions we put forth in an attempt to predict the behavior of phenomenon. For Friedman it is impossible to prove the truth of a theory, we can merely use data and analysis to prove a theory false. The best we can hope to do is produce a theory that is predictive.

According to Friedman, theory conforms to the data. If the data show that a theory is false then the theory must either be thrown out or augmented. Friedman has upheld the use of unrealistic assumptions in his theory that are simplifications of phenomena. He defends the use of these assumptions on the grounds that as long as a theory's predictions are accurate its assumptions can be completely false.

Friedman criticizes the realistic approach of Menger and the Austrians. He considers judgment of a theory on anything but its predictive power to be wrong: "Some economists make the mistake of judging a theory on the realism of its assumptions rather than on its predictions, says Friedman" (Butler 1985, 230). He believes that any realistic theory would have to incorporate all aspects pertaining to a phenomenon and that realistic theories are therefore impossible because of complexity. Believing that "a theory or its 'assumptions' cannot possibly be thoroughly 'realistic' in the immediate descriptive sense" (Friedman 1953, 32), he thinks that all new events must be somehow worked into any theory. This belief amounts to a denial of Mengerian method and an endorsement of methodology similar to that of the German historicist school discussed above. Both Friedman and the historicists deny the possibility of sound abstract theory and both endorse the use of empirical analysis in order to direct action.

## Modern Manifestations of Methodenstreit: Two Methods for Free Markets

Menger and Friedman were both advocates of the free market, though they choose widely different methodological paths to pursue their aim. Much can be said for both methods. Menger's method sparked the beginning of both modern economics and the foundation of the Austrian school of economic thought. His work, along with that of later Austrians such as Ludwig von Mises and F. A. Hayek, has had a major effect on policy and further economic thought. Menger believed that the free market was superior because men best know what their values and ends are and that therefore individuals best know what they need to do to fulfill these ends. He used his Aristotelian method to attempt to derive a complete system of economics. Menger was able to defend the importance of abstract theory and show the limitations of mathematical economics. His work established a firm basis for a true science of economics.

Friedman has been perhaps the single most influential advocate of the free market of all times, second only to possibly Adam Smith. He laid the foundation for the Chicago school of economic thought, arguably the most influential today. He has advised multiple US presidents as well as governments of other countries on economic policy. His work pioneered the study of econometrics, now the standard tool of the average economist. His method enabled him to roll back the tide of Keynesian interventionism and demonstrate the importance of the quantity of money to national economy. Though he advocates many of the libertarian arrangements of his Austrian counterparts, he works toward his goals incrementally through changes in government. His approach to defending the free market was a pragmatic one which was and continues to be highly effective in incrementally instituting a more libertarian state. He has developed an important and useful tool for demonstrating the benefits of freedom.

Menger's method is not completely without faults. The practical problem with abstract theory is just that: it is abstract, too much so at times to appeal broadly. It is a product of our post-Enlightenment sensibility that much of academia and the public at large want to see empirical results to back theory up. Skousen notes that one of the reasons that the Austrians were somewhat unsuccessful in mounting a popular revolt against the Keynesians was the fact that they focused purely on theory at the sake of empirical analysis.<sup>4</sup> Despite the limitations of empirical method and its demonstrated inability to produce solid scientific theory, the fact cannot be denied that it is the 'language' of mainstream economics. Contemporary man's desire for data must be appeased at some point.

In addition to falling victim to the same criticisms as did the German historicists—namely the fact that solid scientific economic theory cannot be derived mathematically—Friedman's method also presents other problems. The main one is a result of the failure he shares with the historicists. Friedman's method can only show that something *has been* so, and that it *should* be so feasibly in the future. It is not able to show that something *must* be so. Thus, he cannot show that free markets are in some way inherently superior to another system based on the natures of the actors involved. If data were to manifest itself that demonstrated empirically that socialism was more effective an economic system, he would have to augment his free market theory. This is a possibility that his method, while effective at pragmatic persuasion and incremental implementation of libertarian principles, could easily be used against him. Menger's method, by comparison, cannot be used against the free market because his system is derived from the essences of the actors. The only way to argue against Menger is by challenging his Aristotelian assessment of man's nature.

Friedman's method presents another serious problem for anyone interested in economic freedom. Though his incremental strategy of altering government to be more oriented to market freedom is very effective in limiting the state, it shows a methodological error. Friedman's key idea is monetarism, an idea that contains an endorsement of fiat money and the manipulation of aspects of fiat money as such by the government. Thus, most of Friedman's recommendations center on how the government should *do* this thing or that, such as how they should control the money supply. He is here essentially doing the

same thing that the historicists and Keynesians did—direct government economic action—only for a different stated goal. For believers in the free market, however, the general disposition is that the government shouldn't *do* much of anything at all. The whole edifice Friedman's predictive economics is oriented toward aiding the government in economic activity. However, it seems that if the purpose of government is limited to protecting individual rights and providing defense, it follows that the government should have no need for predictive economics. If the government were not on the one hand spending massive amounts of money in a Keynesian style attempt to bring about legislated economic outcomes, and on the other hand were not in control of money and its supply or of the rate of interest, they would need only abstract theoretical economics and perhaps descriptive economics. At most, a limited government would need predictive economics perhaps only for budgetary and cost forecasts for law enforcement and adjudication services and defense. Thus while Friedman's method provides a means to limit government, it presupposes within its framework much government action.

### **Conclusion: A Hybrid Method**

Friedman and Menger were both highly influential and important figures in the history of economics. Both have made invaluable contributions to the advancements of free markets. They use very different methodologies, both with its strengths and weaknesses. In the future, it seems as though the best path for those economic thinkers interested in being proponents of free market ideals is to pursue a method that is a hybrid of those of the two thinkers discussed above. By combining the positive and effective parts from both methods, it is possible to construct one that fits with Menger's idea that there is room in economics for both theoretical and empirical orientations. By applying the Aristotelian framework that Menger used to develop solid theory we can then use Friedman's empirical tools to demonstrate that these theories are true and demonstrate their implications in the real world. If data conflict with theory than it is the data that must be looked at as suspect and the theory, if it is sound, must remain unscathed. In this manner it is possible to construct the solid foundations of theoretical science in economics and also to appease popular desire for empirical demonstration of theoretical truth. When the two paths of Menger and Friedman merge into one methodological roadway, it will be possible to speed along to a free market.

### **Notes**

1. For further explanation of Menger's Aristotelian orientation see Younkens 2005, p. 19-23; and Smith 1990.
2. See Bostaph 2005, p. 120-121.
3. 2005, 113.
4. See Skousen 2005, 60-61.

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