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Chapter 3

Entrepreneurial Interaction

Mainstream economists have often described economics, or more accurately microeconomics, as the theory of markets and prices. Austrian economists have also given markets and prices top billing. During the time when the main interventionist arguments were made by Marxists and socialists or by inflationists, a praxeologically-based economics could perhaps justifiably focus on these characteristics of the market economy. Today, however, when the most important interventionist arguments concern knowledge and its transmission, industrial organization, the law, and external effects; such emphasis is out of date. To deal with the interventionist arguments made today, it is necessary to put at the center not markets and prices but the *transaction*. Today, one ought to regard transacting as the fundamental interactive phenomenon of a market economy.

We define a transaction as an agreement by each of two parties (1) to make their behavior different than it otherwise would have been in the eyes of the other or (2) to assure, by subjecting oneself to a penalty, that a particular behavior will indeed be performed, or not be performed, as expected. A transaction in a market economy possesses the added characteristics that the exchange of money must be part of the agreement. We use the verb *transact* to refer to the act of making a transaction. As praxeology makes acting the fundamental phenomenon in the study of human beings, the praxeological economics of this book makes transacting the fundamental phenomenon in the study of human interaction under the conditions of the market economy.

The ultimate goal of transacting is profit. The free enterprise characteristic of the market economy gives everyone the legal right to try to profit by providing consumers with goods they are willing to buy at costs that are lower than their revenue. Some choose to enter the competition; some do not. Because everyone has the right to profit, everyone also faces *competition*. Every seller of a consumer good must compete with others for each consumer's money. Some succeed and some do not. The winners earn profit and are in a better position, other things equal, to compete in the future. The losers experience losses and are, other things equal, in a worse position. A kind of self sorting occurs. We call this interaction that results in such self-sorting competition.

Competition is the most fundamental pattern in the market economy. Traditionally, it has been associated with the metaphor of *consumer sovereignty*. This refers to the idea that (1) if there were no error, (2) conspiracies to monopolize (see below), or (3) external effects, the actions of the producer-sellers would be directed entirely to pleasing the consumer role. Although producer-sellers would determine which items and actions are factors and although they would allocate the factors as among the different lines of business, their quest for profit would lead them to make such decisions on the basis of the "money votes" of consumers.[1]

It is worth highlighting these three classes of limitations to consumer sovereignty. The first is errors. Individuals in a market economy have an incentive to take advantage of what they believe will be others' errors and to avoid being taken advantage of; to induce errors and to try to avoid having their own errors induced; and to defraud and avoid being defrauded. The second is monopoly, especially that due to collaboration. Some specialists who might otherwise compete have an incentive to join together in order to increase their sales profit by raising price or reducing cost and quality of the product. The third is external effects. The wants of consumers to use unowned common resources like clean air and water are not taken into account by producers who use those resources in production. We discuss these further in the

[1]This analogy between the right to vote in a democracy and the possession of money in a market economy is discussed by Mises (1966: 271-2).

pages that follow.

A result of competition is the selection of particular items and actions as factors of production and payments for the factors that reflect the value of the factors to their employers. Competition also results in the selection of particular individuals to be producer-sellers. This "selective process" helps to explain why some people receive higher incomes than others in the market economy.

The purpose of this chapter is to present these various characteristics of the market economy from the praxeological point of view. We begin in part 1 with the theory of transacting, since this foundation (i.e., to comprehend economic action in the market economy) is most likely novel for those who are familiar with Mises's praxeology. This is presented in part 1. Part 2 describes the praxeological theory of competition. Part 3 discusses the idea of consumer sovereignty and its exceptions. Part 4 shows how competition results in the selection of the factors of production and the producer-sellers.

2. THE PRAXEOLOGICAL THEORY OF TRANSACTING

The praxeological theory of transacting refers to the theory of how action causes market economy transactions. It is offered here as a more general and fundamental theory than what Mises called the theory of value, or subjective value. The rationale is best understood by tracing the development of the latter theory.

The Austrian Theory of Value and Cost

The theory of value, or subjective theory of value, is a theory of the relations between the prices of goods of various orders. Mises described this theory in Chapter 4 of his 1933 book *Epistemological Problems of Economics*. Since Chapter Five of this book will use Mises's praxeology to assess his theory of prices in *Human Action*, it is worth quoting him at some length. Mises writes that an important stage in the development of economics was the realization by classical economists that

> every allocation of goods -- even those in the processes of production -- is an exchange, and consequently the basic law of economic action can be comprehended also in the conduct of the isolated farmer. Thus, the foundation was laid for the first correct formulation and satisfactory solution of the problem of the delimitation of "economic" action from "noneconomic" action (Mises 1981: 146).

Here he develops the analogy between (1) actions of the isolated actor that aim to allocate factors to various employments and (2) actions in the market economy that have the same aim. This, he seems to say, is the foundation for the satisfactory solution to the problem of distinguishing between non-economic and the economic action and interaction in the market economy.

Mises wrote that in order to build on this foundation, economists had to overcome two problems. First, they had to recognize that the value of a transaction to a businessperson is derived from the value of the consumers' good to the marginal consumer. In other words, they had to recognize that costs and therefore the incomes received by the factors of production are ultimately based on the subjective valuation of the marginal consumers good via the appraisement of factors by business people who employ the factors to supply consumer demand (*ibid*.: 147). Mises expresses this idea in the following way:

> The fact that production is discontinued beyond the point at which it ceases to be profitable means that production takes place only as far as the goods of higher order and labor required to produce one commodity are not more urgently [wanted] to produce other commodities (*ibid*.: 164).

It was this "opportunity cost" theory that made the Austrian theory superior to that of Walras and Pareto.

> Within the field of modern economics the Austrian School has shown its superiority to the School of Lausanne and the schools related to the latter, which favor mathematical formulations, by clarifying the causal relationship between value and cost...The Austrian School must also be credited with not having stopped at the concept of cost, but, on the contrary, with carrying on its investigations to the point where it is able to trace back even this concept to subjective value judgments (*ibid*.: 165).

The second problem that economists had to overcome was the materialism of their reasoning. One way to understand the materialistic influence is to consider the doctrine of "real cost." According to this doctrine, human beings are limited in their ability to satisfy their wants because of a limit to the material factors of production. According to the subjective

theory of value, however, costs are nothing other than the subjective value of foregone alternatives. The limit to satisfying any particular want is not the lack of materials but the fact that businesspeople recognize that the materials can be used to satisfy a variety of wants.[2]

In his later work, Mises referred to the theory of action and interaction in a market economy as *catallactics*, which he defined as "the theory of exchange ratios and prices" (Mises 1966: 327). The prices in this theory include those of goods and the factors of production. The developers of the theory, according to Mises were Gossen, Menger and Bohm Bawerk (*ibid*.: 334). A more descriptive term for the theory is "the Austrian theory of value and cost" (ATVC.)[3]

ATVC was exactly what was needed to refute the socialist and Marxist arguments that the price of work is an exploitation price determined mainly by the capitalist class. By assigning producer-sellers of goods to each of Menger's orders of goods, one could easily derive the theory of imputation and, correspondingly, describe what Clark referred to as the functional distribution of wealth (Clark 1899; Mises 1966: 254). (See Chapter 4) This conception demonstrated that incomes in the kind of capitalist system that Marx and the socialists had in mind depend not on class but on the function a person performs -- i.e., on the service he helps to provide to consumers.

Error

ATVC contained no error because its purpose was to refute the socialist and Marxist arguments, which also assumed no error. As Israel Kirzner (1979 Chapter 4) and Eric Streissler (see *ibid*.: 55, note 9) have pointed out, however, the school's founder Menger was aware of the potential for error, recognizing that market interaction in reality is always uncertain. Later expositors of the theory were also aware of this.

The Interventionist Ideology

As Mises himself recognized, a new kind of ideology emerged in the 20th century -- the ideology of interventionism. Proponents of this ideology aim to identify rationale for government intervention in markets and, therefore, for particular restrictions on free enterprise. This ideology appears to have had its beginnings in the arguments made by welfare economists like A. C. Pigou (1912, 1938) and by political "progressives." These arguments are not about substituting socialism for capitalism. They are about piecemeal government interventions such as blocking "monopoly practices;" regulating prices of goods and services; requiring products to meet safety standards; regulating wages, working conditions, or the conditions under which employment compacts and contracts can be made; subsidizing or taxing this and that business action or property owner; granting patents and other monopoly franchises; controlling advertising; providing various public goods and services; reducing externally harmful effects; changing liability laws; and so on. To deal with many of these arguments relating to government intervention in cases like these, we must build images of interaction that are more realistic and detailed than those used to demonstrate ATVC.[4]

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[2]This statement reflects the assumption that the market economy is best conceived as a set of actions and interactions, not as one means of causing material factors of production to be transformed into goods. The latter view is held by mathematical economists who have not accepted Mises's argument because they have not fully thought through the central planning problem, the have not learned to appreciation the effects of the market economy, or both.

[3]Mises's own contribution to this theory is discussed in Gunning (1997a).

[4]It is true that Mises dealt correctly with some of these interventionist arguments. See especially Mises 1988. Our argument, which is elaborated below, is that by beginning his theory of the pure market economy with a theory of prices only, he set a precedent that led his followers to think of the "market process" as having mainly to do with prices. In the real market economy, as we

A major source of arguments favoring intervention in the market economy is the recognition that market transactions entail not only prices but also other characteristics. Two other broadly-specified characteristics of a transaction are (1) the nature of the good or factor exchanged (as viewed by the exchanging parties) (2) and conditions of exchange, such as implicit and explicit promises of future actions. To deal with arguments based on the assumption that these characteristics are present (or absent), we must move beyond the phenomena that are suggested by the term "theory of value and cost" or "catallactics," as Mises defined it. We must develop a broader theory that we call here the *theory of transacting*.

The General Thrust of A Praxeological Theory of Market Transactions

A praxeological theory of transacting has two characteristics that distinguish it from the Austrian theory of value and cost. First, it directs one's attention to pre-transaction actions. Second, it includes more variables than only price and quantity. We discuss each in turn.

Pre-Transaction Actions

To help elucidate pre-transaction actions, we begin by considering some possible pre-production actions of the isolated actor. To simulate the basic economic action of a market economy, we focus first on a production action -- an action whose goal is to cause a first order good to be produced with existing higher order goods. Then we immediately shift our focus to actions that the actor might take in anticipation of ultimately taking some production action, although not necessarily a specific one. We assert that during the pre-production period, an isolated actor may learn what her wants are, she may learn to identify the means at her disposal to help satisfy her wants, and she may learn to employ those means in what she believes to be the most efficient way. We now focus on the learning. In learning what her wants are, a person often comes to decide that the items she initially believed she wanted are either less or more important to her. Similarly she may learn that items she initially believed were unimportant as factors or of which she had no knowledge at all are important factors after all. Recognizing and taking account of pre-production actions enables us to broaden our image of action. It enables us to add to what Mises called a "period of provision." This is a period of production that takes account of the fact that a produced first order good may not be fully consumed until some time after it is produced (Mises 1966: 481). We can add a pre-decision period. More accurately, we add a *deliberation period*.[5]

We now use this description of the isolated actor as a starting point for understanding pre-transaction actions in a modern market economy. Some individuals may believe that they already know enough about the wants of others to make a decision about which goods or factors to specialize in producing or helping to produce. Others, however, will regard learning about others' wants as a means of ultimately making the specialization decision. They will have a demand for "market research." This refers to two types of knowledge (1) knowledge of the various characteristics of transactions that prospective future trading partners would like to make and (2) knowledge about the costs of making transactions that have such characteristics. A person may produce all of the knowledge he needs or wants by himself or he may employ specialists or teachers to help him. Once a person has acquired what he regards as a sufficient amount of market research knowledge, he may proceed to test that knowledge by making transaction announcements or by tentatively accepting the transaction announcements of others (see below). Again, he may do this himself or hire specialists in advertising, marketing and negotiation. Ultimately the transaction will be made. Before this can occur, however, all of the transacting parties must possess the necessary market research knowledge. We can refer to the time during which these pre-transaction actions occur as a *pre-transaction period*.

Our recognition of specialization in the acts of learning in the market economy helps us identify a potentially elaborate set of actions relating to error during the pre-transaction period. These are evident in real market economies but are ordinarily neglected by economists. Here we divide the actions into three classes: deception, fraud and parasitic positioning. All three cause harm to decision-makers. In deception and fraud, one aims to do this by supplying false knowledge about market conditions. In parasitic positioning, one person (the parasite) deliberately positions himself to

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shall argue shortly, prices are only one of three general characteristics of transacting. Mises did not take sufficient care in building his theory to point this out to his readers.

[5]The idea that choice entails deliberation is explored in greater detail in Gunning 1990: 77-80.

benefit from the choice of another person (the host). The parasite does not aim to change the host's choice but merely to benefit from it. The parasite knows that his positioning will cause harm to the host. Indeed, he may worry that the host will take evasive or retaliatory action if she thinks that the positioning was deliberate. Accordingly, he may attempt to conceal the fact that his positioning is the result of a choice. A simple example is a knowledgeable stock broker-advisor who advertises his desire to broker a consumer purchase of shares in X company but decides not to tell customers of unfavorable research because he suspects that doing so will discourage them from making a trade.

Deception, fraud and parasitic positioning are possible because of individuals' propensity to err. Error is, of course, appreciated among Austrian economists. Of special importance is the errors of entrepreneurship that correspond to the a priori assumption of entrepreneurial uncertainty. Yet, in presenting his image of the pure market economy, Mises presented no images that contained the pre-transaction actions that accompany the recognition by actors that other actors besides themselves make errors.[6] ATVC, of course, is deliberately constructed to disregard error and such pre-transaction actions.

Deception, fraud, and parasitic positioning are most evident in the purchase and sale of financial assets, where traders ordinarily base their actions partly on the information of others. It is not possible to deal with arguments that regulation of insider trading, stock fraud, and other deceptive financial dealings will reduce prospects for a business cycle and promote economic growth without taking account of these types of actions. This is also true of arguments in favor of laws relating to the protection of consumers and workers from their own errors and laws making producers of goods liable for the damage from their products that they could have prevented.

Transaction Variables

The praxeological theory is broader in that it deals not only with prices and quantities but also with characteristics of goods and conditions of exchange. Conditions of exchange refer to such things as time of delivery, hours of employment, work responsibilities at different times and under different circumstances, timing of the payment for sale, guaranty for credit, collateral requirements, warranties, maintenance and service contracts or compacts, contingencies, and so on. We assume that trading parties aim to determine each of these transaction characteristics.[7] For any given transaction, all of

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[6]Mises does, however, discuss some pre-transaction actions. Specifically, he devotes an entire section of *Human Action* to "Good Will." The section begins with the following statement: "It must be emphasized again that the market is peopled by men who are not omniscient and have only a more or less defective knowledge of prevailing conditions" (*ibid.*: 379). He writes that catallactics has the problem of investigating "the nature of this peculiar thing called good will" (*ibid.*: 380). Remarkably, however, although he recognizes that good will is a (higher-order) good (witness his statement on the same page about making a money investment to establish it); he completely disregards the reason for this "peculiar thing." The reason why good will is a higher-order good is that individuals have an incentive under the conditions of the pure market economy to take advantage of the propensity to err in others. A person establishes good will in order to persuade her customers that she will not deceive, defraud, or position herself parasitically.

[7]Mises, of course, recognized, other dimensions of transactions. In his critique of statistical descriptions of past prices, he writes that "it is a serious blunder to disregard differences in the quality of the commodity in question" (*ibid.*: 331). The problem is that in presenting his theory of prices, which he treats as the foundation of economics, he ignores these other dimensions. On the other hand, his neglect of these variables in his section on "Good Will"

the characteristics may, at one extreme, be set on a take-it-or-leave-it basis by a producer-seller. At the other extreme, they may each be a subject of negotiation and, consequently, be the outcome of haggling.

When price theorists deal with the actions that take place prior to exchange, they commonly write about price announcements and price acceptances.[8] When we consider the complexity of transactions, however, we are led to conceive of a very much wider set of pre-transaction activities. Prospective sellers and buyers often must communicate very complex transaction characteristics in addition to the price. Moreover, the communication may be exploratory. Its aim may be to determine whether an exchange is possible. The aim of a prospective sellers may be to find out who the prospective buyers are, what the buyers want or will accept, and the conditions of sale that are most desired. Prospective buyers may want to find out the nature of the products offered for sale and the attenuating rights and responsibilities associated with their purchases. Communication may not be possible at first; it may require learning. The most obvious case is where the buyer and seller use different languages. Less obvious cases entail teaching about how to use or benefit from buying and owning a particular product. Such learning may entail the use of experts as tutors. Or to avoid some of the learning, a buyer or seller may hire an advisor. All of these are pre-transaction actions associated with the fact that the nature of the good, its quality, and the conditions under which it is exchanged are not given and known but variable.

A buyer or seller who does market research expects ultimately to make a *transaction announcement.* A transaction announcement is a price offer of $X for a specific good and corresponding set of sale conditions. By using the term "transaction announcement" instead of "price announcement," we remind ourselves that we must always be in a position to describe the nature of the good or factor and conditions of sale for which the price is announced.

A transaction announcement is relevant only when it corresponds to a *commitment* to sell the announced item at that price and under the announced conditions. The commitment may be fully enforceable or it may be subject to a number of contingencies, including a right to withdraw the offer at any time. Whatever the contingencies, it will be irrelevant to the prospective buyer unless she believes that the seller is committed, to some degree, to selling at the announced

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let him to misconceive one of th important driving forces behind the literature on imperfect and monopolistic competition. He conceived of this as the principal explanation for the so-called monopolistic position achieved by a seller who "enjoys [a brilliant reputation] within a limited circle of staunch patrons..." The result was that his critique of this literature was of limited relevance. Such interventionist arguments as a ban on advertising, product differentiation, and over expansion that sometimes emanated from economists use used such models of market interaction were best refuted by referring to (a) entrepreneurship in the supply of different variations of the same product, different qualities, and different conditions of sale and (b) the propensity of consumers to err in their decisions.

[8]As we show below, the originator of this transactions view in modern economics is Ronald Coase, his first effort being his 1937 paper on the nature of the firm. However, Coase's own terminology was clumsy, representing the fact that among his contemporaries, there was no means of expressing pre-transaction actions. Conceiving his work as a contribution to "price theory," Coase wrote of the costs of using the pricing mechanism. He labeled the first class of such costs the cost "of discovering what the relevant prices are" (1937: 390) Obviously, what prospective traders try to discover is not only the offer prices but also the goods that are being offered and the possible conditions of exchange. Although it may be understandable that in 1937, Coase would present his theory by focusing on prices, those organization theorists of today who have followed Coase are unlikely to use this language.

price. A transaction announcement need not be a verbal communication of a specific price. A person who merely rents a booth at a local market or who visits a department store also may signal a commitment. The same is true for a person who incurs the expense of advertising. Whether a particular act is a relevant transaction announcement, or part of an announcement, depends on whether the act is perceived as such by the person or persons at whom the announcement is aimed.

The commitment associated with a transaction announcement implies that the announcer is imposing a penalty on herself in the event that she does not keep the commitment. Such a self-imposed restriction deters or even blocks her from availing of a larger range of options that she would otherwise have.

At any given time, the individuals in the market economy are making uncountable transaction announcements. If the transaction announcement actions ever ceased, the cost to each person of calculating profit and loss from any action would be greatly multiplied. It would mark the end of monetary calculation; since the calculation by any single individual depends not only on the presence of money but also on the use of money by others to make transaction commitments that contain transaction offers. Monetary calculation could start again only if someone broke the silence and made a transaction announcement. Then others could use this as a starting point for their own calculations.

Origins of the Theory

The idea of making transacting the basis for the theory of markets and prices was suggested by Ronald Coase in 1937 with an article in which he argued that whether individuals (1) make simple this-for-that exchanges involving money for work or (2) adopt more complex interpersonal forms of organizing their provision of work services depends on the transacting they must carry out to make the simple exchanges. The embryo conceived by Coase was to mature into what today is labeled "transaction cost economics," the "new institutional economics," the "new theory of organization," etc. It is a theory of complex agreements, of their preconditions (including political, legal, and social institutions), and of their consequences. Insofar as the work in these fields is confined to economic interaction under the conditions of the market economy, it is an integral part of the praxeological economics conceived in this book. An understanding of transacting as it has been elucidated in some of the literature in these new fields is essential to deal with many of the modern interventionist arguments. In a much later 1960 article, Coase made transacting the basis for a theory of alternative means of dealing with external effects, including government intervention.

In dealing with external effects and other characteristics of the market economy that are often used in interventionist arguments, Coase differed from Mises. Mises began his study of economic interaction by assuming a pure market economy with a system of complete private property rights in which everyone is fully rewarded for every externally-beneficial act he performs and is held liable for every externally-harmful act (Mises 1966: 655). Coase, however, in his writings that relate to economic policy, began with a system of incomplete rights. As he had done in the case of the simple this-for-that exchange, he reasoned that the type of arrangement people invented to deal with the acts that have external effects, if any, depends on the transacting they must carry out. Other economists took over from there. The result was "property rights economics," "law and economics," and the "new economic history."

This is relevant to praxeological economics because many modern interventionist arguments dealing with external effects realistically assume that the private property system is either too costly or impossible to complete, in the sense described by Mises. It is important to realize that there is nothing wrong with building an image of a pure market economy in order to understand many of the characteristics of economic interaction. However, it is counterproductive to employ that image in the way that Mises does. Specifically, it is a mistake to introduce the problem of external effects with the statement:

> The laws concerning liability and indemnification for damages caused were and still are in some respects deficient. By and large the principle is accepted that everybody is liable to damages which his actions have inflicted upon other people. But there were loopholes left which the legislators were slow to fill. In some cases this tardiness was intentional because the imperfections agreed with the plans of the authorities (*ibid*.: 655).

When he turns to the problem of external effects, he writes that While the starting point for understanding external effects may be an image of complete-private-property-system, pure market economy; it is counterproductive to go on, as Mises does, to start his discussion of the problem of external effects with the statement that by apply economics this

Because human beings anticipate the consequences of their actions, transacting implies the possibility of pre-transacting actions aimed at facilitating the transacting, at obtaining greater benefits from it, or at avoiding the harm from it.[9] The

[9]We are referring here to a situation where A expects a transaction between B and C to harm her.

developing transaction literature has used the term "transaction cost" to refer to value of the factors of production used in such pre-transacting actions.

Coase correctly placed the focus not on the traditional factors of land, labor, and capital but on actions (Coase 1960: 27-28). Followed to its logical conclusion, this means that a transaction cost is a benefit that is foregone due to an individual's taking an action that is different from what she would otherwise take in order to facilitate a transaction, to obtain greater benefits, or to avoid harm. Actions that reduce transactions costs fit nicely into Menger's description of higher order goods. However, because the idea of a transaction is broader, it requires a rethinking of the procedure of dividing first-order goods into distinguishable classes. We must ask what we can reasonably expect to accomplish with such an imaginary construct. What we cannot reasonably expect to do is to evaluate arguments which (unlike the Marxist and socialist argument that workers are exploited, which is discussed below) do not assume a fixed set of goods and factors of production.

Once we commit ourselves to developing a theory of transacting in the pure market economy, we can avail ourselves of the explorations of facts and theory building by those who have followed the trail blazed by Coase. Interpreted praxeologically, transaction cost economics and its relatives amount to an addition to the Austrian theory of value and cost. In effect, Coase described and defined the firm (1937) as the organizational consequence of the effort to save transaction costs under two conditions: (1) the work of two human beings yields greater profit when combined than when employed separately and (2) the employer is uncertain about what kind of work she will need in the future and how it will be performed. The important point for our purposes is that Coase himself conceived economic interaction as an exchange in which the exchanging parties take account of the three general characteristics described above and that others who followed him did the same.

The Special Status of the Employment Compact

A single decision by the isolated actor, Crusoe, to produce a good may entail a series of sub-actions that Crusoe plans out, more or less, prior to his decision. Whether he carries out the whole series depends on the conditions that he perceives unfolding as time passes. If conditions turn out to be different from what he predicted, he may alter his plan and decide to perform a different set of sub-actions. Or he may abandon his plan altogether. An important fact is that, if he does not perceive that conditions have changed substantially, whether the production action is completed in the way Crusoe expected depends mostly on his will to carry out the sub-actions needed to complete his plan. When the time comes, he can choose to perform the sub-actions or choose not to perform them. As an isolated actor, he need not rely on anyone else in his projects. With these ideas in mind, let us turn to plans to produce a good when, under specialization, it is more profitable for one person to be a planner and for others to carry out the actions and sub-actions in accord with the plan.

In economic interaction, there are likely to be many cases in which the plan for a production action is in the mind of one person while the sub-actions needed to complete the plan can be most cheaply performed by other persons. Under these conditions, if the planner expects that he may want to alter his plan, he considers whether it would be cheaper (1) to wait and hire people to perform particular sub-actions at the time when the need for them arises or (2) to hire people now who agree to perform future tasks that are currently not completely specified. Economists have labeled the former "independent contracting" and the latter "an employment compact, or *Coasean firm*." A planner may regard making an employment compact as a less costly way to get tasks performed if he expects to alter his plans. To use a set of independent contractors, a planner would have to incur the costs of communicating his wants and of negotiating each time he wanted a task to be performed.

The main insight in Coase's 1937 paper on the firm was that a demander of work may offer an employment compact if she believes that she can profit from controlling a worker's work, within limits, over time. Implicit in this idea is that the worker also believes that he can profit. Coase specified various reasons why the employment compact may be preferred over independent contracting by either or both of the parties. It is not necessary here to discuss the reasons why a prospective employer might want the right to control another person's work. It is sufficient to explain this fact by referring to (1) the employer's belief that such an arrangement will be profitable and (2) her willingness to pay the employee a sufficient amount to entice him to give up the right to the output he helps to produce. In a free society, this right initially belongs partly to the employee.

The Agency Problem

It became evident in subsequent work that a major characteristic of many employment compacts is the *problem of agency*. This is the problem that, although the employer can give orders to the worker, she must ordinarily implement some kind of monitoring and incentive system to assure that the worker is motivated to follow the orders. In the pure

entrepreneur economy such a problem does not exist since we assume that each pure entrepreneur has complete command over the factors he employs. To deal with the reality of a free society, however, we must build an image of production in which the pure entrepreneur, as an employer can purchase a promise from an employee to allow her to control his work within limits. However, the government is prohibited from completely enforcing this promise. In this circumstance, an employer can monitor and threaten to withdraw the pay of a shirking or dishonest worker. However, the ultimate decision to perform a particular task must remain with the worker. There are ways that employees can persuade employers of their commitment to do agreed-upon work even with no, or a minimum, of monitoring. For example, an employer and employee may sometimes make contracts that require the employee to forfeit pay or even a posted bond.[10]

The agency problem becomes important in many exercises that aim to defend arguments for and against government intervention in markets for work. However, the problem is not unique to the employment compact. It exists in a variety of other circumstances also.

Governance

The governance structure refers to interpersonal relationships that are created to make production decisions when the cognitive input of more than one person is required. By this, we mean that entrepreneurship has made an appraisal of the likely profitability of such combined production decisions and determined, tentatively at least, that they will yield higher profit than production decisions made by a single mind. Our knowledge of the properties of entrepreneurship direct us to consider three general classes of such situations depending on the entrepreneurial task for which the combined inputs are required: appraisement, undertaking, or uncertainty bearing. We discuss each in turn.

It is possible that two or more people would be required to decide whether a particular production project should be started. In other words, it is possible that two or more persons must attach sufficiently high appraisals to the same factors of production before the factors can be hired. The most common instance of this is probably a situation in which a prospective producer seeks partial financing for her enterprise at a sufficiently low cost to her for the enterprise to still be profitable to her. For the production project to be carried out, she must first persuade one or more prospective financiers that the project is profitable enough for him (them) to invest in it instead of in some alternative. In other words, the financier(s) must also come to appraise the factors of production that the production project requires at a sufficiently high value before the project can be undertaken. The prospective financier(s) need not make exactly the same appraisals as the prospective producer. They also need not fully appraise any particular factor. A prospective financier may make his decision entirely on the basis of his estimate of the producer's ability to appraise and of her willingness to make such appraisals and, later, to honestly and competently command the factors that are hired.

A second possibility is based on a requirement for joint cognitive inputs in the undertaking. Suppose that two or more people are required to make ordinary command decisions in the direction of the factors during the period between when factors are hired and when production and sales are complete. Two general cases come to mind. In the first, there is a hierarchy of employees in which the command responsibilities at the top of the hierarchy are ordinarily more general than those of employees at the bottom. The workers are organized into departments, sub-departments, and so on. At the top is the CEO; at the bottom is the "ordinary worker" who follows commands but gives no commands of his own. The project could not be profitable unless workers in each department and sub-department perform their function in the total enterprise. In the second, there is a group, or team of specialists. The completion of the production-sales project requires each specialist to perform his function adequately. Thus, the value of each in the project depends on others making adequate contributions. The cognitive inputs of each of the specialists must be present for the project to be profitable.

The third possibility is based on a requirement for joint cognitive inputs in uncertainty bearing. Suppose that an enterpriser has determined that a production-sales project is highly likely to be profitable, that he has sufficient funds

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[10]The agency problem in the employment compact was not a part of Mises's image of the pure market economy because that image assumed a complete set of private property rights The organizational logic of *Human Action* suggests that he could have treated it in his chapter on "The Data of the Market" as a situation in which private property system is not complete. If this interpretation of the logic is correct, the best explanation for his neglect of the employment compact is a defect in his organization. A chapter is missing, namely, one about situations in which the property system can never be complete.

to finance it, but that he is unwilling to bear all of the uncertainty that future conditions will cause that project to be unprofitable after all. He is willing to invest some amount but his investment is insufficient to launch the production. The project cannot be carried out unless someone else is willing to share in the uncertainty burden. A prospective financier must again be persuaded to invest in the project. Unlike the first possibility discussed above, we assume that the finance partner must be given a share of the profit in order to agree to bear the uncertainty of loss.

The particular governance structure that is chosen for an employment compact ordinarily depends on entrepreneurship's perception of the agency problem. Ordinarily, that structure exists partly because it helps to solve different aspects of this problem. As in the case of the agency problem generally, an understanding of the reasons for and nature of real governance structures is necessary in order to deal with many arguments for and against government intervention in real market economies.[11]

3. PRODUCER-SELLER COMPETITION

A theory of transacting competition among producer-sellers is a theory of how individuals acting in the role of producer-sellers, under free enterprise, compete for the money of individuals acting in the role of consumers. Its focus differs from that of a theory of price competition in two ways. First it deals not only with prices and quantities of goods but also with all of the other characteristics of goods and conditions of exchange that we have mentioned in this chapter. Second, it is concerned with pre-transaction actions. Regarding the first focus, we recognize that producer-sellers compete for consumers' money in their offers of the time of delivery, timing of the payment for sale, guaranty for credit, collateral requirements, warranties, maintenance and service contracts or compacts, contingencies, and other conditions and characteristics. They also compete by inventing and offering new products. Recalling that the Austrian theory of value and cost treats working conditions as consumers' goods, we go on to say that producer-sellers compete for workers by offering various hours of employment, work responsibilities, conditions of work, fringe benefits, incentives for extra or higher quality work, and other characteristics.

Regarding the second difference, a transaction-oriented economist focuses on producer-sellers who must discover which items are most profitable to produce and then communicate the transaction characteristics they are offering before consumers can make informed decisions to buy. Strategies include pinpointing consumers with whom such communication is cheapest; varying the characteristics of the good or conditions of exchange so that the costs of communication are lower than otherwise; employing "teachers" to demonstrate characteristics that a seller believes are desirable to consumers but about which consumers lack knowledge; and choosing particular methods of production and a location, making various commitments or seeking endorsements to assure consumers that the seller will keep his delivery, service, guarantee, warranty, or price offer commitments. To help him carry out these strategies, he may employ specialists. Thus we recognize competition in such acts as educational and informative advertising, marketing, providing guaranty, choosing the sales location, and market research. Every pre-transaction activity we can imagine is a candidate for this competitive action. To outdo rivals, an individual must be alert not only to his potential customers but also to the actions of his potential competitors.

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[11]Mises discusses some of the problems associated with governance in a section that is designed to distinguish what he calls "the entrepreneur qua entrepreneur" from the managers, technicians and bureaucrats (1966: 303-311). He does not identify dealing with the agency problem or setting up a governance structure as a task for entrepreneurship. A possible reason, albeit certainly not a justification, is that he disregards the possibility that decision-making often requires cognitive inputs from more than one person.

Copying and Innovating

It should be evident that a complete theory of transacting competition is impossible to construct. In this section, our modest aim is to describe two broad classes of interaction: copying and innovating. These are potentially present in most competitive interaction. A producer-seller may copy a competitor's exchange characteristics and pre-transaction activities or he may innovate by offering a set of exchange characteristics or engaging in pre-transaction activities that are new to his competitors.

The range of copying and innovation actions that can be performed is as unlimited as the characteristics of an exchange and the number of various pre-transaction activities. The task of fully elucidating their manifestations in all competitive activities would be even more tedious and impossible to complete than the task of fully elucidating the specific characteristics of a producer-seller transaction and producer-sellers' pre-transaction activities. To make the discussion manageable, we adopt the traditional procedure of disregarding competition in the non-price characteristics of an exchange and of assuming that the competition takes place in a market with respect to homogeneous product. Moreover, we disregard all pre-transaction activities. We concentrate on building a theory that includes innovation and copying for a single homogenous good.

Thus, we assume that in an exchange between a producer-seller and consumer, the buyer pays money to a seller who turns over a material good along with all of its attendant rights and responsibilities for use. There is no possibility for negotiating a different quality or other accompanying obligations on the part of the seller or buyer. The rights of the buyer in the good and to the ownership of the good are absolutely secure. To disregard pre-transaction activities, we assume further that the seller and buyer know exactly what the material good is; they cannot be surprised to find that it is different (e.g., that it has different effects on the consumer) from what they thought it would be.[12] The simplest image of competition is one in which we assume that all goods are produced from start to finish by each producer-seller. Each production operation is perfectly vertically integrated. So we make this assumption also.

An image of competition under these circumstances corresponds to the traditional image of price competition in Austrian and neoclassical economics. A good way to describe it is to put ourselves, respectively, in the shoes of the major roles: the producer, the factor supplier and the consumers. We begin by describing competition without innovation. Then we add innovation.

Copying Through the Eyes of the Actors in the Major Roles

We begin with the viewpoint of producer-sellers. If we disregard financing, we can say that producer-sellers operate in two kinds of markets: (1) markets for the goods they produce and (2) markets for the factors they purchase. We begin with product markets. Assume that a single producer-seller is currently earning abnormally high profit. He is the only producer-seller of a particular type of bread. He has a monopoly which he has achieved through innovation. He expects that, if there are no changes, he will continue to earn the high profit in the future. However, he knows that the market economy has freedom of enterprise. So he would expect others, who have abilities or other strategic factors similar to his or who can cheaply obtain them, to acquire them and to copy his actions. Anticipating this, he would keep one eye on the activities of other producer-sellers of other goods. If he comes to expect competition from lower-cost sellers, he would have a greater incentive to innovate further. He also would keep an eye other lines of production. If he observes high profit, he would consider shifting to a different line by copying the profit-maker and possibly adding his own innovation. If he were to shift, we could describe his action as a decision to copy others.

Now consider competition in factor markets. A producer-seller wants to obtain control over the factors he needs at the lowest money cost. To do this, he tries to devise and offer pay that he believes will attract offers and acceptances from the owners of the factors he demands. Anticipating copying and the corresponding

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[12]Thus, we disregard cases of deception and cases in which the exchange of material property carries attendant rights and responsibilities that are viewed differently by the exchanging parties.

competition for those factors that he regards as yielding him the most profit, he will try to offer pay that he believes will outbid his competition.

We now shift to the view of factor suppliers. A person knows that she is the owner of a factor of production because there are bids for her factor. She probably does not know all of the various ways that a factor can be used to produce goods. However, she knows that if it is profitable to use, she will be offered pay. She also knows that the size of her pay depends on its profitability in use and upon the extent of competition for it. Suppose that she owns a factor that is crucial in helping to produce a good that is currently being produced by an unusually profitable monopolist. For the moment, there are no close substitutes for her factor. She will be in a position to bargain for a better price. Even if the monopolist does not offer her the price that she expects, she knows that free enterprise implies that some other producer is likely to compete at some future time with the monopsonist for her factor. The competition is likely to raise the factor's price and she will gain. If there is competition, she knows that regardless of how much profit her current employer is earning, if she is dissatisfied with the offer of producer-seller A, she can seek a better deal from competitor B.[13]

Lastly, we consider the viewpoint of a consumer. Consider first the consumer of the particular bread produced by a monopolist producer-seller who is earning unusually high profit. She knows that if other producer-sellers can produce the bread at the same or similar costs, they have an incentive to copy and to become competitors in price with the first. She knows that copying is likely to benefit her. Thinking more broadly about all consumers, they realize (or they can realize if they take the viewpoint of the economist) that producer-sellers sort themselves into product classes according to the anticipated profit. They know that those who anticipate low profit are continually on the lookout for opportunities to increase their profit by copying the actions of producers who are earning high profit. They realize that because freedom of enterprise enables producer-sellers to gain from copying, goods that are currently selling at unusually high prices will, in the future, be sold at lower prices.

Innovating

Innovating, as used in this simple image of price competition, means producing a substitute product or employing a previously unrecognized method of production. It is an expression of human imagination, creativity and inventiveness. An innovator is motivated by high profit expectations in relation to those he currently has. If he is already in business, his aim may be either to avoid the reduction in profit due to the copying of competitors or to gain what he expects to be high profit in a new enterprise.

To gain a more complete understanding of innovating, we must take the viewpoint of those producer-sellers who are harmed by the innovating. Under the conditions we have assumed, when an innovator uses a new method of production, he ultimately causes a reduction in the price of an existing product. This inevitably harms competing producers who use the old method. When an innovator produces and sells a new product, a consequence is a reduction in demand for existing products with which the new product competes (i.e., for substitutes in the budget). The producers of the existing products are harmed. Accordingly, the producers who compete with the innovator face declining profit.

In the face of declining profit, some producer-sellers may just give up. However, others are likely to be motivated to copy the innovator or to become innovators themselves. Because of the latter possibility, we can say that competitive interaction in the quest for profit leads the market economy to be characterized by continuous improvement in products and methods of production. Mises referred to the "concatenation of the market." We can add substance to this idea by saying that it consists of the pattern of copying and innovation resulting in products that are superior from the consumers' perspectives and methods of production that reduce costs and, therefore, price. This pattern is motivated by the incentive to earn profit in a competitive free enterprise system.

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[13]Keep in mind that we are discussing factor suppliers who themselves cannot produce factors. Regarding the view of competition held by a factor producer, see the discussion above.

It is worth noting the difference in substance between the incentive of an isolated actor to improve his products and methods of production and the incentive of entrepreneurship in the market economy to do the same. Consider first the isolated actor. Unless there is some deterioration in his environmental conditions or factors of production, he can maintain himself without any improvement. In the presence of deterioration, he may have an incentive to innovate in order to avoid a decline in his standard of living. If his environment is improving, however, he may lack such a motivation. In the market economy, competition gives individuals a continuing incentive to improve their methods and products in the eyes of consumers, regardless of environmental conditions. If a producer-seller in the market economy does not try to improve, his ability to satisfy his own wants as a consumer will deteriorate due to the copying and innovating of others.

In this subsection we have discussed price competition among fully vertically integrated producer-sellers of homogeneous products that are fully known to buyers and sellers. Our aim was not to describe competition in reality but to identify the particular patterns of copying and innovation. In the real market economy, competition occurs along the numerous dimensions described at the beginning of this subsection. We must guard ourselves against neglecting these other dimensions since it is only by doing so that we will be able to properly evaluate many of the interventionist arguments that pertain to real market economies.

4. CONSUMER SOVEREIGNTY

The isolated actor, by definition, always acts with the purpose of making his self-perceived condition better than it would otherwise be. We could say that in his role as a producer, Crusoe always uses what he regards as factors of production to produce goods that he regards as more satisfactory than the alternatives that he could produce. Crusoe, as factor supplier and producer, acts in the interest of Crusoe as consumer. The desire for consumers' goods motivates his action. Without that desire, he would not act in the sense that is relevant to his desire for producible goods. Crusoe is not perfect. He makes errors and he is uncertain about the full effects of his actions. His actions also take time to complete. Accordingly, time preference is an important criterion in his planning and decision-making.

The Analogy with Individual Action

When we turn to the action of entrepreneurs, the economist naturally draws on an analogy with the isolated actor. He considers the possibility that individuals acting in the role of entrepreneurs are motivated solely by the desire to cause the wants of individuals acting the role of consumers to be satisfied. Using the traditional language of the economics profession, we can describe this proposition by saying that the consumer is "sovereign" and we can write about the economist's inclination to wonder whether consumer sovereignty is one characteristic of the pattern of producer-seller competition in the market economy.

The case for consumer sovereignty goes something like this. In deciding which good to produce, which methods of production to use, and which innovation to invest in; a prospective producer-seller who aims to earn profit is compelled to cater to the demands of the consumers. If he fails completely to produce a product that consumers will buy, he will incur losses. Persistent failure will deplete his investment funds and drive him out of the ranks of the producer-sellers. Persistent success will raise his investment funds and may expand his role as a producer-seller. We write below of a selective process whereby those who best conform to the demands for goods by consumers are selected *in* while others are selected *out*. In this selection process, the decisions of consumers cause a particular pattern of selection to emerge instead of some other pattern.

Errors in Interaction

It seems evident that the consumer sovereignty patter would be present in the pure market economy.

Nevertheless, the existence of a particular pattern does not warrant the claim that the producer-sellers in the pure market economy would always act in the interests of the consumers in the sense that is analogous to Crusoe-as-producer acting in the interest of Crusoe-as-consumer. Indeed, the presence of errors suggests otherwise. As we shall see, producers, like economists, know that consumers may err. Because they know this, they have an incentive to deceive, defraud, and position themselves parasitically. If they succeed, many consumers may be worse off rather than better off in their own eyes as a result of their purchase of consumers' goods.

A consumer error refers to a self-perceived error in the consumer's judgment about the effects on the satisfaction he receives from the goods he buys. In the case described in the last paragraph, a consumer realizes that he would have been better off if he had chosen a different alternative or if he had not made this particular type of choice. If he were to face identical circumstances again, he reasons, he would not make the same choice.

Let us explore more fully the nature and causes of such errors. We begin by recognizing that no one can be completely certain that a particular choice will yield the differential satisfaction he expects at the time he makes the choice. Recognizing this, if he expects to make a similar, or related, choice in the future, he has an incentive to pay attention to and to record (mentally or with the aid of various tools) his choice and outcome in order to learn. In paying attention to and recording his choice, he reveals a belief that these acts amount to a lower cost way than merely using his raw memory, of improving his future choice-making. The point is that deliberation, the pre-decision act aimed at improving the consequences of the decision itself, is a continuing cognitive activity. At the time during which a person pays attention to her own actions and their consequences, she may not know exactly when or how she will use the knowledge she expects to obtain. She may even believe that she is unlikely to learn anything important. But she pays attention because her anticipated gain from doing so is greater than her anticipated cost. Her choice to pay attention is part of deliberation for some future decision. And she chooses to deliberate because she knows that she is likely to lose from her errors if she does not.

Deliberating over a particular decision is typically costly because an individual ordinarily has valuable alternative uses for the time it takes to deliberate. To economize on deliberation time, individuals often classify decisions and develop routine decision-making procedures that they apply to different classes. For example, suppose that a person in the role of consumer wants to buy a durable good. Instead of incurring the personal costs of learning about the good's properties and studying the relationship between the properties and her satisfaction, she may refer to brand names, appearance, the seller's personality, familiarity with the product or seller, association with other products or consumers, location of the seller, and so on. Classifying decisions and following procedures such as these amount to *shortcuts*. Individuals expect them have the same effect in saving time as the shortcuts one takes in traveling from here to there. As in decision-making generally, the choice of a particular shortcut may also be an error. Moreover, since a person's choice of shortcuts may itself become a routine, the use of shortcuts may lead to *systematic* errors in decision making. Like simple errors in decision-making, an individual has an incentive to avoid errors in the choice of shortcuts and to correct such errors if he expects to be making the same type of decisions in the future.

Producers' Opportunities to Induce and Take Advantage of Consumers' Errors

Errors in consumer decision-making are of no significant interest in building images of economic interaction unless other individuals are in a position to profit by promoting erroneous decisions to exchange or to alter the harm to the decision maker due to the errors. When we take account of the non-price characteristics of transacting and of pre-transaction activities, it is easy to identify ways that producer-sellers can do this.

One way is to *take advantage of consumers' decision-making shortcuts* by means of various advertising and marketing techniques that are suitable for this purpose. For example, suppose that a consumer decides to attach greater value to a product because it contains a specific trademark. Then the producer who possesses the right to use this trademark can shift to lower-cost methods of production that reduce quality. Or, he may attach the trademark to other products that he believes will not meet the consumer's expectations about quality. In doing this, a producer-seller induce consumers to choose products and conditions of sale that they otherwise would

not choose and that they will regret choosing if they become aware of their having been manipulated.

Two other ways that producer-sellers may induce errors is (1) to provide false or misleading information and (2) to divert a consumer's attention away from considering what she would regard, upon otherwise attentive reflection, as her most beneficial course of action. Such error-inducing actions are usually called fraud, deception, and "high-pressured" sales pitches.

Consumers are not the only prospective "victims" of such error-inducing actions. Employees, producers of factors, financiers, and business buyers may also be manipulated.

We know about errors and their being taken advantage of in exchange through experience. Experience informs us that action implies an effort to avoid error and to correct for error when it is discovered. A person who is error prone has an incentive to discover his mistakes, correct them, and avoid future errors. When we take the viewpoint of the prospective error-maker or fraud victim, we recognize that the incentive of producer-sellers to profit from inducing errors and fraud is limited by the prospective victim's incentive to avoid errors and fraud.

Errors and Other Roles

Producer-sellers themselves may make errors and both consumers and factor-suppliers may be in positions to deceive, defraud, and position themselves parasitically. Factor-suppliers may also make errors. Indeed, whenever we build an image of a market economy containing various roles, such as an image of financiers and producers, we must recognize the potential errors as well as the potential profit to people in the other roles to take advantage of those errors.

The Significance of Consumer Sovereignty

From one angle, we can consider the taking advantage of consumer errors as secondary to consumer sovereignty. If individuals acting in the consumer role did not believe that they would gain from an exchange, they would never agree to it. And a consumer who recognizes a previous error has an incentive to avoid future errors of a similar kind. But looking at the matter from this angle can also lead to an important omission. We can see this by recognizing that individuals acting in the producer-seller role have incentives to discover new prospective errors and other flaws in the revised decision-making of consumers. Their imagination, creativity and inventiveness are used in these activities just as they are used to perform actions that we associate with finding new ways to satisfy consumers' wants. It would be incomplete and potentially counterproductive, with regard to our goal of evaluating interventionist arguments, to fail to recognize that actors in the pure market economy may err and that, in anticipation of this, other actors have an incentive to deceive, defraud, and position themselves parasitically.

Mises's Neglect of Error

To see the effects of failing to consider errors and their encouragement as well as attempts to avoid them, consider one of Mises's statements about consumer sovereignty. In his introductory paragraph on consumer sovereignty, he writes: "If a businessman does not strictly obey the orders of the public as they are conveyed to him by the structure of market prices, he suffers losses, he goes bankrupt, and is thus removed from his eminent position at the helm" (*ibid*.: 270). Mises gives no quarter here for the idea that businessmen also take advantage of error-prone consumers, that they encourage errors, and that they defraud consumers. It would be a serious misinterpretation to say that Mises ignored fraud, etc. He did not.[14] However, neither did he describe

[14]In the introduction to his chapter on the market economy, Mises writes that it is the role of the state to use its coercion to protect citizens against "fraudulent aggression on the part of domestic gangsters" (*ibid*.: 256). Although this shows that he recognizes fraud and error, it does not acknowledge the activity of

it at the same time that he wrote about consumer sovereignty. Few readers who are not already convinced that praxeological economics is worth learning would be encouraged to do so by such a lop-sided presentation of consumer sovereignty.

Collaborative Monopoly

A collaborative monopoly is an agreement by two or more sellers of a good or factor to suspend their competition with each other. Each chooses not to take actions that would bid buyers away from the sellers who are part of the agreement. When we consider the wide range of transaction characteristics and conditions of sale, we recognize that such an agreement may be extremely complex. It may also be simple, such as an agreement to charge the same price for a good or factor with similar or practically identical characteristics.

Collaborative monopoly is intended to raise the incomes of the sellers at the expense of a buyer or set of buyers. The cooperators aim to widen the gap between selling price and costs. Such an agreement may be necessary in order for both of the otherwise competing individuals to survive in a small market. In this circumstance it is likely to be a prelude to a merger and ultimate emergence of only a single supplier. The number of buyers may be too small to support more than only one supplier. The suppliers choose to keep price higher than marginal cost in order to earn enough revenue to cover their total costs. Such cases are of minor significance and seemingly irrelevant to interventionist arguments. Collaborative monopoly becomes significant for interventionist arguments in cases where they are made by suppliers who, because of their particular specializations, are not subject the immediate pressure from others who can copy them.

Effective collaborative monopolies, in essence, block the factors that complement those of the specialists from being used in the particular production action that is monopolized. Even though buyers value additional units of the products higher than marginal cost, the owners of the specialized factors block the complementary factors from being used by refusing to employ them. Their purpose is to avoid reducing product price to buyers

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taking advantage of someone's proneness to make errors or the various persuasive activities of advertisers. Nor does it deal with the means that a state may use to prevent fraud. Mises also recognizes persuasive and deceptive advertising. Towards the end of the chapter, long after his discussion of consumer sovereignty, he writes that "it is certainly possible for an advertiser to induce a man to try an article which he would not have bought if he had known its qualities beforehand" (*ibid.*: 321). But his discussion of this subject is not about a characteristic of successful entrepreneurship but about why it would be a mistake to advocate the prohibition of all advertising just because some of it is harmful to consumers. Mises is correct to criticize those who advocate the prohibition of all advertising on the basis of the harmful effects of one type. But this is no excuse to disregard the argument that the one type should be prohibited. That argument must be dealt with in a different way. Perhaps the most charitable explanation of Mises's failure to give fraud and deception the status they deserve is his use of the term "entrepreneur" to mean not the praxeological entrepreneur, as defined here, but the entrepreneur as economists had traditionally used the term. We discuss his definitions in Chapter 4.

who are willing to pay the higher price.[15]

So long as additional amounts of the specialized factor can be produced, the collaborative monopoly is mainly a short run phenomenon. Its relevance to interventionist arguments is that it is evident to even the most casual observer that, so long as the higher income earned through collaboration is not a reward for producing the specialized factor in the first place, the combined loss to buyers and the owners of complementary factors, in terms of money, is greater than the gains to the parties in the cooperative agreement. So long as there are no other offsetting gains, this is a case where consumer sovereignty, as described earlier in this chapter, does not prevail. A law or policy that deters agreements that fall into this class has the potential of raising overall gains in terms of money. Whether it will accomplish this in fact, without offsetting losses, cannot be determined without knowing the particular facts and without applying the theory of political economy.

External Effects

Under a complete set of private property rights, the prospect for error and monopoly would be the only exceptions to consumer sovereignty in the market economy. But private property rights are never complete and never could be. There are several reasons. The first is that it is impossible for one person to control another person's will. Understood correctly, a complete set of property rights implies that someone completely controls the performance of all actions that have external effects. In social interaction, such a situation implies that one person would have to have to be able to completely command the action of another whose actions he has the legal right to command. Thus, if A owned the legal right to control B's performance on an assembly line, he would have to be able to cause A to do it without uncertainty. In a free society, this is impossible. The degree of completeness of private property rights depends partly on the willingness of someone whose actions are controlled by others to submit to the commands she is given. Second, enforcement is costly. On the one hand, this means that under some circumstances it is cheaper not to establish and enforce a private property right than to do so. On the other hand, it means that in a continually changing society, the tradeoff will be continually changing. A property right that was not previously worth establishing and enforcing may become so; or a new property right may come to be identified that was previously non-existent. Harold Demsetz (1967) describes the case of beaver trappers. When the price of a beaver pelt was low in early North America, the actions of one trapper did not harm other trappers enough for a set of beaver trapping rights to be worth establishing and enforcing. However, when the price of a pelt rose, the situation changed. Through war and peace treaties, legal rights to exclude others from trapping in particular places were established and enforced.

The establishment of private property rights in the case of positive external effects is even more tenuous. Ideally, a person who was benefited as a consequence of another's action would have a legal duty to compensate the person whose action was responsible for the benefits. However, to impose such a duty would be virtually impossible to completely achieve since it would require a judge to determine the exact amount of the benefit and a police to compel the beneficiary to pay. For example, suppose that you observed a fallen tree that was blocking one lane of traffic on a busy four-lane highway. You stop your car and remove the obstacle. A judge would have to determine how much benefit each subsequent driver would receive from your action. Then the police would have to compel the beneficiaries to pay you an amount that is greater than your costs. This scenario is sufficiently contra reality to suggest that it is not feasible. Economists can build images of a market economy in which such legal rights exist, but such an economy would never exist in reality.[16]

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[15]This incentive is present only if effective price discrimination is costly or impossible.

[16]Reciprocity of rights assignments in light of the Coase theorem(Coase, 1960) suggests the alternative of imposing costs on you for failing to remove the tree. This solution is equally infeasible.

In a real market economy, there are both externally harmful effects for which actors are not held accountable and externally beneficial effects for which they are not given rewards. In the case of the harmful effects, a producer, factor supplier or consumer may cause more damage by her actions than are gained as a consequence of the interaction. In the case of beneficial externalities, consumer wants are insufficient to lead entrepreneurship to acquire and command the factors needed to satisfy the wants even though there is a gap between the costs of the factors and the price of the product. In both cases, consumer sovereignty does not prevail in the direction of factors to their employments.

Factor Supplier Sovereignty?

It might be thought that entrepreneurship must also satisfy the factor suppliers. This is true in the sense that the employer who offers the combination of pay, benefits, conditions of work, and payment schedule that is most appealing to the owner of a given factor is selected over one who offers a less appealing combination. Praxeological economics, which separates praxeological entrepreneurship from the consumer role, treats "factor supplier sovereignty," if you will, as just a different manifestation of consumer sovereignty. Individuals acting in the role of consumers, as a functional category, want low consumer goods' prices and low felt uneasiness of working conditions so that they can obtain the greatest subjectively-perceived benefit.

5. SELECTION OF THE FACTORS OF PRODUCTION AND PRODUCERS

We can gain some insight into the market economy by considering how the factors of production and producers are selected. We assume that each producer-seller is constantly in competition with the other producer-sellers and must outbid them in pay. To decide how much she would be willing to bid for a factor, a producer-seller must identify an item or action as a factor and then judge how much profit it is likely to add, independent of its cost. In other words, she must appraise it. This requires her to build images in which the factor is combined with other factors to produce a good, which is then sold at some price. Thus, she must estimate the prices she would have to pay for the complementary factors, which may require her to build other images. She could avoid some uncertainty about prices of the complementary factors and, therefore, save on her costs of making appraisals by obtaining price commitments from current factor owners but this is likely to be costly also. She must then compare the images in which her factors are employed with an image in which her factors are not employed.

In addition to appraising each of the factors she may wish to employ, a producer-seller must simultaneously, try to determine how much she will have to pay for each factor. This requires her to make judgments about the pay that will be demanded by the initial factor owner, which in turn depends on the bids she expects other producer-sellers to make. Here also she may try to avoid uncertainty by obtaining price commitments, although again this is likely to be costly.

A factor may add to the producers-sellers' profit by enabling him (1) to offer the same product as his competitors but at a lower price, (2) to offer a different product that is in greater demand, or (3) to offer the same product with a more highly demanded set of transaction conditions. Individuals who possess items or who can perform actions that producer-sellers judge to have these characteristics can expect the items and actions to be identified as factors, offered relativelyh high pay, and "selected in." In the absence of external effects, monopoly, and error; such factors contribute relatively more to consumer satisfaction in terms of money than their alternatives. Otherwise, the producer sellers would not bid so much for them. However, it is also true that a factor is more likely to be selected and to be paid higher if it helps producer-sellers defraud, deceive, or achieve parasitic positions or if it helps achieve a collaborative monopoly.

Further insight into the interaction that results in selection can be gained by considering how the producer-sellers themselves are selected. In some cases, they are selected by financiers. Here, they become the equivalent

of hired managers and the same selection criteria applies to them as that described in the last paragraph regarding other hired factors. The only difference is that the financiers are selecting producer-sellers instead of the producer-sellers selecting other factors. The most revealing case is where the producer-sellers select themselves. In this case, their being selected in the future and even to expand depends on whether their actions in the past have been profitable and upon their wealth (and willingness to use it to finance their enterprises). Assume first that producer-sellers have only a sufficient amount of personal wealth to finance their existing enterprises. Then those who earn profit will be able to continue in the same line of business in the future, while those who incur losses will not. Now assume that some producer-sellers have more wealth than they need to finance their existing enterprises. Then those with the greater wealth will be able to continue in the same line of business even if they incur losses. They can continue to incur losses until their wealth is exhausted. They have a cushion of wealth on which to rely should the future bring losses. Those with less wealth who incur losses will be compelled to leave the ranks of the producer-sellers sooner. In short, the producer-sellers will self-select. Those who are most willing and able to bet that their appraisals of themselves and other factors are correct will select themselves into the ranks of the producer-sellers. Others will select themselves out of these ranks.

As with the selection of other factors, the selection of individuals into the ranks of the producer-sellers depends partly on their contribution to consumer satisfaction and partly on their ability to deceive, defraud, and achieve parasitic positioning.

A Note on the Common Use of the Term "Entrepreneur"

The term "entrepreneur" has been used in ordinary speech to refer to those individuals who achieve and are able to maintain positions as employers of other factors, including human factors. By virtue of their relative control over the factors, such "entrepreneurs" exert proportionately greater influence on the outcome of economic interaction. They are the people who directly decide, in competition with others, whether a particular item or action is a factor and how much to bid for it. They are also products of the selective process we have just discussed.

While it may be a convenient makeshift to use an image of this sort in order to stress individual differences, the individuals who fit into these positions are continually changing. Thus it would be fruitless to attempt to identify a "class" of such "entrepreneurs." At any particular time, a specific set of individuals will have achieved the positions of greater importance. However, free enterprise assures (1) that only those members of the set who have been successful or who are willing to squander some of their wealth will remain in the set and (2) that any other individual who initially has wealth to squander or who can obtain financing may join the set.

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