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

Chapter XVI. Prices

Chapter Summary

1. The Pricing Process

When two individuals trade goods as an isolated event, catallactics can only say that the exchange ratio in this act of barter will ensure that each trader gains something more valuable than what he gives up. Beyond that truism, the exchange ratio (barter "price") could be anywhere in a wide range. However, in an organized market with many buyers and sellers of the same item, the modern theory of price formation explains that the price must fall within narrow limits (as explained in the Technical Notes below).

The modern, subjectivist theory of prices does not assume that people have "perfect knowledge" of the market. On the contrary, catallactics can explain the formation of actual prices in the real world. Indeed, those mainstream economists who study static "equilibrium" outcomes ignore the crucial process in which speculative entrepreneurs drive the market towards equilibrium. By spotting disequilibrium (but real-world) prices and acting to seize the profit opportunities that they entail, it is the entrepreneurs who move the whole system towards the equilibrium state that the mathematical economists take for granted as the starting point of analysis. By buying "underpriced" goods or factors of production, and selling "overpriced" ones, the entrepreneurs push up the former and push down the latter prices, earning profits and equilibrating the economy.

2. Valuation and Appraisement

All prices are ultimately formed because of the subjective valuation of the consumers. We must always remember that the price that results from an act of exchange is not determined by an equality of values (e.g., "one car equals 30,000 dollars") but rather a difference in valuation (e.g., the seller values the 30,000 dollars more than the car, while the buyer values the car more than his 30,000 dollars).

Appraisement is different; it is an objective assessment of how much money an item will fetch in the market. Though the subjective valuations of consumers ultimately explain these prices, the appraiser himself needn't consider his personal opinion of the utility of the object being evaluated. Even so, in a modern economy, even the consumer must act as an appraiser. This is because to gauge the true cost of a purchase, the consumer must consider what other goods and services could be acquired with the money instead. To answer this question, the consumer must be familiar with the purchasing power of money, i.e., with the typical prices of goods and services that he might desire instead.

3. The Prices of the Goods of Higher Orders

The economist explains the prices of higher-order goods (i.e., factors of production) in the same way that he explains the prices of consumer goods, i.e., by first explaining what motivates purchases and then by imagining what conditions would cause the market to cease. When it comes to consumers, they purchase products so long as the units they acquire are valued more highly than the money they trade away. With entrepreneurs in the markets for factors of production, the same is true. However, unlike consumers, they do not value their purchases for the direct utility they provide. On the contrary, the entrepreneurs evaluate factors of production based on their appraisal of the products that these factors can create. Thus, subjective consumer valuations determine the prices of the first-order goods, and then appraising entrepreneurs forecast these prices in order to guide their buying decisions, which lead to the formation of the prices of 2nd-, 3rd-, and higher-order goods.

4. Cost Accounting

For the entrepreneur, costs are the money required to purchase the factors of production. Naturally, the entrepreneur seeks out factors of production with prices low enough to allow him to create and sell a product, earning enough revenue to cover his explicit costs. Determining the optimal quantity of factors to purchase is a complicated task because (for technological reasons) proportional increases in inputs do not always yield proportional increases in yield.

Although there are strict rules of accountancy (both for shareholders and tax purposes), we must remember that the entrepreneur is always guided by his forecasts of likely future prices. At any time, there is no "fact of the matter" of the capital value of a given inventory; what matters is not how much the firm paid for the inputs, but rather what the firm is likely to get when it sells the inventory in the future (and what the relevant interest rate will be in the interim).

5. Logical Catallactics Versus Mathematical Catallactics

The mathematical economists deride the "literary" approach, believing that only empirical measurement is scientific. But there are no constants in human action, as there are in the natural sciences (charge of an electron, speed of light in a vacuum, etc.). The statistical analysis of prices is merely a study of economic history, as past prices have no necessary relation to future ones. The mathematical study of prices also proceeds as if there is no monetary good or market process, and hence entirely misconstrues the way prices are formed in the real world. Finally, the attempt to model the differential equations of classical mechanics is faulty. The physicist can describe the motion of a ball in a vacuum at any point in time, but he doesn't know "why" the ball moves. In contrast, the praxeologist knows why men exchange in a market, but he can't predict beforehand the actual market price at any moment (because, in reality, any such price will be a "disequilibrium" one, while the equations refer to hypothetical equilibrium prices).

6. Monopoly Prices

The sovereignty of the consumer is violated only very rarely on a free market, namely when the sole seller (or a group of all sellers acting in concert) find it profitable to restrict output and raise the price above what the competitive price would have been. The monopolist will only be able to do this when the demand curve is inelastic at the competitive price (meaning the seller will receive more total revenues by raising the price and selling fewer units), and when the seller can't discriminate among the buyers. (If the monopolist could segment the market, charging different prices for each group, then he wouldn't need to restrict output in order to maximize profit.)

It is important to realize that being a "monopolist" per se is insignificant. If we define the product or service narrowly enough, every producer is a monopolist. (Only one person can sell Mary Rosen's litigation services.) For Mises, the seller violates consumer sovereignty only when he restricts output below what the consumers desire, i.e., below the competitive level.

7. Good Will

Because people are endowed with different information and areas of expertise, buyers often must rely on the integrity of the seller. As a particular producer gains trust over time, this "good will" gives him an advantage over competitors who lack it. Many paternalist reformers wish to substitute government certification for the market's response to "asymmetric information," but if the government appointees are themselves fallible (or corrupt), this is no solution. Though inefficient when compared to a world where people are omniscient, the market outcome of brand-name recognition and trust overcomes the problem of asymmetric information.

8. Monopoly of Demand

If there is a single buyer, or if all of the buyers act in concert, they can restrict demand in order to lower the price. However, they will necessarily buy (and hence enjoy) fewer units of the good compared to the status quo. Thus the "monopolistic" buyer cannot earn a specific gain the way a monopolistic seller can.

9. Consumption as Affected by Monopoly Prices

Generally speaking, the happiness of consumers is impaired by monopoly prices. The one exception is a situation where a product would not be produced at all, were it not for monopoly prices in one of its essential inputs. (This is the justification for granting monopolies—in the form of patents or copyrights—to the creators of "intellectual property.")

Most discussions of monopoly are confused. In a free market, only a few minerals and local network goods (phone lines, electricity) would have monopoly prices. In reality, it is government privileges that establish cartels and monopolies.

10. Price Discrimination on the Part of the Seller

Generally, economists discuss market prices as if there is a single price prevailing for "the same" good or service. However, it is sometimes possible for a seller to charge different prices based on a particular customer's willingness to pay. This can only happen if it is difficult for the buyers to resell the good among themselves, and it will only happen if the seller will thereby gain more profit than if he had charged a uniform price. The textbook example of price discrimination is a country doctor who charges more from his wealthy clients than from his poor ones.

Specific clients may be hurt by price discrimination, but it is possible that a certain good will only be provided if price discrimination occurs.

11. Price Discrimination on the Part of the Buyer

Although monopolistic buyers cannot achieve monopoly prices (and monopoly gains), they can conceivably benefit from price discrimination, i.e., from paying different prices to different sellers. This situation would not persist on a free market, however, because it relies on the crass ignorance of the sellers.

12. The Connexity of Prices

The prices of certain goods have a special connection; a sale on peanut butter may affect the price of jelly. But even more generally, the prices of all goods are related because they all compete for the money of buyers. And since labor is required for every good, they are all interrelated on both the consumption and production side. It is impossible to analyze a particular price in isolation.

13. Prices and Income

The market process does not engage in distinct activities of price determination and income determination (or production versus "distribution"). The market process entails the definite exchange ratios in actual, specific transactions. It is only a subjective attitude that views a capital good (or even land or labor) as a source of income. Only the successful, acting individual can maintain capital equipment or his body in order to continually sell goods or services in the future to reap this anticipated flow of "income."

14. Prices and Production

The market process directs the factors of production into those lines that best satisfy the desires of the consumers. In a free market, there cannot be long-run unemployment of labor, as labor is the ultimate nonspecific factor. However, there can be sustained unemployment of specific land or even capital goods—"idle capacity." So long as this outcome occurs on a free market, it represents the most efficient use of resources, given the mistakes of the past. For the government to pass legislation to spur employment of these factors (hence ignoring reality) only makes the consumers poorer.

15. The Chimera of Nonmarket Prices

It is nonsense to speak of prices besides those formed in the actual market. There are always segments of the population who would benefit from higher (or lower) prices for a particular good or service, but their desire for a different price in no way impugns the actual price. Because market prices take into account all relevant facts, those attempting to alter prices would necessarily be ignoring these real considerations. For example, if the government requires an equal price for all types of running shoes, this will not eliminate the fact that the consumers really do "arbitrarily" value some brands more than others.

Why It Matters

In yet another long and important chapter, Mises lays out the nature of prices and (briefly) sketches how they are actually formed.

(A more elaborate treatment of the formation of specific prices is in Rothbard's *Man, Economy, and State*.)

Mises is very clear on the complicated but crucial relationship between subjective consumer valuations and objective prices of the factors of production. The material in this chapter is necessary to fully understand Mises's critique of socialism.

Technical Notes

(1) In the beginning of the chapter (p. 324), Mises somewhat obliquely refers to the limits set on a market price with many buyers and sellers. He has in mind a large market with individuals initially having different amounts of the good in question, and then some individuals trade with each other at a uniform price, while others refrain from trade. If we assume that a certain number of units are bought and sold at a common price—and that every buyer and seller has transacted exactly the number of units desired—then it must be the case that the price is low enough to induce the "marginal buyer" to purchase the last unit being traded and to simultaneously prevent the "marginal offerer" from being willing to sell an additional unit, and high enough to induce the "marginal seller" to sell the last unit traded and also high enough to prevent the "marginal potential buyer" from wanting to purchase an additional unit.

(For this argument to work, we must assume that every trader knows what the common price is. That's why Rothbard actually titles this section "Determination of Price: Equilibrium Price" in *Man, Economy, and State*.)

(2) Mises says, "It is permissible to declare that, due allowance being made for time preference, the value attached to a product is equal to the value of the total complex of complementary factors of production" (p. 332). His purpose with this concession is to distinguish such a claim from the truly erroneous approach of many economists in which they declare that the subjective value of the final consumer good is equal to the sum of the subjective valuations of the factors that contribute to its production. However, even Mises's concession goes too far, because in practice no single individual knows all of the factors (and what quantity of each) required for something as simple as a pencil. Therefore, even though it is not nonsense to say that the factors needed to make a pencil are (in their totality) valued the same as a (future) pencil, it is a rather empty statement, since no one is in a position to make such a "permissible" valuation.

(3) Murray Rothbard rejected the distinction between a monopoly price and a so-called "competitive price." Rothbard argued that only government privileges could establish monopoly prices, and that all the economist had were real-world free-market levels of output. Every producer "restricts" output if so doing yields more profit, and since

there is no such thing as a hypothetical "competitive" level to use as a benchmark, there are no grounds for criticizing some of these producers.

Study Questions

1. The Pricing Process

- What does every exchange imply with regard to the value attached by each party?
- Why is the concept of perfect information useless for the explanation of prices?
- How is the inequality of people important for understanding of the market process?
- Who are the driving forces of the market process? How do they interact?
- Do entrepreneurs take into account final or equilibrium prices?

Comment: "[C]atallactics shows that entrepreneurial activities tend toward an abolition of price differences not caused by the costs of transportation and trade barriers."

2. Valuation and Appraisement

- What is the ultimate source of the determination of prices?
- What distinguishes appraisement from valuation?
- Is the notion of a "fair price" scientific?

3. The Prices of the Goods of Higher Orders

- In what way are the prices of the goods of the higher order determined by the goods of the first or lower order?
- Does the pricing process of higher-order goods involve a connection of subjective values?
- Which method do we owe to Gossen, Menger, and Böhm-Bawerk?
- Why would it be absurd to speak of a sum of valuations or values?
- Why don't the prices of the past influence future prices?
- What is the pricing process if the production of a product requires two or more absolutely specific factors? What would be the pricing process if all factors of production were specific?

4. Cost Accounting

- What is meant by the law of increasing returns or decreasing costs?

- What would happen if all of the imperfectly divisible factors were utilized at less than full capacity? What would be the result of an expansion of production? What would happen when full utilization of the capacity of one of the imperfectly divisible factors was attained?

- How do transportation costs relate to prices of the factors of production?

- Why aren't fixed costs determined merely by technological reasoning?

5. Logical Catallactics Versus Mathematical Catallactics

- What are the main currents of thought in the field of mathematic economics?

- Why does the statistical approach imply the presentation of historical facts? Why does this make it inappropriate for economics?

- In what way can a datum of experience or a statistical fact add to the understanding of the determination of prices?

- What are the objectives of the investigations of the relations of prices and costs applied by mathematical economists? What is the role of money within the analysis?

- Why are calculations on the basis of units of utility nonsensical?

- What are two fundamental principles of the theory of value?

6. Monopoly Prices

- What are the special conditions required for the emergence of monopoly prices? Give a short overview.

- Why isn't a monopoly the only prerequisite for the emergence of monopoly prices?

- Why is it fallacious to assume a third category of prices? What are the roots of this problem?

- According to Mises, how is the control of supply misinterpreted?

- Why does entrepreneurial profit have nothing to do with monopoly?

- What is a cartel? Is it harmful to an economy?

- Is the number of competitors important for competition?

- What are optimum monopoly prices?

- What is meant by an incomplete monopoly? What are the consequences?

- In what way is free entry into the branch of production decisive for the preservation of cartels? What is the importance of this fact for analysis of monopolies?
- What is the role of licenses with regard to the formation of monopoly prices?
- What is meant by a failure monopoly?
- Why do labor unions not aim at monopoly prices?
- What can mathematics teach us about the demand curve of monopolies?

7. Good Will

- What is the meaning of good will? What are some of Mises's examples?

8. Monopoly of Demand

- How does a monopoly of demand differ from a "competition" of demand?
- How can an apparent monopoly of demand turn out to be a monopoly of supply?

9. Consumption as Affected by Monopoly Prices

- What are the different reactions possible vis-à-vis monopoly prices? Give a short overview.
- In which case would the reactions of the consumers create a situation where the price under monopoly equaled the competitive price?
- What would be the situation if all consumers spent less for a product under a monopoly price than under the competitive price?
- What is the argument in favor of patent and copyright legislation?
- How does government interventionism influence the formation of cartels and monopolies?

10. Price Discrimination on the Part of the Seller

- What conditions must be met in order to make price discrimination advantageous?
- How can price discrimination render the satisfaction of a need possible that would have remained unsatisfied in its absence?

11. Price Discrimination on the Part of the Buyer

- Can price discrimination by the buyer occur without government intervention?

12. The Connexity of Prices

- Why does the fact that labor is nonspecific bring about the general connexity of all human activities?

13. Prices and Income

- Why is income a category of action? What does it mean?
- Can there be a "safe" income?
- Can market incomes accurately be viewed as a distribution?

14. Prices and Production

- What do prices determine for the production process?
- Why is it nonsense to lament the fact of unused capacity?
- What is malinvestment?

15. The Chimera of Nonmarket Prices

- Is there such a thing as "real costs"?
- Why is the idea of cost prices fallacious?