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Chapter 1

Introduction

Ludwig von Mises's most important contribution to economic theory was, in the view of this book, his demonstration of its praxeological roots (Lachmann 1977:56). It was this demonstration that gave Austrian economists their most potent weapon against the late 19th and 20th century claims that behaviorism, positivism or panphysicalism should be the basis of economics. Nevertheless, Mises's "praxeological economics" has not been fully understood, even among the succeeding generations of U.S. neoAustrian economists.[1] Although some neo-Austrian writers on methodology and philosophy seem to have accepted Mises's praxeology as an approach to a theory of action or sociology,[2] they have only sparingly referred to his economics. The goal of most of the neoAustrians has not ordinarily been to draw readers' attention to the praxeological

[1]The term "neo-Austrian" was employed by Israel Kirzner to describe a mix of different ideas of economists who associate themselves with "the revival of interest in the ideas of Carl Menger and the earlier Austrian School, particularly as these ideas have been developed through the work of Mises and F. A. Hayek" (Kirzner 1987: 149).

[2]Examples are Murray Rothbard (1973), Walter Block (1980), Patrick O'Sullivan (1987), and H. H. Hoppe (1988). A particularly insightful work from a philosophical perspective is that of Raimondo Cubeddu (1993).

roots of economics but rather to Mises's specific arguments against interventionism and socialism.

The reason for this, in the author's view, is Mises's failure to develop the image of the praxeological entrepreneur. This made it impossible for followers to trace the interaction that he described as occurring under the conditions of the market economy back to human action. Corresponding to the absence of the praxeological entrepreneur was Mises's unimaginative use of the equilibrium concept. He defined equilibrium, or the evenly rotating economy, as a hypothetical situation in which the prices of the factors of production add up, excepting interest, to the prices of the products they are used to produce. He used this concept of equilibrium mainly to represent a situation of imputation that resulted from the market process. This was less important, by the standards of the mid-20th century and afterwards, than other uses of the equilibrium concept in helping to achieve the ultimate goal of dealing with arguments for and against market intervention, which Mises proclaimed as the goal of economic theory. In addition, it was misleading because it neglected the imagination, creativity and inventiveness associated with praxeological entrepreneurship.

This book uses the term "praxeological entrepreneur" to refer to characteristics that can be derived solely from (a) the definition of action and (b) the most fundamental characteristics of the market economy. More specifically, it refers to all distinctly human action under the conditions of the pure market economy. We shall see that the praxeological entrepreneur appraises factors, bets that her appraisals are correct by making decisions to employ workers and other factors of production, and bears the uncertainty connected with the production and/or exchange that results from her decision-making. We call these the *personal properties of entrepreneurship*. In exercising these properties, she is imaginative, inventive, and creative.

This book has two aims. The first is to present the concept of the praxeological entrepreneur. In the process of defending this concept, the book shows how it provides a foundation for dealing with arguments for and against intervention that are most common in the modern economics literature. The second is to identify the proper use of the concept of equilibrium in praxeological economics. Since Mises himself identified and used two concepts of the entrepreneur in his economics, a convincing achievement of the first goal requires a critique of his concepts. This critique will be presented in the context of showing where Mises's descriptions of the market and pricing process went wrong. Regarding the second goal, the concept of equilibrium has two major uses in

praxeological economics. The first is to help identify the most fundamental characteristics of human action under the conditions of a market economy -- the personal properties of entrepreneurship. The second is to help give examples of entrepreneurial action. Since Mises used the concept of equilibrium somewhat differently, this book will also criticize his claims about the role of equilibrium in praxeological economics.

If the book is successful, it stands to reason that Mises's descriptions of the market process need to be rewritten if his project of providing a praxeological basis for evaluating interventionist arguments is to succeed. From this point of view, this book is constructive, rather than destructive. It is a step in the direction of building the praxeological economics for which Mises himself provided a foundation in his writings on praxeology and its relationship to economics. That we must set aside part of his economic theory should not be disturbing to one who is interested in the progress of the science that Mises identified and helped develop. In the normal progress of science, less fundamental, adequate, or relevant concepts are replaced.

We begin in this chapter with a brief discussion of goal, nature and basic method of economics. In this presentation, we follow Mises. We offer no dispute with him on these issues. The dispute concerns the way he used the method. For it is in his use of the method that he introduced the concepts of entrepreneurship and equilibrium. At the end of the chapter we describe the plan of the rest of the book.

1. THE GOAL OF ECONOMICS

Mises pointed out that the ultimate aim of economics is to assess the various ideologies that support the belief that particular interventionist policies will enable ordinary people to obtain more of what they regard as wealth.[3] This aim presupposes an image of the unhampered market economy. Accordingly, our first goal consists of describing "the contractual order of society" (*ibid*.: 198). "Economics is essentially a theory of that scope of action in which calculation is applied or can be applied if certain conditions are realized" (*ibid*.: 199). In sum, the economist's initial goal is to build an image of cooperation and

[3]Mises says that the aim of the economist is to try "to influence public opinion in order to make sound policies prevail in the conduct of civic affairs" (Mises 1966: 869). Also see his discussions on pp. 93, 238, 178-184, and his final paragraph on p. 885.

coordination in the realm of monetary calculation -- an image of the pure market economy. His ultimate goal, however, is the evaluation of arguments for or against government intervention in real market economies.

It is worth pointing out even at this early stage that an image of the contractual order -- or of cooperation and coordination -- does not necessarily preclude the presence of actions that do not contribute to that order and, indeed, may detract from it. Mises recognized this when he wrote about monopoly prices (*ibid*.: 357-91). If our ultimate goal is to evaluate ideologies, we must understand (1) the real conditions in which what we might call a pure contractual order is embedded and (2) the panoply of real patterns that emerge and that coexist with this.

2. NATURE OF ECONOMIC PHENOMENA

Let us use the term "market phenomena" to refer to the "scope of action in which calculation is applied" in the previous quotation. This helps us understand what Mises means when he writes that economics is one branch of praxeology, a branch that is concerned with market phenomena (*ibid*.: 232-4). Market phenomena are historical phenomena and, as such, they are "complex." Complexity has a specific meaning to Mises. From the viewpoint of one who aims to study market phenomena, complex phenomena differ from non-complex phenomena in that '[w]e are never in a position to observe the change in one element only, all other conditions of the event remaining unchanged." We cannot do experiments. As a consequence, these phenomena

> become intelligible only through an interpretation in terms of theories previously developed from other sources. In the case of natural phenomena the interpretation of an event must not be at variance with the theories satisfactorily verified by experiments. In the case of historical events there is no such restriction (*ibid*.: 31).
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> In the field of human history [including market phenomena] a limitation similar to that which the experimentally tested theories enjoin upon the attempts to interpret and elucidate individual physical, chemical, and physiological events is provided by praxeology (*ibid*.: 32).
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> ...[T]he experience of a complex phenomenon -- and there is no other experience in the realm of human action -- can always be interpreted on the ground of various antithetic theories. Whether the interpretation is considered satisfactory or unsatisfactory depends on the appreciation of the theories in question established beforehand on the ground of aprioristic reasoning.. (*ibid*.: 41).

Taking these points for granted, we recognize that the economist must build praxeologically-based theories to help her interpret market phenomena. The ultimate goal of her action is to help her assess the policy proposals that stem from the various ideologies. But to accomplish this goal with respect to market phenomena, she needs praxeological-based economic theories.

3. THE METHOD OF ECONOMICS

The method, or procedure, of economics is derived from the method of praxeology of which economics is a branch. Mises divides the procedure of doing praxeology into two broad classes of tasks. "The first task [of praxeology] is to extract and to deduce...the concepts and theorems [that are] implied in the category of human action...to expound their implications and to define the universal conditions of acting" (*ibid*.: 64). The second is to "go further and define -- of course, in a categorial and formal sense -- the less general conditions required for action" (*ibid*.). Because "the end of science is to know reality," praxeology "restricts its inquiries to the study of acting under those conditions and presuppositions which are given in reality" (*ibid*.: 65).

Now turn to economics. To present its results, economics "adopts...a form in which aprioristic theory and the interpretation of historical phenomena are intertwined" (*ibid*.: 66).

> From the unshakable foundation of the category of human action praxeology and economics proceed step by step by means of discursive reasoning. Precisely defining assumptions and conditions, they construct a system of concepts and draw all the inferences implied by logically unassailable ratiocination" (*ibid*.: 67).

Mises writes that the method of building theories is that of imaginary constructions.

> The specific method of economics is the method of imaginary constructions...This method is the method of praxeology. That it has been carefully elaborated and perfected in the field of economic studies in the narrower sense is due to the fact that economics, at least until now, has been the best-developed part of praxeology...The method of imaginary constructions is indispensable for praxeology; it is the only method of praxeological and economic inquiry (*ibid*.: 236).

The method of imaginary constructions is full of dangers. The method

> is difficult to handle because it can easily result in fallacious syllogisms. It leads along a sharp edge; on both sides yawns the chasm of absurdity and nonsense. Only merciless self-criticism can prevent a man from falling headlong into these abysmal depths (*ibid*.: 236-7).

One must interpret this in conjunction with his earlier statement about avoiding error in praxeology and economic theory. The way to avoid error in the use of an imaginary construct is to "trace back all theorems to their unquestionable and certain ultimate basis, the category of human action" (*ibid*.: 68).

How does one use the method of imaginary constructions? Mises provides an answer of sorts. He writes

> The main formula for designing of imaginary constructions is to abstract from the operation of some conditions present in actual action. Then we are in a position to grasp the hypothetical consequences of the absence of these conditions and to conceive the effects of their existence. Thus we conceive the category of action by constructing the image of a state in which there is no action, either because the individual is fully contented and does not feel any uneasiness or because he does not know any procedure from which an improvement in his well-being (state of satisfaction) could be expected. Thus we conceive the notion of originary interest from an imaginary construction in which no distinction is made between satisfactions in periods of time equal in length but unequal with regard to their distance from the instant of action (*ibid*.: 237).

Unfortunately, in this discussion, Mises gives only one example of an economic idea that is derived from the use of this method: the notion of "originary interest." However, the notion of originary interest has not achieved very wide acceptance. Indeed, it has not even been understood (Gunning 2000). Mises's example must have fallen on deaf ears. To demonstrate the use of the method of imaginary constructions in economics, we must go beyond Mises, which is what I aim to do in the rest of this book.

4. THE PURE MARKET ECONOMY

Economics begins by building an image of the pure market economy. Then, in order to evaluate various interventionist arguments, it modifies that image as needed. Mises defines this construction in the following way:

> The imaginary construction of a pure or unhampered market economy assumes that there is a division of labor and private ownership (control) of the means of production and that consequently there is market exchange of goods and services. It assumes that the opera-

> tion of the market is not obstructed by institutional factors. It assumes that the government, the social apparatus of compulsion and coercion, is intent upon preserving the operation of the market system, abstains from hindering its functioning, and protects it against encroachments on the part of other people. The market is free; there is no interference of factors, foreign to the market, with prices, wage rates, and interest rates.(237-238)

We can say that four conditions must exist for there to be a market economy: the use of money as a means of acquiring resources and goods, specialization, a private property system, and free enterprise. In the *pure* market economy, the private property system is complete in the sense that someone owns the right to control all actions that have effects on others.[4]

5. PLAN OF THIS BOOK

The next two chapters of this book present the theory of praxeological entrepreneurship and its methodogical foundations in a nutshell. Chapter two logically derives the personal properties of entrepreneurship under the conditions of the pure market economy. Among other things, it shows the necessity of using the imaginary construction of a robot economy in the derivation. Chapter three expands the concept of entrepreneurship to deal with economic interaction. It introduces the idea of *transacting* and discusses entrepreneurial competition, consumer sovereignty, the selection of the factors of production, and economic organization under the employment compact, or firm. The ideas developed in these two chapters are then used as a basis for critiquing Mises's discussions of entrepreneurship, markets, and prices in *Human Action*. Chapter Four criticizes Mises's discussions of entrepreneurship while Chapter Five criticizes his discussions of economic interaction in his chapters on "markets" and "prices."

Next, we turn to the concept of equilibrium. Chapter Six describes three uses of the equilibrium-like concepts in praxeological economics. This description is used in Chapter Seven to assess Mises's uses of similar concepts in *Human Action*. Chapter Eight discusses two neo-Austrian authors who have written about praxeology, equilibrium and Misesian

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[4]The assumption that money is used to satisfy all wants is based on the idea that "[e]conomics is mainly concerned with the analysis of the determination of money prices of goods and services exchanged on the market" (*ibid*.: 234). Also see the importance Mises attaches to money in his chapter 19: "Monetary Calculation as a Method of Thinking."

entrepreneurship: George Selgin and Joseph Salerno. The book ends with a conclusion.

Gunning's Address

J. Patrick Gunning
Professor of Economics/ College of Business
Feng Chia University
100 Wenhwa Rd, Taichung
Taiwan, R.O.C.
Please send feedback
Email: gunning@fcu.edu.tw

Go to Pat Gunning's Pages
Mirror Site of Pat Gunning's Pages