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Chapter 5

Critique of Mises on "The Market" and Prices

In his chapter on "The Market" in *Human Action*, Mises derived what he probably would have called various "theorems" based on fundamental economic assumptions.[1] The most important of these is consumer sovereignty. This theorem is related to his image of entrepreneurial competition and to what he called the "selective process." It is in deriving this theorem and related concepts that the insufficiency of his entrepreneur concept and his failure to develop a theory of transacting become most evident. These are also evident in his subsequent chapter on "Prices."

The purpose of this chapter is to describe Mises's discussion of the market and prices and to present praxeological critiques. Part one critiques his chapter on the market, part two critiques his chapter on prices.

[1]A term that appears to have similar meaning in the neoAustrian literature is "pattern."

1. THE MARKET

Mises begins his chapter on "the market" by pointing out that this term refers to the economic interaction under the conditions specified in the definition of the market economy (part one); by describing capital accounting and defining the concept of capital, to the individual, as the monetary sum of "the whole complex of goods destined for acquisition (part two);" and by discussing capitalism in relation to the pure market economy, of which he plans to build an image in later parts of the chapter (part three).

Sovereignty of the Consumers

The image-building begins in part 4 where he discusses "The Sovereignty of the Consumers." He writes that "the owners of the material factors of production and the entrepreneurs are virtually mandatories or trustees of the consumers, revocably appointed by an election daily repeated" (Mises 1966: 271). He identifies only one exception -- that of monopoly prices (*ibid*.: 272), which he later describes as a situation in which a seller may restrict supply in order to sell a product at a higher price (*ibid*.: 357-63).[2]

In light of our earlier discussion of consumer sovereignty in Chapter Three of this book, Mises's presentation contains several gaps. First, there is no mention of interaction between producer-sellers and consumers relating to errors, persuasive advertising and fraud. Second, there is no discussion of interaction between producer-sellers and employees relating to the employee's views of the desirability of various work conditions and conditions of work compacts. Third, Mises does not qualify his presentation by discussing external effects. Why are these things missing? Mises did discuss these things elsewhere in his book. But why not include them in the subsection on consumer sovereignty? One answer is suggested by Kirzner. It is that Mises saw his work on consumer sovereignty as the "completion of Menger's vision" (Kirzner 1999: 219). We agree and discuss this below.

Whatever the reason for these gaps, Mises did not explain them at this juncture. Therefore, it should not be surprising to find that readers of his discussion of consumer sovereignty would regard it as a biased diatribe

[2]See also *ibid*.: 681 and Mises: 1998.

that deliberately misrepresents the actions of real entrepreneurs in a capitalist system.

Competition

Most of part five on competition appears aimed at non-economists. He only writes briefly to economists. His main message to economists is captured by the following statement:

> In the market economy, competition manifests itself in the fact that the sellers must outdo one another by offering better or cheaper goods and services, and that the buyers must outdo one another by offering higher prices (Mises 1966: 274).

This sounds very much like an extension of his discussion on consumer sovereignty. One addition, however, is his inclusion of innovation in his discussion. In the statement just quoted, he writes about "newer and cheaper goods." One must presume that by "newer" goods, he means goods that have never previously been produced and not newly-produced goods of the same kind. Also, in a discussion of complaints by popular writers about how competition in the railroad industry is nowadays difficult or impossible, he points out the emergence of the motor car and airplane (*ibid*.: 275). Thus, he seems to have in mind a broad view of economic competition, which includes the discovery of new products and methods of production. In other words, he seems to recognize innovation and copying. Nevertheless, there are two limitations. First, he neglects competition in actions the aim of which is to gain by taking advantage of the propensity to err. There is no place in Mises's image of competition for fraud, deceit and parasitic positioning. Second he does not discuss transaction competition. There is nothing in the section about competition in advertising and marketing or in the non-price characteristics of goods and conditions of purchase and sale. Nor is there anything about pre-transaction activities. Thus, his presentation is incomplete by the standards of the theory of competition described in Chapter Three of this book.

Entrepreneurial Profit and Loss

We skip by the next two sections on "Freedom" and "Inequality of Wealth and Income" to get to the part on "Entrepreneurial Profit and Loss." Mises begins the section by incorporating the notion of profit into the analysis that he has already presented. He writes that a person's profit or loss

> reflects his fellow men's evaluation of his contribution to social cooperation. This evaluation is ultimately determined by the efforts of every member of society to attain the highest possible psychic profit. It is the resultant of the composite effect of all these people's subjective and personal value judgments as manifested in their conduct on the market (*ibid*.: 289).

He proceeds to distinguish between the income of the promoter as such and income due to technological knowledge and luck (*ibid*.: 291). A remarkable aspect of this section is that he says he is writing totally about the promoter concept of the entrepreneur. This personage represents, among other things, differences in the quickness to perceive gains, shrewdness, intelligence, quickness of apprehension, and far-sightedness. Thus, Mises is asserting that these characteristics are in a different class from one's relative technological knowledge. How about other knowledge? In particular, how about knowledge of his employees' "personalities" that would enable him to install a more effective governance system than his competitors? Mises certainly recognizes the significance of this ability. For he later writes of "assistants to whose solicitude [the promoting entrepreneur] entrusts the care of subordinate entrepreneurial duties" (*ibid*.: 304). And he recognizes that "these assistants in their turn can be aided according to the same principle by assistants appointed for a smaller sphere of duties. In this way a whole managerial hierarchy can be built up" (*ibid*.).[3] But what kind of knowledge is necessary to set up this hierarchy? And should we consider this knowledge as capable of generating a profit? If not, how is such knowledge different from quickness to perceive gains, shrewdness, intelligence, quickness of apprehension, and far-sightedness? Mises does not make it clear.

It appears that Mises's distinction between (1) the promoter and (2) the assistants and hired managers is based on the "level of abstraction." Quickness in perceiving gains, shrewdness, etc. are more abstract than using technological knowledge and interpersonal knowledge. Alternatively, we could say that the former are adjectives describing one individual's relative ability to use these two types of knowledge.

Such distinctions may be useful in ordinary communication. However, Mises presents them as if clarity in praxeological economics requires them. For a reader whose mind has not fully internalized the concept of entrepreneurship as distinctly human action under market economy conditions, this must be confusing.

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[3]Thus Mises recognizes governance structures. But he fails to put them in the proper context of the employment compact.

It is true that Mises had written that we cannot define the promoter with praxeological rigor (*ibid*.: 255). It would seem to follow that we could not define the profit and loss of the promoter with praxeological rigor. So perhaps we should presume that he does not mean here to use a rigorous definition of profit and loss. But if this is true, why try to distinguish between profit and other income and between the promoter and his assistants? From the perspective of praxeological economics, we must conclude that this section generates greater confusion than clarification.[4]

Finally, we should recognize the half truth yet again that "the entrepreneur [i.e., promoter] can succeed only by best serving the consumers. His profit depends on the approval of his conduct by the consumers" (*ibid*.: 291). Mises had defined the promoter as more eager to profit and more venturesome. Why, we must ask, would we not expect some promoters to be willing to operate at a loss in order to satisfy their want to play the appraiser-undertaker-uncertainty-bearer role? And why exclude fraud, deception, and passive parasitic positioning?[5]

Promoters, Managers, Technicians, and Bureaucrats

The next section is entitled "Promoters, Managers, Technicians, and Bureaucrats." In this section, Mises aims to distinguish between the role of the "entrepreneur qua entrepreneur" and other roles (manager, technician, and bureaucrat). The "entrepreneur" directs labor. "He" earns profit or loss. The others earn other incomes. It appears in this discussion

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[4]For a definition of profit that is apparently more rigorous, see Mises's discussion of interest. He writes:

> Like entrepreneurial profit and loss, interest is not a price, but a magnitude which is to be disengaged by a particular mode of computation from the price of the products of successful business operations. The gross difference between the price at which a commodity is sold and the costs expended in its production (exclusive of interest on the capital invested) was called profit in the terminology of British classical economics. Modern economics conceives this magnitude as a complex of catallactically disparate items. The excess of gross receipts over expenditures which the classical economists called profit includes the price for the entrepreneur's own labor employed in the process of production, interest on the capital invested, and finally entrepreneurial profit proper. If such an excess has not been reaped at all in the sale of the products, the entrepreneur not only fails to get profit proper, he receives neither an equivalent for the market value of the labor he has contributed nor interest on the capital invested (*ibid*.: 535).

To what properties, or characteristics, of entrepreneurship we should attribute this "profit proper" is not specified here. But Mises is surely correct in saying that entrepreneurial profit and loss, properly understood, is a magnitude "to be disengaged by a particular mode of computation." And he is on the right track to distinguish it from the producer-seller's labor income and from interest.

[5]A similar objection can be made to the statements that begin at the bottom of p. 292 and end at the top of p. 293. We discussed this point in Chapter Four.

as if Mises's goal is to emphasize the praxeological definition of entrepreneurship and profit. However, in addition to the fact that he does not distinguish between technological knowledge and interpersonal knowledge, he includes "promoter" in the title of this section. If his purpose is indeed to develop a praxeological definition of entrepreneurship and profit, such choices detract from this purpose. Moreover, the most direct way to develop such a definition is to deduce how the properties of action would come to be expressed under the conditions that define the market economy. It is not, as Mises does here, to distinguish between profit and other incomes.

The Selective Process

The final section that we shall consider is on the "selective process." Mises's main purpose here seems to be to incorporate the selection of the factors of production and producers into the discussion. He writes that capitalists, landowners, proprietors, laborers and captains of industry and business must employ their resources in such a way that consumers will select them over their competitors. At least three ideas are missing from this discussion. The first is a clear distinction between those who select (individuals acting in the role of the praxeological entrepreneur) and those who are selected (the functionaries). The second is that selection is often a joint decision, one that may involve financiers, undertakers, and employees. In this case, selection is a consequence of the entrepreneurship of all of these actors. The third is interaction relating to consumer errors and fraud. Since praxeological entrepreneurship can often gain by taking advantage of others' errors and by defrauding them, we must presume that actions and items that contribute to these are also selected in. Also missing is a proper reckoning of monopoly in this context.

Conclusion

From the viewpoint of the goal of advancing praxeological economics, Mises's chapter on entrepreneurship in the market economy reflects a fateful series of errors. The first set is due to his failure to clearly distinguish entrepreneurship in the imaginary construction of the pure market economy from that in a more realistic market economy. To build an image of praxeological entrepreneurship that only serves the consumer role and causes no harm under the conditions of the *pure* market economy is an indispensable step in preparing one to deal with arguments

for and against market economy intervention. From this point of view, a chapter containing this image is a necessary part of economics. But Mises does not make it clear that his image of entrepreneurship refers only to the pure market economy and that building an image of it is only a necessary first step. He writes as if he is describing entrepreneurship in a real market economy -- i.e., a market economy that is embedded in a specific culture and that has a particular structure of (necessarily) incomplete private property rights. To describe the market economy in reality, it is necessary also to recognize that the prospect for gain due to others' errors motivates many people who act in the entrepreneur role to try to gain from others' errors during the pre-transaction period. Fraud, deceit, and parasitic positioning are salient characteristics of every capitalist culture we know. Also important are external effects and the decision of entrepreneurship to exclude external effects in their accounting. Finally, one ought to account for other characteristics of transactions, including nature of the good, quality, and conditions of sale. Mises's neglect of these factors rendered his work vulnerable to the reasonable charge that his description of the market was biased. In short, Mises's failure to take the intermediate steps of deriving the properties of entrepreneurial action and of subsequently identifying entrepreneurial interaction led him to relegate the other characteristics of exchange -- (1) error and the interaction that aims to take advantage of it, (2) external effects and (3) transactions in the sense defined here -- to subsidiary status.

The second set of errors relates to his failure to distinguish clearly between praxeological entrepreneurship and the promoter. His discussion of profit and loss seemed to have the goal of isolating the praxeological concept of the entrepreneur. In fact, however, it was confusing since he used the concept of the promoter to present it. In the end, the best we can say about Mises's chapter on the market is that he confused those readers who had been persuaded by his arguments that praxeology should be the foundation of economics.

We have already proposed that Mises's aim was to present ATVC. Since ATVC did not include pre-transaction actions, error, external effects, and aspects of exchange other than price and quantity, Mises's chapter is understandable. However, it is not sufficient to deal with modern interventionist arguments.

2. PRICES

In his chapter on prices, Mises's initial aim is to show the relationship between the prices of consumers' goods and the prices of the factors of production. This is the so-called image of imputation. To accomplish this goal, he focuses specifically on the pricing of the goods and factors, or the "pricing process" (*ibid*.: 327-31). This part begins by assessing Mises's image of imputation. Next it points out how the focus on price has led to a neglect of other praxeological aspects of transactions. Then it assesses Mises's preoccupation with monopoly price and his blast against mathematical economics.

The Image of Imputation

In the mid-to-late nineteenth century, socialists and Marxists (S-M) advanced the proposition that the income earned by the owner of a factor of production is ultimately determined unilaterally by an employer or collectively by a *class* of employers. Several economists, including Menger, Clark and Bohm Bawerk sought to refute this proposition by building an image in which the prices of the factors of production are determined through the *simultaneous* profit-maximizing actions of individuals acting in the role of employer-producer-sellers. They imagined that these employer-enterprisers maximize profit and that they hire all factors of production for which the marginal revenue product exceeds the price. In competitive interaction, the marginal revenue product of a factor equals the money-evaluated contribution of the factor to the satisfaction of consumer wants. Because of this, it could be said that employer-enterprisers make price offers for factors that tend to mirror the satisfaction of consumer wants by means of those factors. Admittedly, the employer-enterprisers *could* set the prices of factors, including labor, without paying attention to consumer wants. But they could only do this if they pursued some other goal besides maximizing their profit. This argument was sufficient to refute S-M.[6]

To make this argument effectively, the economists had to produce an "image of imputation" in which the prices of different, divisible, homogeneous factors of production add up to the price of the product they are used to produce. Because error and uncertainty are absent from this image, it is, in effect, a robot economy. Mises aptly labeled it the evenly rotating economy and pointed out that it was populated by automatons (*ibid*.: 248).

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[6]Accordingly, the claim by many S-M that the unrealism of the ERE renders such criticisms incorrect is beside the point.

The image of economic interaction that the early subjective value theorists used to present this argument is represented in the following passage in this part of *Human Action*:

> The tasks incumbent upon the theory of the prices of factors of production are to be solved by the same methods which are employed for treatment of the prices of consumers' goods. We conceive the operation of the market of consumer's goods in a twofold way. We think on the one hand of a state of affairs which leads to acts of exchange; the situation is such that the uneasiness of various individuals can be removed to some extent because various people value the same goods in a different way. On the other hand we think of a situation in which no further acts of exchange can happen because no actor expects any further improvement of his satisfaction by further acts of exchange. We proceed in the same way in comprehending the formation of the prices of factors of production. The operation of this market is actuated and kept in motion by the exertion of the promoting entrepreneurs, eager to profit from differences in the market prices of the factors of production and the expected prices of the products. The operation of this market would stop if a situation were ever to emerge in which the sum of the prices of the complementary factors of production -- but for interest -- equaled the prices of the products and nobody believed that further price changes were to be expected. Thus we have described the process adequately and completely by pointing out, positively, what actuates it and, negatively, what would suspend its motion. The main importance is to be attached to the positive description. The negative description resulting in the imaginary constructions of the final price and the evenly rotating economy is merely auxiliary. For the task is not the treatment of imaginary concepts, which never appear in life and action, but the treatment of the market prices at which the goods of higher orders are really bought and sold (*ibid*.: 334).

What Mises added to Menger et. al. is the idea that economists can learn something by studying the "process" through which the endpoint would be reached if, in fact, it could. We shall see the limitations of this idea when we discuss equilibrium in Chapters 6 and 7. For the moment it is worth noting that its merit stems from the criticism it evokes of mathematical economists, who neglect entrepreneurship and only study states of equilibrium.

Given their goal, the early builders of the grand image of the robot economy and the expositors of pricing could avoid a number of details that we would want to include in a more comprehensive description of pricing under market economy conditions. First, as mentioned, they did not need a theory of how all the characteristics of a transaction are determined. They could focus entirely on the determination of the prices of factors of production and goods. Second, since S-M was not concerned with error, they could abstract from error, deceit, fraud, and passive parasitic positioning. Third, since the main argument of S-M was not concerned with job satisfaction, they could abstract from the wants of individuals who act in the factor supplier role. Finally, since S-M was not

concerned with innovation, they could abstract from imagination, creativity, and inventiveness.

The Pricing Process

Mises's exposition of the image of imputation using the simplistic image of prices is fully understandable when one considers his goal. But it should not be regarded as an appropriate starting point for a modern theory of market interaction. The reason is that it neglects characteristics of interaction that are just as important as pricing and that must be included if one aims to evaluate the kinds of interventionist arguments that have gained popularity in the twentieth century. The "positive description" provided in the above passage is not of pricing as it actually occurs in a market economy but of pricing as it would occur under the restrictive assumptions used to build the image. The description neglects consumer errors and the prospect for profiting from others' error-making propensity, non-price aspects of transacting, pre-transacting actions, and innovation. It also neglects monopoly and external effects.

Consider one of these omissions -- other aspects of transacting. Besides pricing, transacting also includes choosing the nature of the product and factors of production and the conditions of sale. The perceived prices of the same good could be different yet there would be no "profit" opportunity. All that is necessary is that the conditions of sale are different. Along the same lines, taking advantage of, say, an opportunity to gain from offering a product with different characteristics or with different conditions of sale might increase the price discrepancies rather than reduce them.[7]

It is evident, then, that the "positive description" Mises provides in the quoted paragraph is not of the pricing process as it occurs in the market economy. It is of a pricing process that Mises had contrived for a specific purpose.

Given the importance of error, we should today relegate simplistic descriptions of pricing that disregard the other characteristics of exchange in order to emphasize price to the history books. We must today regard statements like the following as anachonistic:

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[7]Of course, if one adds the qualifier "goods and factors of like kind and quality," this would not be true. But to add this would beg the question of how such a logically correct image is relevant to the kind of pricing assumed in modern arguments for intervention.

> The operation of the entrepreneurs brings about a tendency toward an equalization of prices for the same goods in all subdivisions of the market, due allowance being made for the cost of transportation and the time absorbed by it. Differences in prices which are not merely transitory and bound to be wiped out by entrepreneurial action are always the outcome of particular obstacles obstructing the inherent tendency toward equalization (*ibid*.: 329).

> Catallactics shows that entrepreneurial activities tend toward an abolition of price differences not caused by the costs of transportation and trade barriers. No experience has ever contradicted this theorem. The results obtained by an arbitrary identification of unequal things are irrelevant (*ibid*.: 331).

We must regard such statements only as an effort to describe the thinking behind the image of imputation of the 19th century economists. In light of the kinds of interventionist arguments made today, we should not limit our descriptions of market interaction to the kind of "market process" that Mises describes here. The market process concept is discussed further in Chapter Seven.

Praxeological Entrepreneurship and Final Prices

When we focus on entrepreneurship as we have understood it in this book, we recognize an even more important limitation of Mises's pricing image. An image of market interaction requires examples of praxeological entrepreneurship. Yet there is no praxeological entrepreneurship in his image. As mentioned in Chapter Two (and more fully discussed in Chapter 6), an image of praxeological entrepreneurship would contain an example like that in the passage. However, it would be followed by "a contrast between the entrepreneur *behavior* that we assume will lead to the endpoint and a reference to real entrepreneur *action*, which is beyond our ability to completely comprehend" (see the last subsection in Chapter Two). Among other things, we must realize that as one entrepreneur takes advantage of a discrepancy, the discrepancies recognized by the other entrepreneurs change because the data changes. Every entrepreneurial act is likely to change the data and, therefore, to affect the actions of other individuals in the entrepreneur role. The other entrepreneurial acts, in turn, change the data upon which the initial entrepreneurial act was based. Such entrepreneurial interaction, or process, can never end by virtue of the very nature of entrepreneurship. The whole idea of a tendency toward equilibrium driven by entrepreneurship if there was no change in the data is a contradiction. We discuss this further in Chapter Seven.

Interventionist Arguments Not About Price

We have already discussed the importance of transactions in the market economy and Coase's contribution to the literature in this field. The purpose here is to elaborate on this. Coase's work and the work in much of the voluminous literature that has followed his lead[8] enables one to evaluate interventionist arguments for which Mises's price theory is too general. To show the limitations of Mises's theory of markets and prices, we consider here two types of arguments: (1) arguments favoring intervention in the contracts and compacts among individuals involved in team production and (2) arguments favoring intervention in the case of external effects.

Intervention in Compacts and Contracts

The task of evaluating arguments relating to market intervention often demands that economists distinguish between two extreme types of transactions: the contract or compact in which the actor agrees to have his work controlled partly by others and one in which he does not agree to this. This is the distinction that Coase drew between the firm and "the market." He saw the firm as what Jensen and Meckling (1976: 311-12) called a "nexus" of broadly specified employment compacts; he saw the market as a set of more or less narrowly specified contracts to supply specific goods and services. To evaluate many interventionist arguments, it is necessary to identify the conditions under which freely choosing individuals in the market economy will decide to form one or the other type of arrangement for supplying work and other factors. Since the prospect for deception and fraud (as evident, for example, in the agency problem) may influence the choice of arrangements, the evaluation of such arguments requires an understanding of this influence. The theory of the firm, as it has developed over the last 40 years or so is partly an effort to identify these pivotal conditions. To evaluate other arguments, it is necessary to know the kinds of compacts within the firm that individuals may decide to make. Again deception and fraud, as represented by the agency problem, often influence the choice among alternative compacts. The literature has also been concerned with this issue.[9] Nothing in Mises's theory of markets and prices helps one evaluate

[8]For a survey of this literature, see Peter Klein (2000).

[9]See, for example, Li and Zhang (2001).

the logic of specific interventionist arguments that aim to restrict or tax the kinds of arrangements for the supply of work we are discussing here.

Externalities

Coase's 1960 paper on "social cost" was actually an introduction to the theory of how property rights emerge and change in a real market economy. Whereas Mises began his study of market interaction by building an image of a pure market economy with a complete system of private property rights, Coase explored how individuals in market economies without such a complete system (i.e., in a more realistic image of a market economy) had interacted to overcome "externality problems." These are problems that had prompted many mainstream economists to make arguments in favor of government intervention. Coase pointed out that whatever the merit of arguments for intervention, history showed that it had sometimes been chosen by individuals who were presumably free not to choose it and that it had sometimes not been chosen.

The theory he presented was, in the final analysis, a theory of the production and distribution of legal (and otherwise socially enforced) rights to control actions. Consider first the theory of distribution of legal rights. Coase maintained that the existence of an external effect implies the corresponding existence of a distribution of legal rights to control actions that is less valuable than some benchmark distribution. The benchmark distribution would have greater value. Whether individuals actually have an incentive to move toward the benchmark distribution through a transaction depends on the cost of transacting. In some cases, intervention may help to solve the problem. To know for sure, however, one must possess much more knowledge than the proponents of intervention ordinarily claim to possess.

Coase's theory of the production of legal rights is based on the assumption that when individuals believe that the value of the resulting set of rights is sufficiently greater than the value of an existing set, they have an incentive to produce such rights. Legal rights may be costly to produce and to enforce. Accordingly, individuals will stop short of producing a complete set of such rights even if a complete set is more valuable.

Let us contrast this approach with that of Mises. In his chapters on markets and prices, Mises builds an image of the pure market economy, which contains a complete set of private property rights. It is not until long after he describes interaction in the pure market economy that he turns to the problem of external effects. He does this in his section on "The Limits of Property Rights and the Problems of External Costs and External Economies." But he seems to not appreciate a basic implicit

assumption by Coase that no real market economy can ever have (and that actors in it would never want) a complete set of private property rights. On the contrary, he suggests that the cause of incomplete private property rights is the deficiency in laws: "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" (Mises 1966.: 655). This trivialization of a characteristic of real market economies goes far to explain the strange treatment that Coase's work in this field has received from some neoAustrians.[10] Without guidance, these authors have followed a natural rights theory of Rothbard (1978) and seem to have completely misinterpreted the Coasean theory.[11]

Refutation of the Socialist and Marxist Theory of Wages

The S-M hypothesis about wages is that under the conditions of the pure market economy, they are determined mainly by employers and that, as a result, the workers who earn them are paid less than their contribution to the satisfaction of consumer wants is worth in money terms. The employer exploits the worker by taking part of the true or deserved wages for himself.

Stated in this way, the S-M hypothesis is not a policy argument. Even if the hypothesis was true, the best realizable alternative might be worse from the viewpoint of the goals that S-M wanted to achieve. To transform the hypothesis into an argument that can be evaluated with the tools of praxeology and economics, some policy must be proposed and the goals that one aims to achieve by means of the policy must be specified. Before we do this, however, let us use the theory of transacting to assess the claim that wages in a pure market economy are determined by employers.

Do Employers Set Wages?

To assess this claim, we must first distinguish between the idea of an employer's setting take-it-or-leave-it wages and her negotiating a wage independently with each worker of a given general type. The theory of

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[10]This includes papers by Walter Block (1977) and a book by Roy Cordato (1992).

[11]See, for example, Harold Demsetz's (1997) criticism of Block (1995) and the author's (2000) criticism of Cordato.

transacting suggests that if an employer anticipates high costs of negotiating independently with each worker, she may have an incentive to set take-it-or-leave-it wages. Moreover, after hiring, anticipated high transactions costs may lead employers to be unwilling to negotiate raises or bonuses. So they may set rigid conditions and formal qualifying rules that they refuse to change. From the transacting point of view, the phrase "employers determine wages" is a pretty accurate description of the actions of an employer who is hiring many workers in the same class and who anticipates high costs of negotiating separate wage compacts.

The Argument That a Government Administrator Should Set Wages

The S-M argument is not only about who determines the wages but about who decides whether wages will be high or low. The claim is that employers set them too low. To evaluate this argument, one must begin by specifying the goals and the alternative means of achieving them. Mises correctly focused on one general goal of S-M: adequate material wealth for workers and, indeed, all members of the society. The policy alternative usually suggested is some kind of intervention to block employers, not from determining wages but from paying wages that are "too low." Typically, S-M wants someone other than the employer to decide what the wages will be. They do not trust independent price setting and negotiating.

Our discussion is oriented toward evaluating the following policy argument. A policy in which government bureaucrats determine a rigid schedule of take-it-or-leave-it wage rates will benefit workers and leave other members of the society with adequate material wealth. Is the theory of imputation and the imaginary constructions of the final prices and evenly rotating economy needed to evaluate this argument? We shall claim that it is not. To evaluate this policy in full, we would have to (1) compare entrepreneurship in the presence of an effective policy with entrepreneurship in its absence and (2) judge whether the policy can be effective and the costs of making it effective. The first evaluation is purely economics. The latter requires an understanding of policy-making and policy-implementing institutions in relation to the actors who are affected by the policy. It is the subject matter of modern political economy, or Public Choice.

Since this book is mainly about economics, we are only interested in comparing entrepreneurship under the two conditions. Since we have already described entrepreneurship in the pure market economy in some measure, our main interest will be to try to understand how entrepreneurship would be affected by the law if it were put into effect.

We should recognize at the outset that wages are only one of many conditions in an employment compact. In deciding what offers to make to employees, a wise employer considers a variety of non-wage characteristics. These include fringe benefits, hours of work, working conditions, prospects for a greater salary and other benefits in the future, guarantees of future employment, education, experience relevant to future employment, and so on. The non-wage characteristics are too many to specify. Most of these are, in some measure, substitutes in the minds of the workers for wages. In other words, a worker may be indifferent between, say, (a) an agreement that pays him high wages but, for instance, that enables him to gain little experience relevant to future employment and (b) one that pays him lower wages but offers opportunities to get employment-relevant experience. The non-wage characteristics may also be substitutes in the calculations of the employer. Better working conditions, for example, may result from investment in climate control, meal and toilet facilities, transport for workers, and so on. But the money used for these things may also be used to pay higher wages. Given these substitution possibilities, an effective law requiring employers to pay high wages may have only a small impact on the actual costs paid by employers and benefits received by workers. If the law sets wages higher than the employer would otherwise have set them, she may substitute a lower cost set of other job characteristics that are presumably less desirable to workers. The policy will not effectively benefit the workers and, therefore, will not achieve the goal that S-M wants to achieve.

Recognizing the potential slippage, S-M may recommend a policy that attempts to freeze all the other characteristics of work. We should question the feasibility of this on the basis of the role of entrepreneurship in identifying potential characteristics of working conditions that are not now evident to lawmakers or to entrepreneurship. Not even entrepreneurship is currently aware of all of the characteristics of work that may be substituted for wages. However, even if it could be effective, the result may be harmful to workers. This is because the substitution of working conditions for pay is a means used by both employers and workers to gain from exchange. To block such substitutions is to reduce the prospective profitability of the exchange. Since the market economy contains continuing innovation, the likely result is to reduce the profitability of innovation along with the employees' abilities to profit from it both in their his role as workers and in their role as consumers.

A proponent of government wage setting may admit the presence of these disadvantages but assert that the gains to workers from a higher

wage are sufficiently great to offset the disadvantages. This raises the question of whether there are, in fact, advantages and, if so, what they are. To focus on this question, let us completely disregard the other conditions of employment. The next thing that we need to recognize is that, from the viewpoint of both employers and employees, work differs in quality. Employers who are forced by law to increase wages to workers of a given quality may demand higher quality from their workers under threat of being laid off. In a highly competitive environment, a particular employer may have no choice. Imagine competition between a range of employers, some of which already pay wages that are equal to or higher than the wage mandated by the government. Other employers pay wages that are lower than mandated wage. Only the latter employers will be affected by the law. If they can find higher quality workers in the labor markets, they have an incentive to substitute new workers for the old, thereby harming the existing workers. If the higher-quality workers are already employed at a higher wage, as we would expect them to be; the employers have only one set of alternatives: go out of business or require that existing workers improve the quality of their work. If workers respond to this requirement by increasing the quality of their work, we should presume that they are worse off; since they presumably had that opportunity beforehand to receive more pay by increasing their work quality but chose not to do it. They must have estimated that they benefits of the higher wages were not worth the costs. The government-mandated wage now requires them to pay these higher costs in order to keep their jobs.

In point of fact, many proponents of government-mandated wages disregard differences in quality. This makes their argument largely irrelevant to the market economy as we know it. The reason is that the specialized knowledge of profit opportunities must be produced at a cost. Human actors are naturally imaginative, creative, and inventive. However, whether they apply these natural abilities to identifying profit opportunities depends on their expected return. Because a government-mandated wage reduces the profitability of identifying such opportunities, it follows that a fewer number of them will be identified. This means that the mandated wage will not only reduce employment opportunities for workers in general but consumer benefits also.[12]

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[12]Some economists have expressed this point by referring to the "supply of entrepreneurship." This mode of expression has the disadvantage of confusing the production of knowledge with the concept of human action under the conditions of the market economy. It is wise to avoid such a confusion.

It is possible that at least for some types of jobs, not so much specialized knowledge by employers is necessary. In this event, the main effect of the mandated wage, under the conditions assumed, would be to raise the cost of causing goods to be produced by means of the employment compact. The result is that entrepreneurship would have an incentive to replace this form of economics organization by alternatives. In short, people who would otherwise have chosen to be employees would respond to employer' decisions to lay them off by going into business for themselves and, in some cases, supplying the same kinds of services they supplied when they were employed. An example is a laid-off maintenance crew that goes into business for itself. Although such a crew could avoid the higher losses due to unemployment, they would still have to offer the maintenance services at a low enough price for the former employer to earn profit in competition. This means that the overall charge to the employer must be less than the sum of the wages and other costs of employing that the employer previously paid. The previously employed workers would be worse off, by their own assessment, than if they had been able to keep their jobs. Consider, for example, the case in which the employment compact is formed to take advantage of gains from teamwork production. At least some employees of at least some teams would either become partners, shifting their income from wages to profits; or they would be laid off and attempt to start new businesses (or try to replace other higher-paid workers, who would then be put in the same position).[13]

There is only one condition in which, at first thought anyway, the argument would not be irrelevant, even under the very restrictive conditions that we have had to assume up to this point. This is the condition in which most or all employers who are compelled to pay a higher mandated wage own some strategic factor of production. Ownership of this factor enables them to raise wages yet still anticipate profit. However, the argument is correct only if we apply it to existing workers and not to workers as a category through time. The reason is that it disregards the fact that strategic factors are ordinarily acquired by competing businesspeople through purchase, through exploration and research, or through personal effort. And its original form must often be altered in order to ready it for use with complementary factors. In these

[13]The "market process" approach of Mises, which refers to a tendency towards equilibrium due to competition among promoting entrepreneurs steers one's thinking away from this kind of role-switching, although Mises certainly recognized that individuals might supply their services to others in many ways.

cases, a law requiring employers to pay higher wages would reduce the profitability of discovering, identifying, producing and readying strategic factors for use. The result would be a reduction in employment opportunities and in benefits to consumers from the use of such factors. The aim of a person who acquires, produces or readies a factor for use is monopoly profit. To earn this profit, she must outdo her competition in the satisfaction of consumer wants. So, disregarding error and incomplete property rights, her production of the strategic factor is beneficial to consumers. Thus simple maximization logic suggests that a compulsory high wage policy is counterproductive even when an employer could afford to pay it because she owns a strategic factor. It would have a substantial dampening effect on the imagination, creativity, and inventiveness of individuals in their production of strategic factors that would raise the marginal revenue product of workers. As compared with a similar society that did not impose compulsory high wages on employers who possess strategic factors, individuals would not have adequate material wealth.

There is only one circumstance in which the mandated wage would make workers, as a class through time. This is the circumstance in which the above-mentioned strategic factors, in usable form, are acquired by employers through sheer luck. In such a circumstance, no entrepreneurship is needed to discover, identify, produce or make ready-for-use the strategic resources. We can imagine that all employers merely stumbled upon the strategic factors. Of course, they would have to be sufficiently "alert" to know that what they stumbled upon was in fact a factor of production. But if we are bothered by this assumption, we can further assume that the characteristic of being alert is itself acquired by luck. So we imagine a case in which each of the employers earns enough profit to absorb the cost of higher wages. And his profit is due to his ownership of the strategic factor that he previously stumbled upon and owns.[14] In this event the employers would be better off paying the higher wage than laying off employees.

It is the unrealistic assumptions required to defend the argument that a mandated, higher-than-market wage would benefit workers that informs us that, in reality, such a mandated wage would, in general, harm the very people the proponents of such a wage aim to help. Strategic factors are

[14]We must also assume that ownership rights accrue to the finder, who is also the producer. Thus, the mandated wage amounts to a tax on a factor that was acquired by sheer luck an that, as a result, could not affect future discoveries.

seldom discovered by luck and, when they are, they are seldom discovered by the people who use them in their businesses.

Do Workers Receive Less Than Their Contribution?

So far we have mainly dealt with Marxism and socialism by focusing on the policy alternative and the goals. We now consider the claim that, in general, production workers earn less than the contribution of their work to the satisfaction of consumer wants. This seems at first to be correct, since employers take account not only of the value of the worker in production but also of the transactions costs. They also take account of factors used to identify potential workers, to negotiate pay, to monitor, to finance, and to supply many other non-production services to the modern business. However, while these factors do not contribute directly to production, a modern business could not function without them. In other words, without these, there would no employment opportunities in such businesses because there would be no such businesses. This suggests that one response to the claim that workers wages are lower than their contribution is to ask for a detailed listing of all of the contributory factors of production and a statement about each one's contribution. The claimant should be advised that in order to calculate a worker's contributions, it is necessary to identify all of the transacting and pre-transacting actions associated with the employment of the worker to help produce goods. Each of these actions is performed at the expense of alternatives and, therefore, is associated with costs. To correctly calculate the contribution of any particular factor to the satisfaction of consumer wants, the totality of costs (and therefore factors) associated with the supply must be determined. In other words, we must consider not production costs but supply costs. To identify each of these, we must ask "but for" questions about all the factors. The S-M claim cannot be evaluated if it neglects these costs and factors.

Are Wages Set by a Class?

Sometimes the S-M argument that wages are too low is bolstered by an accompanying claim that wages are set not by individual employers but by members of a class. Even though the profitability of a particular line of business is widely known, the employer class operates as a unit. To support this claim, S-M often refer to writings about the entrepreneur in mainstream economics and business. This claim must be answered in a twofold way. The first step is to point out that the assumption of free enterprise means that no one can be excluded from the ranks of the employer. Anyone with money can make credible employment offers. A

prospective employer may use her own wealth or she may borrow from someone else who trusts her to repay. Only a lack of appraising, undertaking, and uncertainty-bearing skills or a lack of financing could stop a worker who is displeased with his wages from becoming an employer. Let us continue with our earlier assumption of disregarding the non-price conditions of an exchange. Because of freedom of enterprise, if there is a substantial gap between selling prices and supply costs, copying will occur if it is possible. If it is widely known that the entrepreneurial profit from an employment compact is high, a worker can enter the ranks of the entrepreneurs. If no one is willing to finance his entry, this means only that the entrepreneurial profit is not, in fact, widely known, which contradicts the assumption.[15]

The second step is to give a lesson in methodology. The complexity of the market economy requires that to describe economic interaction, one is compelled to place individuals into roles that perform functions. Economists often use the concept of the employer, enterpriser, or entrepreneur to build an image of an entrepreneur economy in order to illustrate certain general characteristics of economic interaction. Their goal is not to depict reality but to describe general cases of entrepreneur interaction, the specifics of which will be added if it is warranted according to the goal of evaluating some policy argument.

The Collaborative Monopsony Problem

This is not to deny the possibility that collaborative monopsony might cause wages to be lower than otherwise. However, it would be a mistake to base a general wages policy on this possibility. First, unless the collaborators own strategic resources, the monopsony is likely to be temporary. Unusually high entrepreneurial profit under free enterprise attracts copiers. In this case, it would attract employers who offer higher wages that compete with those of the monopsony. Second, the additional earnings due to collaboration may constitute a reward for industry or inventiveness. To compel the collaborators to pay higher wages may reduce these, resulting in fewer employment opportunities and consumer benefits. research.

The Monopoly Price and Mathematical Economics

The problem of the monopoly price refers to the profit-maximizing action of an individual who happens to be in a monopoly position and

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[15]See *ibid*.: 594.

who is unwilling to reduce his price in order to sell additional units even though the money value to consumers is greater than the marginal opportunity cost. Mises devotes about thirty pages to this subject. The reason for such an extensive treatment seems to be mainly that it is a case where profit maximizing action leads consumers to be harmed. His discussion of this issue contains no obvious improvement over the most basic geometric treatment. Moreover, in spite of his lengthy discussion, he is not led to consider the issues that are most important in the 20th century literature on intervention to curtail monopoly. There is nothing on the collaborative monopoly (conspiracies to monopolize) or on so-called monopoly practices. In other words, there is nothing about the numerous arguments made by antitrust or anti-monopoly proponents that deal with the various means people have at hand to maneuver themselves into monopoly positions or with the various non-pricing practices that would enable them to gain from achieving such positions.

University courses and even programs in anti-monopoly policies are sufficient evidence of the importance of the collaborative monopoly and monopoly practices to modern microeconomics. The ideas taught in such courses are the basis for many arguments in favor of market intervention. Yet Mises does not address these. This seems to have been a direct result of his limiting himself to the price perspective at the expense of the transacting perspective. The former enables one to deal with elementary textbook arguments but not with the more complex arguments involving transaction conspiracies among sellers, tied goods, exclusive dealing, and other so-called monopoly practices that occupy the courts and the pages of modern textbooks in antitrust economics.

A similar criticism applies to his critique of mathematical economics. In his section on "Logical Catallactics Versus Mathematical Catallactics," Mises makes several points that are indisputable. The concern here, however, is with his statement that mathematical economists disregard the market process. About this, he writes:

> Now, the mathematical economist does not contribute anything to the elucidation of the market process. He merely describes an auxiliary makeshift employed by the logical economists as a limiting notion, the definition of a state of affairs in which there is no longer any action and the market process has come to a standstill. That is all he can say. What the logical economist sets forth in words when defining the imaginary constructions of the final state of rest and the evenly rotating economy and what the mathematical economist himself must describe in words before he embarks upon his mathematical work, is translated into algebraic symbols. A superficial analogy is spun out too long, that is all.
>
> Both the logical and the mathematical economists assert that human action ultimately aims at the establishment of such a state of equilibrium and would reach it if all further

> changes in data were to cease. But the logical economist knows much more than that. He shows how the activities of enterprising men, the promoters and speculators, eager to profit from discrepancies in the price structure, tend toward eradicating such discrepancies and thereby also toward blotting out the sources of entrepreneurial profit and loss. He shows how this process would finally result in the establishment of the evenly rotating economy. This is the task of economic theory. The mathematical description of various states of equilibrium is mere play. The problem is the analysis of the market process (Mises 1966: 355-6).

We have already pointed out the limited relevance of an image of market interaction that focuses on action that "would finally result in" a state of equilibrium. Its relevance stems from (1) its capacity to illustrate the image of imputation, (2) its use in giving examples of entrepreneurship, and (3) its use in helping us identify means of synchronization. In light of the advances in praxeological economics, as represented by the arguments earlier in this chapter, the first of these is obsolete. The second and third, while important, are not what Mises is writing about here. There is wide gulf between the meaning of Mises's phrase "analyze the market process" and this book's phrase "give an example of entrepreneurship," as we show in Chapter Seven.

In short, to "assert that human action ultimately aims at the establishment of such a state of equilibrium and would reach it if all further changes in data were to cease" (as quoted above) is misleading. It conflates the goal of refuting the S-M class theory of wages with two other goals: to give examples of entrepreneurship and to identify means of synchronization.

The problem with mathematical models is that they are necessarily too simple to capture the economic interaction entailed in transacting, taking advantage of propensities to err, and actions that adjust to and help to create new private property rights. They also have no way to capture the imagination, creativity, and inventiveness of entrepreneurship.

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