



Austrian economics and development: The case of Sudha Shenoy's analysis

Giandomenica Becchio¹

Published online: 6 January 2018

© Springer Science+Business Media, LLC, part of Springer Nature 2018

Abstract The aim of this paper is to describe Sudha Shenoy's use of Menger, Mises, and Hayek (she explicitly called them 'the older Austrians') to explain development and growth. Her aim was to show that the application of Austrian economics, based on the notions of capital structure and division of labor, embedded in a specific legal framework (common law), historically promoted development and growth (as in early modern England); and can promote development and growth in underdeveloped countries (her specific focus was India). Shenoy also claimed that any policymaking as well as government's intervention are either useless or dangerous, having two main dysfunctional effects, which are often interrelated; namely, make development slower (or even stop it), and increase corruption.

Keywords Development · Capital structure · Division of labor · Catallaxy · Common law · Economic plan

JEL classification B25 · B31 · B53

✉ Giandomenica Becchio
giandomenica.becchio@unito.it

¹ Department of Economic and Social Sciences, Statistics and Mathematics, University of Torino, Torino, Italy

1 Introduction: Shenoy within the Austrian school of economics

Sudha Raghunath Shenoy (1943–2008) was an Indian academic scholar.¹ She belonged to the fourth generation of Austrian school of women economists (Becchio 2018),² and had covered a significant role in the so-called Austrian revival, which took place at the South Royalton conference (1974), considered the founding meeting of the modern Austrian movement. In an interview she gave to the *Austrian Economics Newsletter*, Shenoy remembered her “longest connection to the Austrian movement” (Shenoy 2003, 1). Her father, Bellikoth Raghunath Shenoy (1905–1978), a student of Hayek’s in the 1930s at LSE, was “the only liberal economist between Athens and Tokyo”.³ He deeply influenced his daughter’s political vision as well as her economic analysis. Shenoy remembered that although Murray Rothbard’s *Man, Economy, and State* and Israel Kirzner’s studies on entrepreneurship were fundamental for her decision to become an economist, it was Hayek’s works on political philosophy, which greatly impressed her. Both *The Constitution of Liberty*, and *Law, Legislation and Liberty* were crucial to understanding the central role of market in social orders, being the market which precedes the state and not vice versa. Along with Hayek’s works, Shenoy was deeply impressed by Menger’s analysis of institutions:

¹ S. R. Shenoy, Ph.D. in Economics (New Castle, Australia, 2001), was educated at Mount Carmel School and St. Xavier’s College, Ahmedabad, India, the London School of Economics, the University of Virginia, and the School of Oriental and African Studies (University of London). Research Assistant at Queen Elizabeth House in Oxford, between 1971 and 1973; lecturer in Economics, University of Newcastle, Australia, between 1973 and 1974; lecturer in Economics at Cranfield Institute of Technology, between 1975 and 1976; and senior tutor in Economics, University of Newcastle, since 1977. She held visiting positions at California State University, George Mason University, and Ludwig von Mises Institute.

² Since the beginning of the twentieth century, a group of Austrian women economists gathered around Wieser and Böhm Bawerk first, as well as Mises and Hayek thereafter. The first two generations were Viennese economists active between the early twentieth century and 1938 before the massive emigration due to the *Anschluss*. The first generation (up to 1919) received their academic degrees outside Austria due to the persistent ban against female students in Austrian universities, including Else Cronbach (1879–1913), Louise Sommer (1889–1964), and Toni Kassowitz Stolper (1890–1988). The second generation (active during the interwar period) finally had the opportunity to enroll in and graduate from the University of Vienna: formally students of Mayer, they were massively influenced by Mises, such as Marianne Herzfeld (1893–1976), Martha Braun (1898–1990), Helene Lieser (1898–1962), Gertrude Lovasy (1902–1974), Elly Spiro (1903–2001), and Ilse Schüller Mintz (1904–1978). The third generation of Austrian School women economists was no longer from Austria: it was formed by Hayek’s students at LSE (1930s–1970s) and by Mises’ students at NYU (1938–1960s): they were Marjorie Grice-Hutchinson (1909–2003), Vera Smith Lutz (1912–1976), Mary Sennholz (1913–), and Bettina Bien Greaves (1917–). A fourth more recent generation began after the so-called Austrian revival in the 1970s with the work of Sudha Shenoy. Austrian school women economists shared with their mentors and colleagues an economic theory focused on individuals’ plan coordination and decentralized knowledge; the disutility of any monetary policy as well as of any governmental intervention to minimize distortions; the fundamental role of innovation to explain the link between growth and development, and a specific interest in the history of political economy.

³ B. R. Shenoy was a member team of the Planning Commission for the Second Five year Plan, prepared by the Indian Government in 1955. He was the only dissenting voice to the plan based on the following reasons: 1. The plan’s size: an excess of the capacity of the available real resources would have led to uncontrolled inflation and wastage; 2. Deficit financing as a mean of raising resources to make the plan work: a hard gap to fill between the size of the investment program and available resources; 3. A short-sighted policy: taxes on lower income groups, extension of nationalization, continuance of controls, and price support of agricultural produce, which would threaten individual freedom and democratic institutions; 4. Institutional implications of the plan itself: a very plausible source of corruption (Bauer 1998; White 2012; Prakash 2013; Anand 2015).

The older Austrians were examining institutions and social forces that had already developed in people's actions. Then they were trying to work out the principles that are implicit in how people are acting. The point is that they realized that there was already a market economy out there working. They began to see that people were acting on rules that were first manifested in people's actions and then articulated. This is like language. It is a way of understanding the origins and background of Austrian analytics. The "something" they are analyzing is preexisting, not created by one mind or one generation but over a long period of time. The older Austrians were the latest in this analytical line. (Shenoy 2003, 3)

From a methodological perspective, Shenoy recognized some peculiar regularities in economic behavior, and the importance of the historical framework in order to understand them. She explicitly criticized the methodological turning point that occurred in economics in the 1930s; i.e., the adoption of mathematics and the method of natural science in economics, which determined the rupture between the discipline and its real object of study: human action and its application, which is, according to her, not related with a rational economic agent, but with the complex dynamics of social phenomena, which are the object of economic history. Shenoy explicitly followed McCloskey's argument that economists are not scientists, but story-telling historians: "neoclassical economists are even further removed from even the remotest possibility of learning about the issues involved in studying human action" (Shenoy 2010, 60).

Shenoy's research field was focused around the historical origins and causes of development: her main theoretical efforts were directed to present an endogenous theory of progress. Her Ph.D. thesis dealt with modern England as a case study to show the evolution of Western countries towards a flourishing economy as well as a liberal democracy. In her works, she applied Austrian categories⁴ to underdeveloped countries in order to test the validity of those categories and to show the disutility of any governmental policy oriented to promote development (she deeply criticized the massive planned regulation in India, during the 1960s and 1970s, whose aim was to promote development), including Keynesianism. Following Hayek's suggestions (Hayek 1944), she regarded interventionism as a way to a dangerous escalation towards corruption, illiberalism, and even totalitarianism.

2 Development explained by the capital structure and the division of labor

Growth and development have always been a fundamental topic in economics since Adam Smith's inquiry on the cause of the wealth of a nation (1776). Shenoy's researches came after a long debate about the causes of growth of industrial countries, which took place in the 1950s and continued during the following decade. More

⁴ A methodological explanation: the term 'category' in this paper refers to the distinction made by Schumpeter (1954) between vision (an economist's cultural framework, which deeply influences her theory) and analysis (the set of categories, which determines her economic theory). In Shenoy's case, her Austrian categories are: capital structure, division of labor, common law, catallaxy, and their peculiar combination. Shenoy used these categories as real-types in Machlup's terms; i.e., "categories of observation, classification, description, and measurement" (Machlup 1978, 258).

specifically, during the late 1950s, the concepts of development was distinguished from the concept of growth, and development economics arose as a new research field whose aim was to analyze specific problems of developing countries. Rosenstein Rodan (1943) had previously claimed that a big investment package could be helpful in underdeveloped countries.⁵ Nurske (1953) proposed the so-called balance growth theory, based on the idea that investments of government in underdeveloped countries would have been able to enlarge the market size, and to provide an incentive for the private sector to invest. Solow (1956) explained growth as a consequence of an exogenous technological progress: technology increases the amount of output per workers, which depends on the amount of capital per worker; if capital per worker increases, so does output per worker. In Solow's model, growth comes from capital accumulation and technological progress, and government has no role. According to Hirschmann (1958), development depends neither on an optimal combination of resources nor on the level of savings: it depends on the capacity to discover new capabilities in an uncertain framework. Besides Rosenstein Rodan, development and growth have been studied within the Austrian tradition: Schumpeter (1934 [1912]) and later Kirzner (1973) focused their analysis on the role of entrepreneurship; Lachmann (1956) focused his attention of on the role of capital structure. Lachmann's theory of capital structure specifically influenced Shenoy, although her credit to Lachmann in her writing is not always recognized, especially if compared with her references to Menger, Mises, and Hayek.

Although her contribution has been almost completely neglected, Sudha Shenoy was part of this story.⁶ She did not follow Schumpeter/Kirzner, who insisted on entrepreneurs' psychology, vision and activity in describing development, or Rosenstein Rodan's big push theory. Influenced by her father, as well as by the economist Peter Bauer, she also criticized the utility of international aid to promote development in underdeveloped countries. She addressed development using Menger, Mises, Hayek, and Lachmann's theory of capital structure. Shenoy's contributions can be also regarded close to Hirschman's, although they had an opposite vision about market: Hirschman thought that the market is unable to coordinate dispersed knowledge and potential decisions, while Shenoy considered market as the only institution able to make it.

According to Shenoy the 'older Austrians' contributions were fundamental to understand either the causes of the wealth of industrialized countries or the possible development in underdeveloped countries (Shenoy 1970, 1991). Like Hirschman, she regarded the local potentiality as fundamental, but in contrast she thought that only the mechanism related to pricing in a free market is one that is able to coordinate dispersed

⁵ More specifically Rosenstein Rodan studied the causes of development, he recognized in four factors: an increase of population, especially in countryside, the so-called 'agrarian population'; economies of scale; an increase of infrastructures (social overhead capital); and the increasing specialization of workers. He applied these factors to the case study of Italy, Latin America and India.

⁶ Contemporary to Shenoy's contributions, another Indian economist, Padma Desai (1931-), wrote about development in India (Desai 1961, 1963). Different from Shenoy, Desai was in favor of a short-term plan for India: she adopted a neoclassical approach, focused on the problem of resource allocation in an underdeveloped county like India. In her model, the planning authority should fix exports, government expenditure, and gross capital formation, which are exogenous variables in order to enhance the distribution of expenditures on the variable of consumption amongst different households.

knowledge in order to promote the division of labor and to increase the capital structure, which are the two factors of both growth and development.

Shenoy reminded that Austrians (from Menger to Lachmann) considered capital as a heterogeneous set of goods, which might be classified into orders or stages, depending on their closeness to final consumption (as initially explained by Menger). In order to obtain this goal, capital must be embedded into a capital structure made by a series of interlinked investments (capital structure can be simple or very complex). Different production units, such as households, individual producers and firms, might make investments, which are coordinated into a coherent capital structure by costs. Depending on technical feasibility and on other historical circumstances, the capital structure can be expanded in order to significantly increase the investment process. These investments could be either good or bad: good investments yield profits and capital gains, while bad investments lead to capital losses.

According to Shenoy, the re-allocation of investments requires savings, to be classically intended as the willingness to postpone consumption. Quantity of savings also depends on historical circumstances: in any case, saving is necessary to increase the length of any capital structure, which is composed of specific capital goods. When historical circumstances change, the capital structure must adapt. The role of information is crucial in this passage: when capital structure is supposed to change, information will provide a better way to adjust specific capital goods. Partially acquired information in any form of planning results in inefficiency as well as being dangerous.

The same principle is valid for extending the division of labor, which is required to extend the capital structure itself: specialization is able to create new jobs as well as modify others, and, in the long haul, unemployment becomes frictional. Like in the transformation of the capital structure, the transformation of labor depends on historical circumstances. Information at this stage is indeed crucial: for the reason mentioned above about capital structure, any form of intervention in the job market is bound to fail.

An extended capital structure and an extended specialization (division of labor) are “two sides of the same coin”; i.e., development and growth. In order for both to increase, market exchanges should be supported: “this does *not* mean ‘rational invention in full precognition of the results. It only means the adoption – for whatever reason – of customs and practices that have the *effect* of extending the division of labor – which cannot be foreseen in any case” (Shenoy 1991, 410).

The notion of catallaxy, originated by Menger's distinction between organizations and organisms, was reshaped by Mises and Hayek. Catallaxy is intended as a continuous process of adaptation to new circumstances; an overall order that promotes exchange and enables individuals to cooperate via price system is able to explain the emergence of development, which was intended to be an extended capital structure and a specialized division of labor in the context of privately evolved legal framework. In fact, in Shenoy's perspective, the capital structure and division of labor are possible only in a specific legal framework that is able to extend the market order. From a historical perspective, countries able to expand capital structure and to make labor gradually specialized have been ruled by common law (such as in England and in the United States), or by other systems based on private property, such as the Roman and the Japanese empires.

In another article about development and Austrian theory (Shenoy 2007), Shenoy tried to apply Menger's analysis of investment chains against Solow's (neoclassical)

theory that technology is the only, or the most important, factor to explain development. In contrast to the theory of Cameron and Larry (2003), based on the centrality of technology in “raising the ceiling” of economic development, Shenoy underscored the importance of “a fertile environment for productive innovation” (Shenoy 2007, 187): innovations are made possible by an expansion of the capital structure and an increasing division of labor. The role of entrepreneurs and the liberty of institutions are fundamental in starting the so-called investments’ chains, able to produce a various range of final outputs, which determines growth and development, as it happened during the first Industrial Revolution. Again, contrasting to the neoclassical theory of the growth based on mechanical and statistical description of flows of input and output, Shenoy stressed that the Austrian theory of capital structure is grounded in people’s actions: “people’s actions bring about a particular historical context and the investment chains within in” (Shenoy 2007, 207).

Shenoy used to give many examples of what she has in mind when talking about the application of Austrian categories to the notion of development. Her examples included, besides India, Hong Kong, Africa, and Latin America. Although the economic and social situation in different underdeveloped countries is very heterogeneous, they share some common features:

- An intense emigration (with the historical exception of Latin America countries);
- A low per capita income (which measures only the physical output of goods and services);
- A high rate of population growth (due to high birth rates in spite of a decline in death rates) with a short life-expectancy. This feature shifts the entire economy towards consumption and reduces per capita savings. Therefore investments on human capital are reduced⁷;
- Underemployment mainly due to three factors: high labor supply, low capital supply and an economy prevalently based on agriculture (in order to supply food for a constantly increasing population);
- Illiteracy affects undeveloped countries, but a rising of overall education cannot be pursued by some educational plans, because it has not to be intended as a *precondition* of economic development: education (or literacy) is a consequence of economic development, which is possible only in a complex capital structure able to promote entrepreneurship⁸;
- A comparative advantage export, due to low-price labor services and a deregulated labor market, and a consequent tendency to protect their internal market, as in the case of the Indian plan, without understanding that any protectionist policy is bound to fail.

Besides these common features as listed above, Shenoy claimed that underdeveloped countries/areas do *not* present the peculiar traits of developed countries; i.e.. a complex capital structure and a specialized division of labor embedded into a liberal political scenario of free exchange.

⁷ This element has an enormous impact on the economy of underdeveloped countries: the age to join the force work is around 8–12 with a life expectancy of 50 years and a high rate of infant mortality.

⁸ Shenoy considered entrepreneurship as the main attitude of literacy.

3 Against planning and intervention to promote development. The case of India

Shenoy's fight against protectionism and planning in the Indian economy could be better understood in the Indian context of her time. Since the 1930s, a planning apparatus for Indian economic development had been set up, and it was renewed after India's independence in 1947. There were twelve Five-Year Plans in India, generally grounded on three pillars: expropriation of big estates, transfer of land from big farmers to small farmers, and international support. More specifically, the plans were focused on the development of the industrial sector, and the Indian government's intention was specifically oriented to strengthen heavy industries. There were very few opponents to the plans; among them, Sudha's father, the liberal economist Bellikoth Raghunath Shenoy, who was later joined by his daughter (Bauer 1998; Shenoy 2003; Manish et al. 2015).

The aims of India's Five-Year Plans were to raise the standard of living of the people, to develop the economy, to reduce unemployment, and to obtain social justice. However, according to Sudha Shenoy (1962, 1966a, 1971), it achieved the opposite result: per capita daily food grain consumption had stagnated below the nutritional standard; annual cloth consumption declined; and living conditions per se were not better. In the same time, the agricultural sector, which usually provided more than 80% of GDP, collapsed.

Shenoy adopted Hayek's argument against socialist control of an economy in order to criticize the Indian government's plan. She thought that both the plan and the specific sectors chosen by the government were a huge mistake and bound to fail for three reasons: (1) it would weaken exports; (2) it would create inflation to cover a budget deficit; and (3) it would increase corruption, due to the collusion between potential licensees by issuing import quotas and government oversight. This misallocation of resources delayed economic development, increased unemployment, and made inequality higher by transferring wealth from fixed income groups to corrupt functionaries of the state: "permits, licenses, quotas, concessions, and so on, which centralize economic power in the hands of officials, and create numerous monopolies or semi monopolies in the private sector" (Shenoy 1962, 46). The reasons for this failure stands on the following fact that, as in any planning experiment,

"... the bulk of the country's resources are forcibly drawn into the sector with the lowest returns, the public sector (...) about 4 per cent of India's national income is provided by employment in the public (government) sector. But government absorbed 60 per cent of total resources in the Second Plan; and the Third Plan proposes to raise this figure to about 70 per cent. Practically the entire public sector expenditure is on uneconomic, low-return, heavy industries and on giant river-valley projects—imitation TVA's" (Shenoy 1962, 46).

A few years later the application of the Third Plan, Shenoy described the political situation in India acts as an oligarchy like in Aristotle's word; i.e., "the government of the richest, who became wealthy not in a free market, but via political connections in both legal and illegal ways" (Shenoy 1966a, 36). In such a situation, even wealthy businessmen have been strictly controlled by a complicated network of regulations and by a rigid bureaucracy.

Moreover, the Indian economic system after the plan resulted in inefficiency due to three more rigid governmental measures:

- Government's strict control on imports-exports⁹;
- No addition occurred in the national income, despite the government sector's expansion, had provided a rise in employment;
- A dangerous increase of the powers of officials over the citizens due to additional control exerted by the government over many other sectors of the internal economy.

The essential and dangerous consequences of this plan have been an increasingly limitation of the whole private sector, which has no connection with the government. And this reduction of freedom in private sector inevitably has led to a reduction of political freedom, being all business supporters of the government, especially because international aid is entirely converted to finance the government's plan. The real nature of planning in India was to be a "forced transfer of resource out of the uses where they would benefit the masses — i.e., the agricultural sector — into an artificially created and propped up 'industrial' sector" (Shenoy 1966a, 39) making Indian hungrier than before the plan. Shenoy continued:

"Since planning implies the concentration of economic and political power in the hands of the ruling clique, it has effectively smothered a wide range of potential political opposition. (...) Democratic forms in themselves are meaningless. The right to vote can be effective only in the context of a whole network of other freedoms. Elections can be free only in the framework of a free market and the Rule of Law" (Shenoy 1966a, 39).

In her final analysis of India (Shenoy 1971), Shenoy summed up the situation after ten years of plans: government's plan brought an overemphasis on industrial and urban sectors, and increased inequality. She suggested the abolition of such economic regulations as industrial licensing and controls of capital issues, as well as exchange and trade controls; and the abolition of all price and distribution controls and economic regulations, which were applied to specific industries such as road transport and textiles. She also suggested the elimination of public sector claims on capital resources, implying sale to private industry of all public undertakings as well as the abolition of food-grain controls. In fact, the growth of the agricultural sector, which provides jobs for large numbers of people, has been held down by moneylenders' legislation.

4 The road to true liberalism: the battle against Keynesianism

Strictly related with her fight against government's intervention was her critique of Keynesianism. During the meeting of the South Royalton conference, Shenoy

⁹ No import was permitted without a license, and prohibitive tariffs had been imposed on a large number of goods. Furthermore, all exchange earnings were fixed by the Reserve Bank at an official price, which was below the market price. Furthermore, it was forbidden to send rupees out of the country in any form.

presented a paper on inflation, recession and stagflation that was co-authored with O'Driscoll (O'Driscoll and Shenoy 1976). The authors attacked both Keynesianism and monetarism for relying on the general assumption that, over the long term, the real side of the economy is in equilibrium, and that monetary factors influence “only the price level or money income and not the structure of relative prices or the composition of real output” (O'Driscoll and Shenoy 1976, 185). The authors suggested, as the only possible alternative to both Keynesianism and monetarism, the Hayekian analysis, based on the assumption according to which any monetary changes in real terms will break the spontaneous economic order.

Central in her battle against Keynesianism was Shenoy's introduction to *A Tiger by the Tail* (Shenoy 1972): a historical reconstruction of the debate between Hayek and Keynes after the publication of Hayek's *Price and Production* (1931). Shenoy recognized that the main fault of Keynes' macroeconomics was to neglect the real structure of production and the insistence on aggregative macro concepts. According to Shenoy, Hayek's approach to macroeconomics, based on an analysis of the structure of relative prices and their interrelations as an allocative tool, is much more able to explain macro dynamics than Keynes' macroeconomics. She insisted on the fact that Hayek did not adopt the neoclassical framework of a general economic equilibrium, according to which prices are seen as “dynamic shifts between two general equilibria”. Hayek considered prices as “empirical reflectors of specific circumstances and price changes as an *interrelated* series of changes” able to produce “a gradual adaptation in the entire price structure (and hence in the outputs of different commodities and services) to the constant, unpredictable changes in the real world” (Shenoy 1972, 9).

According to Shenoy, Keynesianism has many faults when applied to an underdeveloped country. It is useless and potentially dangerous for the following reasons:

- The level of inflation, raised in order to reduce unemployment in the short run, must be continuously increased, and the consequence would be a decrease in domestic demand;
- Any income policy would freeze a particular set of price and wage while their supply and demand are continually changing, especially in economies oriented toward development;
- Any income policy presents a “discoordinative” aspect, which will affect the price system and will require a permanent income-policy, which will inevitably lead to a form of permanent planning;
- A permanent planning, especially in underdeveloped countries, will likely lead to some form of dictatorship or totalitarianism.

The only institutional framework able to make price mechanisms possible as an informative signal is the liberal system. Shenoy used the term ‘liberal’ in a very Austrian sense: her reference was classical liberalism. Quoting Mises, she defined liberalism as a system based on “free trade, free movement of people, free movement of capital, falling prices, [as] a continuation of the growing division of labor on a global basis” (Shenoy 2003, 5). Following Hayek's definition of true individualism (Hayek 1948) as well as Mises' *laissez faire* (Mises 1949), Shenoy's aversion against any government intervention had a fundamental part in her own battle for true liberalism.

Any other political framework will have two effects: to stop development and growth, and lead towards forms of totalitarianism.

Unfortunately, according to Shenoy, a major misunderstanding occurred amongst liberal thinkers and economists. On one side, many liberals (in the sense of leftist liberals) consider economic freedom, even in democratic systems, as an instrument of wealthy people (what today is called “the 1%”) to exploit the many (today’s “the 99%”). On the other side, even many free-market economists consider monopoly (which allows the accumulation of the 1%’s wealth and the growing of inequality) as a natural result of the market, and they do not realize that monopoly is in fact a consequence of government intervention that creates barriers to entry. Barriers are either “exclusive patents, grants, charters, concessions, permits, licenses, tariffs, and quotas”, which restrict “market supply below the competitive level”, or “progressive taxation, labor legislation, and the special privileges granted to labor unions”, which interfere with the investments’ chain and the dynamics of the division of labor (Shenoy 1966b, 858).

For a true liberal (a classical liberal) freedom is indivisible, and it spreads through the market process of profit and loss. Shenoy saw freedom as the foundation of the social system as a whole: intervention is bound to destroy the social order and to establish “an order founded on the principle of political exploitation: the politically strong exploiting the politically weak. In short, intervention leads to the suppression of *potential* political opposition and thus ends in totalitarianism” (Shenoy 1966a, 36).

Shenoy had always had clearly in mind the connection between politics and social order. The market cannot work alone, of course: in a complex historical milieu, it needs a good performance of some essential functions by the state, which are aimed at establishing and maintaining the Rule of Law. Shenoy defined the Rule of Law as a legal system grounded on a concept of selective justice (Shenoy 1965). Selective justice is the idea that the *same* rules should apply to *all*. In contraposition with selective justice, there is the concept of social justice. Social justice is the application of the rules accordingly with the circumstances of those to whom the rules are intended to be applied. Social justice is an instrument for politicians to exploit minorities. Instead of limiting the freedom of entrepreneurs (the minority who form the only class able to increase the capital structure and the division of labor), authentically liberal politicians should promote liberty for them.

Unfortunately, Shenoy insisted, it is impossible to take for granted that the state, which is formed by politicians and bureaucrats, will adequately perform its essential functions. Usually, the state will go beyond its limits and will attempt “to do things beyond its scope”, by interfering in economic issues. When this happens, the state becomes illiberal, or even dictatorial. Furthermore, the resulting distortions in the market (due to the interference of government) will be regarded as normal phenomena of the market, and government’s intervention will be considered necessary:

“The politicians will then proceed further with the identical policies that caused the imbalance in the first place—or with worse policies—all to the accompaniment of humanitarian slogans, and with the encouragement of these so-called “liberals.” This is a vicious circle, and the essential duties of the state will probably be forgotten or neglected” (Shenoy 1962, 45).

At this point, Shenoy mentioned the situation in the United States in that period (early 1960s):

“Thus, when American and other ‘liberals’ (statists) criticize something labeled ‘free enterprise,’ they imagine they are criticizing the free market. But what these people consider to be the natural corollaries of the free market are riot not integral parts of it at all. They are distortions produced in its working by misguided interventionism—the attempts of the state to do the duty of other parts of society, while neglecting its own duties. This causes imbalances and distortions in the market, and these are usually taken by the statists to be its normal and essential features” (Shenoy 1962, 44).

When social order is constrained by politicians, social development is stopped, and corruption arises in order to get confidence from the many; furthermore, the economic system becomes even more constrained. Totalitarianism might arise from this chain of economic regulation and restriction, which happened during interwar Italy, Germany and in communist countries. The influence of Hayek (1944) is quite obvious and deserves no further comment.

5 Early modern England: a case study to explain historical development in Austrian terms

Shenoy's Ph.D. thesis (Shenoy 2010) deals with the application of previous Austrian economic categories (Menger, Mises, Hayek, Lachmann) to a specific historical case study, namely, the history of early modern England. Shenoy adopted Menger's organicism,¹⁰ Mises' market process, Hayek's catallaxy, and Lachmann's capital structure in order to describe the peculiarity of the economic and political system in early modern England. Modern England is the best historical example of how the combination of Austrian categories (division of labor, exchange, capital structure, and common law) worked and made development and growth possible during the XVIII century. Shenoy claimed that the combination of a peculiar economic vision (individualism and free market), the expansion of both the capital structure and the division of labor within a specific legal framework (common law) made the first industrial revolution and the following development possible. The history of England between XVII and XIX century is the story of capital accumulation through savings, a constantly increasing of division of labor embedded in a common law framework, as described by Austrian categories. The same process happened in the rest of Western countries, although later and more quickly.

Shenoy's analysis started with a Mengerian classification of social phenomena, regarded as “the unintended results of human action and of historical development” (Shenoy 2010, 9). Among these facets, she included language, customs, moral rules,

¹⁰ Menger distinguished between “organic” as it applies to the natural world and “organic” that applies to the social sphere. The latter is, as Ferguson puts it, the results of human action, but not of human design. In Menger (1985), in the social realm, spontaneous orders that arise via human interactions cannot be reducible to a mechanistic approach as in physics.

common law, capital structure, and catallaxy (the social order). These social phenomena are objects of either analytical investigation or historical research, as clarified by Menger in his *Untersuchungen* (Menger 1985), and therefore by Mises and Hayek as: “an undersigned historical growth, developing gradually from unstated custom to wider, interrelated, and more complex rules” or “the unintended outcome of individual actions pursuing individual ends” (Shenoy 2010, 17). According to Shenoy, Mises’ praxeology, more than Menger’s notion of organicism, clarified the way modern societies emerged and developed: people’s actions and interconnections gradually formed a historically grown and complex social structure without any rational-designed contract.

This was the case of early modern England. Shenoy analyzed the crucial role of the division of labor (intended, in Mises’ terms, as a synonym of ‘society’, i.e.. the way through which individuals achieve their aims by serving the aims of others) in the emerging of exchange (intended, in Hayek’s terms, as a complex set of interactions on the basis of common rules to achieve an individual goals). Along with the division of labor and exchange, Shenoy identified the capital structure (intended, like in Menger, Mises, Hayek, and Lachmann, as a social formation made by the chain of investments, which encompasses all the specific investments made by all the firms) as a fundamental feature for development.

Shenoy considered development the final result of the division of labor, exchange, and the capital structure; it emerges in contexts ruled by common law and catallaxy. She specifically described them as follows:

Division of labor and exchange The crucial element in the genesis of modern societies is the division of labor, which increased final goods in quantity and quality, and has been extended from an autarkic household model to a worldwide scenario. According to Shenoy, among the Austrian school of economics both Mises and Hayek emphasized this specific role of the division of labor along with reason and language. The history of humankind was a progressive intensification of the division of labor, which led to the evolution from autarky of households to the worldwide markets of XIX century. Among the categories of human action, the category of exchange is fundamental in order to understand the beginning of any development. Mises also saw the division of labor and exchange as values per se, and not ends-dependent: the division of labor and exchange “bring peace *without* agreement on ends” (Shenoy 2010, 181).¹¹

Following Mises’ example, Shenoy insisted on the fact that the division of labor enabled the emergence of social cooperation, morality and justice, which “are the other side of the coin of social cooperation” (Shenoy 2010, 22). Like Menger and Mises, Hayek gave emphasis to the complexity of social phenomena, and besides the division of labor, he introduced the centrality of the division of information, which produces knowledge that is always complex and dynamic, and increases development. The market in Hayekian terms is the place where fragmented knowledge is coordinated and individual plans can be achieved, being not the results of anyone’s design, but the spontaneous outcome of social order.¹² Hayek’s theory of group selection enables us to

¹¹ Shenoy underlined that Mises’ analysis is far from the neoclassical notion of perfect competition, perfect markets, and Pareto-optimality.

¹² Menger, Mises, and Hayek recognized that social phenomena could consist of two kinds: organization (designed by people) and organism (spontaneously arisen).

understand the success of some groups within a society, and a success of some countries among others, constantly having in mind historical circumstances. The division of labor, and knowledge, and the expansion of capital have been allowed the selection of successful groups and societies. Division of labor made exchange possible, as underlined especially by Mises, who claimed that the category of exchange “is a category of human action” which enables us to understand growth in both underdeveloped areas and highly developed countries (Mises’ specific examples, as reported by Shenoy, were tribal groups and Germany (Shenoy 2010, 25)).

The capital structure As in her previous publications, Shenoy insisted on the centrality of the capital structure composed by the investment chain, which led to the final output. Lachmann’s analysis of “how the investments made by individual firms were continuously brought into coordination so as to produce an integrated capital structure, as these and other circumstances changed” is especially central in order to understand the process of development and growth (Shenoy 2010, 322).

Shenoy recalled the earlier focus of the Austrian School on the fact that development is made possible by the ability of ‘consumer-savers’ to handle with the complexity of capital investments in a framework of time-preferences. Western developed countries in the mid-twentieth have been developed upon this capital structure over centuries:

“Previous generations saved and invested to such effect that production processes were repeatedly lengthened; political and social conditions did not repress large-scale saving and investment; the world economic order, which developed faster in the nineteenth century, enabled large quantities of capital goods to be transferred to the capital-importing developed areas, and also to the less developed countries. Thus all areas now benefit from the actions of past generations – all have more resources to obtain their several ends”. (Shenoy 2010, 55).

At the beginning of modern age, in England a complex capital structure began to emerge: in Menger’s terms, people learnt to use higher order goods, and the quantity and quality of final goods continuously increased.¹³ Menger, Mises, Hayek, and Lachmann considered the production chains as adaptations to a particular set of historical circumstances: especially Hayek (1931, 1941) who abandoned the average period of production and focused on a multi-period of production.

In Anglo-Saxon villages, final outputs were simple and limited in quantity; the division of labor was narrow with a scant specialization. When agricultural investments, based on specialization and technical improvements, extended the capital structure, more resources were removed from the final consumption and the specialization of labor was increased. The distance between new productive stages and between them, such that outcome gradually increased, and a large quantity of goods-in-progress was produced. At each stage of production, a massive wave of new investments have been introduced, providing a continuous flow of

¹³ Shenoy pointed out Menger’s critique to Smith about the division of labor as the only cause for the wealth of a nation: according to Menger, reported by Shenoy, the division of labor can only increase specialization in goods already available. Only an increase in capital structure can introduce innovations in the market.

intermediate as well as final goods. This complex capital structure generated a sophisticated division of labor:

“Since each individual investment is only part of a link in an investment chain, profit and loss are *equally* essential (...) As historical circumstances change, particular investments will have to be altered to maintain the chain and its contribution to the range of final outputs, themselves changing. So, capital and operating losses remove the malinvestments that no longer ‘fit’, while better adapted investments, including new ones, earn profits and capital gains” (Shenoy 2010, 246).

Common law and catallaxy A fundamental condition to create a social order based on a complex capital structure and a specialized division of labor is given by common law rules, which are able to create favorable conditions for the spread of catallaxy. Common law is a judicial order which had historically evolved through people’s actions, formal and informal, over time. Catallaxy is the continuous process of adaptation to new circumstances and an overall order that enables individuals to exchange and cooperate via price system; it is the system of economies (Hayek included households, enterprises and governments among them); “an overall order which enables people to cooperate in the production of the final outputs they all purchase” (Shenoy 2010, 47).

Before Burke, Edward Coke was the first scholar to describe the nature of common law in England as “an outcome of many generations of judicial decisions” (Shenoy 2010, 74). His position was basically an attack against Hobbes’s contract theory. Later, Burke applied common law principles to legislation: he considered social phenomena as undersigned and put legislation under the scrutiny of common law principles. Mandeville explained in the same way other social phenomena, especially economic phenomena, which have been able to accumulate and to transmit knowledge. Smith and Hume went further on: they regarded the division of labor, as well as exchange as results of individuals’ actions, with no deliberate intent in order to raise their real income. Catallaxy is the result of the division of labor and of the increase of capital structure: it started in modern England, and it globally spread to the rest of western countries and in some Asian regions.

A possible objection to Shenoy could be the fact that common law might generate some perversions of the system: political systems ruled by common law are not perfect, and many problems persist. To this objection, Shenoy would have replied that, the history of developed countries has shown that common law, although far away from perfection, remains the most suitable and versatile system able to render catallaxy a reality.

The signs of development According to Shenoy, between XVI and XVIII centuries, the signs of development in England can be detached as follows:

- Total population grew up by 111%, but the rural population decreased;
- Production increased in quantity and quality: the capital structure had been extended through a massive rise of investment goods further removed from final use;
- Non-agricultural sectors arose and more than doubled in size;
- Employment increased and diversified;

- Clothing and footwear rose in quantity and quality, and was produced both in the household, and outside, and fabrics and clothing were specialized according to gender usage;
- Furniture developed in style and grew in quantity and quality;
- Non-basic goods, such as pottery, and service for leisure were introduced in any social group;
- Housing became a consumer asset: size increased as they were modernized.

These features along with an enlarged chain of investments and a more complex division of labor, which reinforced each other, and increased development as well as the exchange of goods through non-local trade. The role of exchange in this process is fundamental: it made possible the crucial transition to civilization, as Mises and Hayek underlined: the growth of exchange increased population growth: “through exchange in the market order, its members can all achieve their several aims, with no need to have any ends in common” (Shenoy 2010, 47).

The final stage of this historical process was the so-called “first industrial revolution”, which had been made possible by a more specific division of labor as well as by a complex chain of investments. Simultaneously, the legal framework in England developed as well: transactions were concluded with formal agreements, and legal professions expanded; the number of civil cases also rose as competition amongst courts became common. A new society needed a set of institutions that enforces the law, and therefore the liberal revolution spread in England (as Mises taught, any government is a praxeological necessity), showing the intertwined growth of common law and market order.

6 Conclusions

Among the Austrian school of economists, Menger, Mises and Hayek linked the possibility for a country to prosper by the nature of its institutions to be intended as the unintentional results of individual actions in a historical framework. Austrian theories on development and growth allowed the development of an endogenous theory of progress, which was able to explain real-world economic growth and to understand why some countries had prospered while others did not (Schulak and Unterköfler 2011; Manish and Powell 2014).

Shenoy combined the earlier definition of common law by the Austrians, catallaxy, the division of labor and capital structure, in order to describe and to explain development and growth (as in the case of early modern England) as well as to criticize any form of an economic plan involving the government (as in the case of India).

Earlier Austrians, in Shenoy's terms, discovered highly complex regularities in individual interactions; the combination of these complex interactions among people created social cooperation, which had been embodied into institutions. The main interaction was exchange, which started within a system of autarky and spread worldwide. England and other western countries were the initiators: industrial revolutions happen as consequences of a combination of the accumulation of capital, entrepreneurial spirit, and the rule of law. In the late XIX century, the expansion of the international catallaxy made opportunities possible to rise in underdeveloped countries, such as India.

Shenoy explained that development works only spontaneously through innovations, not in a designed way planned by a political agenda. Spontaneous innovations generate a better capital structure, “which gradually emerges over time in the context of privately evolved legal rules” (Shenoy 1991, 20). The nature of socially complex phenomena, which enable development, is an end-purposeless, or in Hayek’s terms un-designed. Therefore, government is only required to guarantee private property and individual freedom. Due to the high level of corruption among politicians and the lack of any specific competence or knowledge by politicians, any other governmental intervention is regarded by Shenoy as a possible cause of perverse economic consequences as well as corruption, which inevitably will be leading to structural underdevelopment.

Shenoy’s work might be relevant not only for contemporary Austrian economists who work on social order, entrepreneurship, and the correlation between any economic policy and growth; but also for scholars, especially those who profess classical liberalism, whose efforts are mainly focused on a serious analysis of an endogenous theory of development.

Acknowledgements I want to thank William Butos, David Harper, Shruti Rajagopalan, Mario Rizzo, Joseph Salerno, and other participants to NYU Colloquium on Market Institutions and Economic Processes, along with two anonymous referees, for their helpful suggestions and comments. All mistakes remain mine.

References

- Anand K (2015) B. R. Shenoy: A forgotten economist and what Modi can learn from him. <https://swarajyamag.com/author/17948/kumar-anand>. Accessed 30 Sept 2017.
- Bauer, P. (1998). B. R. Shenoy: Stature and impact. *Cato Journal*, 18, 1–10.
- Becchio, G. (2018) Austrian school women economists. In Madden K. and Dimand R. (Eds.) *Routledge handbook of the history of women's economic thought*. London: Routledge.
- Cameron, R., & Larry, N. (2003). *A concise economic history of the world: From Palaeolithic times to the present*. Oxford: Oxford University Press.
- Desai, P. (1961). A short-term planning model for the Indian economy. *Review of Economics and Statistics*, 43, 193–200.
- Desai, P. (1963). The development of the Indian economy - an exercise in economic planning. *Oxford Economics Papers*, 15, 308–317.
- Hayek, F. (1931). *Prices and Production*. London: Routledge.
- Hayek, F. (1941). *The Pure Theory of Capital*. London: Routledge.
- Hayek, F. (1944). *The Road to Serfdom*. London: Routledge.
- Hayek, F. (1948) *Individualism True and False. Individualism and Economic Order*. London: Routledge. 1–32.
- Hirschmann, A. (1958). *The Strategy of Economic Development*. New Haven: Yale University Press.
- Kirzner, I. (1973). *Competition and Entrepreneurship*. Chicago: University of Chicago Press.
- Lachmann, L. (1956). *Capital and Its Structure*. London: Bell and Sons, Ltd..
- Machlup, F. (1978). *Methodology of Economics and Other Social Sciences*. New York: Academic Press.
- Manish, G., & Powell, B. (2014). Capital Theory and the Process of Inter-Temporal Coordination: The Austrian Contribution to the Theory of economic Growth. *Atlantic Economic Journal*, 42, 133–142.
- Manish, G., Rajagopalan, S., Sutter, D., & White, L. (2015). Liberalism in India. *Econ Journal Watch*, 12, 432–459.
- Menger, C. (1985). *Investigations into the Method of Social Sciences*. New York: New York University Press.
- Mises, L. (1949). *Human Action*. New York: The Foundation for Economic Education.
- Nurske, R. (1953). *Problems of Capital-Formation in Underdeveloped Countries*. Oxford: Oxford University Press.
- O’Driscoll, G., & Shenoy, S. (1976). Inflation, Stagflation, and Recession. In E. Dolan (Ed.), *The Foundations of Modern Austrian Economics* (pp. 185–211). Kansas City: Sheed and Ward Inc..

- Prakash, S. (2013). An Appreciation of B. R. Shenoy, Economist. *The Quarterly Journal of Austrian Economics*, 16, 353–362.
- Rosenstein Rodan, P. (1943). Problems of Industrialization of Eastern and South-Eastern Europe. *Economic Journal*, 53, 202–211.
- Schulak, E. M., Unterköfler, H. (2011). *The Austrian School of Economics: A History of Its Ideas, Ambassadors, and Institutions*. Auburn: Ludwig von Mises Institute.
- Schumpeter, J. A. (1934 [1912]). *The Theory of Economic Development: an Inquiry into Profits, Capital, Credit, Interest, and the Business Cycle*. Cambridge: Harvard University Press.
- Schumpeter, J. A. (1954). *History of Economic Analysis*. London: Allen and Unwin.
- Shenoy, S. (1962). Statism and The Free Market. *The Freeman*, 14, 44–46.
- Shenoy, S. (1965). Selective Justice. *The Freeman*, 9, 47–48.
- Shenoy, S. (1966a). The Coming Serfdom in India. *The Freeman*, 8, 35–39.
- Shenoy, S. (1966b). The Sources of Monopoly. *New Individualist Review*, 4, 875–860.
- Shenoy, S. (1970). *Underdevelopment and Economic Growth*. London: Longman.
- Shenoy, S. (1971). *India: Progress or Poverty*. London: IEA.
- Shenoy, S. (1972). The Debate: 1931–1971. In S. Shenoy (Ed.), *Tiger by the Tail: The Keynesian Legacy of Inflation by F.A. Hayek* (pp. 1–14). London: Institute of Economic Affairs.
- Shenoy, S. (1991). Austrian Capital Theory and the Underdeveloped Areas: An Overview. In R. Ebeling (Ed.), *Austrian Economics: Perspectives on the Past and the Prospects for the Future* (pp. 379–423). Hillsdale College: Hillsdale College Press.
- Shenoy, S. (2003). The Global Perspective. An Interview with Sudha Shenoy. *Austrian Economics Newsletter*, 23, 1–8.
- Shenoy, S. (2007). Investment Chains through History or an Historian's Outline of Development: 'Using Goods of Ever Higher Orders'. *Indian Journal of Economics & Business*, Special Issue: 185–215.
- Shenoy S ([2001] 2010) *Towards a Theoretical Framework for British and International Economic History*. Ludwig von Mises Institute, Auburn.
- Solow, R. (1956). A Contribution to the Theory of Economic Growth. *Quarterly Journal of Economics*, 70, 65–94.
- White, L. (2012). *The Clash of Economic Ideas. The Great Policy Debates and Experiments of the Last Hundred Years*. Cambridge: Cambridge University Press.

Reproduced with permission of copyright owner.
Further reproduction prohibited without permission.