Study Guide to *Human Action* by Robert P. Murphy

Chapter XV. The Market

Chapter Summary

1. The Characteristics of the Market Economy

The market economy is a social system where individuals specialize in their occupations and the means of production (natural resources, tools, etc.) are privately owned. Although everyone acts to serve his own interests, in a market economy this is achieved by aiming to satisfy the desires of other people.

The market steers individuals into those areas where they can best serve the wants of their fellow men. It does this through voluntary inducements; a person who produces what others desperately desire will make more money than if he spends his day toiling on what he himself thinks is best. Compulsion is the characteristic of the state, which is necessary for a market to function but is itself not part of the (voluntary) relations of the market.

The market is not a place or a thing but rather a process. At any time, the state of the market is summarized by the vast array of prices for all goods and services. These (constantly changing) prices guide individuals as they adjust their conduct to best serve each other in the division of labor. Market prices permit economic calculation, which is the basis of the market economy.

2. Capital

Economic calculation rests on the notions of capital and income. The capital associated with a particular enterprise is the estimated sum of money that could be raised if all of the assets were sold and all the liabilities were discharged. Income is the amount of consumption that a particular collection of goods can yield without lowering the capital. If income exceeds consumption, the difference is saving. If consumption exceeds income, the difference is capital consumption.

Capital is a mental concept that makes sense only in a market economy, with actual prices to guide the appraisal of particular items. The term capital goods refers to the physical objects that man produces and can be used to augment future production. Although a socialist community would have capital goods, it would only metaphorically have capital, for the latter requires economic calculation to be meaningful.

3. Capitalism

History shows that private property goes hand in hand with civilization. Ironically, those who wish economics would become more of an "experimental science" are the ones who ignore this evidence and clamor for interventionism or outright socialism. Although the market economy has never existed in a pure form, the Western civilizations embraced it more and more since the Middle Ages, and because of this, population figures exploded and the standard of living grew fantastically.

The economists must study "pure" capitalism not because they mistakenly think such a system has ever existed, but because economic calculation is only possible in capitalism. Once the benchmark has been analyzed, the chaos of interventionist and socialist approaches can be contrasted with it.

Contrary to popular belief, big business does not necessarily favor laissez-faire, but often seeks government privileges or restrictions that at least hamper their smaller competitors more. But to call such interventionism "mature" or "late" capitalism is pure confusion; it is simply that nowadays, big business does not favor capitalism.

4. The Sovereignty of the Consumers

Although the entrepreneurs appear to be "in charge" of a market economy, this is a superficial view. In reality, even the head boss must answer to the consumers. The entrepreneur hires laborers, purchases raw materials and equipment, and decides how many factories to build. But if those factories churn out products that no one wants, he will soon lose his "authority."

In a sense, every penny the consumer spends is a vote for that particular product or service. Because the entrepreneurs must compete with each other for scarce factors of production, the consumers ultimately determine which businesses expand and which contract. If an operation shuts down because it can't turn a profit, what that means is that the consumers weren't willing to hand over enough money for the products to allow the entrepreneur to purchase the necessary inputs on the labor and factor markets.

5. Competition

The biological competition in nature, in which the fittest survive and the weak perish, is totally different from the social competition in a market economy. Even though some positions are more coveted than others, all participants benefit from exchanging; there are no "losers" in this competition.

The purpose of social competition is to entrust control of scarce resources to those who are most likely to satisfy the wants of the consumers. Writers often say there is "no competition" in a field dominated by large companies. Yet absent government barriers, newcomers can enter the field provided they have a superior method of serving consumers. The large startup costs and other "barriers" reflect real conditions of scarcity, and to ignore them would be to miss the purpose of competition.

The term "competition" is often used as the antithesis of monopoly. Yet even a monopolist must compete with all other producers for the dollars of the consumers. The true restrictions on competition come from government, not the market.

6. Freedom

Freedom and liberty represent the most precious goods to many thinkers in the Western tradition. These terms have meaning only in society; there is no freedom in nature. In interpersonal relations, to be free means to live without being at the mercy of arbitrary decisions of other people.

At first the socialists sneered at the "bourgeois" love of freedom, but it soon became clear that the masses would never support an open restriction of their liberties. Thus the socialists contrasted political and economic freedoms. But if the socialist government controls the printing presses and can assign its critics to work in Siberia, constitutional guarantees of free speech are pointless.

7. Inequality of Wealth and Income

People are not born equal, and it is no surprise that the market economy—where incomes are based on how well the consumers are served—yields disparities in wealth and income. However, this inequality is necessary if society is to preserve the freedom of occupation. Without the incentives of higher pay, force must be used to channel workers into areas where they are needed.

8. Entrepreneurial Profit and Loss

In the first place, profit and loss are psychic phenomena; an individual profits when he improves his situation according to his subjective value scale. For this very reason, psychic profit and loss can't be measured. However, in a market economy an individual may use the monetary profit or loss as an indication of everyone else's appraisal of his actions. If a farmer can earn more planting tobacco than corn, that doesn't mean he will be happier with the former crop. But it does mean (in a loose sense) that the consumers are indicating a preference for him to plant tobacco.

Even in the evenly rotating economy, where there is no money profit or loss, actors would still achieve psychic profit. In the ERE people still go to work, and consumers still purchase products, all because they hope to achieve greater satisfaction through these actions.

Entrepreneurial profit and loss ultimately stem from the uncertainty of the future. If a man buys factors of production for $1,000 and creates a good that he sells for $10,000 one week later, this is an indication that other entrepreneurs were mistaken in their evaluation of the usefulness of those factors of production. Had others been able to anticipate the future revenues from the good, they too would have entered the factor markets and bid up the "cost" of making the good (and lowered its sale price as more units were created). An entrepreneur earns true profits (over and above what he pays himself as wages for his labor) when he forecasts the future better than others.

9. Entrepreneurial Profits and Losses in a Progressing Economy

A progressing economy is one in which the per capita quota of capital is increasing. In such an economy, the sum total of entrepreneurial money profits exceeds losses. However, the entrepreneurs do not exhaust the increase in wealth made possible by the additional savings and investment. In order for them to incorporate the additional capital goods into their operations, they must bid up the prices for other factors of production (including labor). This raises the incomes of others in society, which in turn leads them to purchase the increased stock of consumer goods (made possible by the injection of new capital goods). Once the economy has fully adjusted to the new capital goods, the entrepreneurs do not enjoy any lasting increase in income; it has been absorbed by the owners of natural resources and by the workers.

10. Promoters, Managers, Technicians, and Bureaucrats

Entrepreneurs direct business operations, but they must delegate particular tasks to subordinates. This is made possible through economic calculation: The owner of a giant company can look at the books to determine how much profit (or loss) a particular manager generates in his department. This allows the manager to be given relatively free rein, so long as his branch remains profitable.

In contrast, when an enterprise is not run for profit (such as a police department or a soup kitchen), then the conduct of subordinates must be strictly regulated to ensure that they fulfill the purpose of the enterprise. Otherwise, the fire department could "cut costs" by selling off all of its engines and hoses, and using water bottles to fight fires. This obviously wouldn't serve the consumers, but because city taxes fund the agency, they wouldn't go out of business. Hence the government puts in place strict guidelines, i.e., a bureaucracy.

11. The Selective Process

The market constantly adjusts to new conditions and "selects" those most capable of handling the scarce resources available. In a pure market, there are no privileges and past success is no guarantee of future wealth. If someone comes along who can use factors of production to better serve the consumers, he or she will become wealthier and supplant the incumbent entrepreneurs. Ironically, it is outside of a market economy—such as in medieval times or under interventionist policies—where the rich and powerful had secure positions and didn't need to prove their merit daily.

12. The Individual and the Market

Economists often speak of "the market" acting, but the market is simply a collection of individuals. There are no "automatic" market forces, but simply the outcome of each individual's actions. Every producer is also a consumer, and thus "producers' policies" (which simultaneously hurt consumers) are nonsensical.

13. Business Propaganda

It is true that commercials do not display the highest artistic qualities, but that is because they appeal to the masses. Their purpose is to cultivate desires and transmit information to the bulk of consumers, and (by definition) the majority will not have the refined tastes of the elite. Contrary to popular belief, commercials cannot force people to use inferior products. The sellers of the "truly" better goods can likewise hire ad writers and musicians to compose jingles.

14. The "Volkswirtschaft"

Volkswirtschaft is a term German statists used to denote the total complex of economic activities directed by the government. It embodies the desire to expand the boundaries of the state in order to acquire resources and achieve self-sufficiency; other countries are viewed as threats and infringements on the growth of the homeland. This mentality is completely alien to the classical liberal who believes in a market economy, where foreign boundaries are irrelevant.

Why It Matters

In this very long and very important chapter, Mises lays out his analysis of the market itself. (The chapter could almost serve as a stand-alone introduction to free market economics.) Mises explains what the market really is—a process where millions of individuals interact through voluntary exchanges—and how it gives rise to the quantitative prices that undergird the mental concept of capital and hence of economic calculation. Mises lays out his view of consumer sovereignty, a discussion that explains why he is such a strong supporter of the market economy.

Technical Notes

(1) Although Mises himself (p. 271) was aware of the limitations of such terminology, Murray Rothbard was very much opposed to the term "consumer sovereignty," especially as used in the writings of William Hutt. Rothbard stressed that in a market economy, no one has sovereignty over anybody else. The consumers can't force a producer to make something; all they can do is offer him money to do so, just as the employer can only use voluntary payments to persuade workers to join his firm.

(2) In his discussion of monopoly price (p. 278), Mises has in mind a sole producer who faces an inelastic demand curve in the region where the market price would have been, in the absence of monopoly. It seems that Mises thinks that even a monopolist would charge the "nonmonopoly" price if the demand curve was elastic. However, if there are any marginal costs of production, the monopolist will want to restrict production, even if his total revenues drop. Moreover, Rothbard argues that it is nonsensical to contrast the monopoly price with a hypothetical price that would have occurred in the absence of monopoly. If someone invents an entirely new product that no one else had imagined, what is the "nonmonopoly" price and output to which the innovator's price and output should be compared?

(3) Mises argues that capital accumulation necessarily leads to an excess of money profits over losses (pp. 292–295). Strictly speaking this needn't be true: if everyone perfectly anticipated a steady accumulation in capital per capita over a ten-year period, prices would adjust so that no profits were earned during the decade. It appears that Mises has in mind a scenario where the injection of new savings catches most people by surprise. (More generally, Mises doesn't entertain the notion of a certain future where things still change; i.e., he reserves a zero-profit world for the ERE.)

Study Questions

1. The Characteristics of the Market Economy

- What are the main characteristics of the market economy?
- What is meant by "the market is a process"?

Comment: "There is no mixture of the two systems possible…there is no such thing as a mixed economy, a system that would be in part capitalistic and in part socialist."

- How does taxation influence the market?

2. Capital

- What are the definitions of capital, capital consumption, and saving?
- Why is it impossible to separate the concept of capital from the context of monetary calculation?
- What is the notion of real capital? Why is it nonsensical?

3. Capitalism

Comment: "The market economy is a man-made mode of acting under the division of labor. But this does not imply that it is something accidental or artificial and could be replaced by another mode."

Comment: "Entrepreneurs grown old and tired and the decadent heirs of people who succeeded in the past dislike the agile parvenus who challenge their wealth and their eminent social position."

4. The Sovereignty of the Consumers

- Who really determines what is produced?
- What is the role of the entrepreneur?

Comment: "The entrepreneurs, capitalists, and farmers have their hands tied; they are bound to comply in their operations with the orders of the buying public."

- What is the difference between a political democracy and a free market with regard to the power of votes?
- Why is it absolutely fallacious to compare big companies with kingdoms? What is the main difference between a company and a political sovereign?

5. Competition

- What is the difference between biological competition and social competition?
- What is meant by catallactic competition? To which field is it restricted? Why is it a social phenomenon?
- What are the two connotations of monopoly? What is the significance of each for the market?

- Why can we safely neglect the existence of monopolies if there are no monopoly prices that emerge?
- What are monopoly prices, in Mises's view?

6. Freedom

- Are freedom and liberty to be found in nature?

Comment: "A man is free as far as he can live and get on without being at the mercy of arbitrary decisions on the part of other people."

- How are the terms liberty and freedom related to the state and the market economy?
- Why were the socialist doctrines—which reversed the original meaning of the terms liberty and freedom—able to triumph, according to Mises?
- What is the confusion behind the slogan, "Planning for Freedom"?

7. Inequality of Wealth and Income

- Is it necessary to guarantee equality of income in order to obtain freedom?
- When is compulsion justified, according to Mises?

8. Entrepreneurial Profit and Loss

- Why does Mises say profit and loss are in their original sense psychic phenomena? Can they be measured? Why or why not?
- What role do the complementary factors of production and the final product play for entrepreneurial profit?
- What are the main reasons for entrepreneurial loss?
- What information do the prices of the factors of production provide for us?
- What is the ultimate source from which entrepreneurial profits and losses are derived?

9. Entrepreneurial Profits and Losses in a Progressing Economy

- What is the definition of a progressing economy?
- Why can't the surplus of the total sum of entrepreneurial profits exhaust the total increase in wealth by economic progress?
- Who benefits from an increase of productivity?
- Do we have to draw a sharp line between short-run and long-run effects?

- How can a surplus of the total sum of all entrepreneurial profits over all entrepreneurial losses come into existence?
- Who contributes to economic progress?
- Is there still entrepreneurial activity in a retrogressing economy? Why?
- Why is the socialist concept of "unearned income" fallacious?
- What is Mises's critique of the underconsumption doctrine?

10. Promoters, Managers, Technicians, and Bureaucrats

- What distinguishes the entrepreneur from the manager?

Comment: "Economic calculation as practiced in the market economy…make it possible to relieve the entrepreneur of involvement in too much detail."

- What is the significance of double-entry bookkeeping?
- What is the difference between bureaucratic management and profit management?

11. The Selective Process

Comment: "The market makes people rich or poor, determines who shall run the big plants and who shall scrub the floors, fixes how many people shall work in the copper mines and how many in the symphony orchestras."

- Why is ownership a liability?
- Why is it not right to pretend that "penniless" people are not able to climb the ladder of wealth and entrepreneurial position? What is the role of institutions?
- Why doesn't a degree in business administration imply a career as an entrepreneur?

12. The Individual and the Market

- What is meant by the statement, "The market is a social body"? Why are interventionist policies not necessary to "humanize" the market?
- What does Mises think of the distinction made between a "producers' policy" versus a "consumers' policy"? What is the psychological root of the producers' policy, as practiced by governments in the 20^{th} century?
- What is the lesson of the story of the man asking an innkeeper for ten dollars?

13. Business Propaganda

- What is the definition of advertising according to Mises?

- How can advertising influence the choice of consumers? Is it relevant for praxeology?
- Why are business and political propaganda essentially different things?
- What is meant by, "Freedom is indivisible"?
- Do advertising costs constitute part of production costs?

14. The "Volkswirtschaft"

- What is the definition of the "Volkswirtschaft"?
- What is meant by "Gemeinnutz geht vor Eigennutz"?
- What is the meaning of "Lebensraum"?
- Is "Volkswirtschaft" compatible with the free market?
- Under which conditions is "Volkswirtschaft" realized?