

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

Chapter XI. Valuation Without Calculation

Chapter Summary

1. The Gradation of the Means

Acting man values means according to the valuation he places on the ends they can achieve. (An apple seed is valued through consideration of the future apples it can produce for consumption.) The totality of means needed for a given end would possess the same value as the end, except for the discount due to the waiting time involved. (The concept of time preference will be discussed in a later chapter.)

Often actors must choose between various outcomes that all consist of countable supplies of different goods. Even so, the fundamental act of choice always involves a purely ordinal value judgment, not a quantitative "measurement" of subjective value. If a person, in one fell swoop, trades away five oranges in exchange for eight apples, all we can conclude is that he derived more satisfaction from "eight apples" than from "five oranges." The units involved allow us to go no further than if he had traded away one baseball card for one lollipop.

2. The Barter-Fiction of the Elementary Theory of Value and Prices

The modern theory of economic value traces back the objective, quantitative prices in a market economy to the subjective, ordinal rankings of individual actors. In such an exposition "imaginary constructions" are needed, i.e., the economist must rely on simplifications in order to analyze one part of the economy, even though in the real world such a simplification would disrupt the very element being analyzed.

In this chapter, Mises discusses the imaginary construction of the barter economy, i.e., the tentative (and false) assumption that all exchange ratios emerge with goods being traded directly against each other, with no use for a medium of exchange (i.e., money) at all.

This assumption is necessary to understand the actual role of money. However, historically it led many economists into two great errors. First, many economists believed that money was neutral and served only to facilitate the "real" transactions that had been studied in the imagined state of barter. So if, say, the economist concluded that, in barter, one apple traded for two oranges, then it was a mere afterthought to add in money and conclude that (say) one apple traded for \$1 and one orange traded for 50 cents.

The second great error of many economists was to suppose that items exchanged in a market were of equal value. Even the great classical economists thought that long-run prices were due to the quantity of labor needed to produce the goods in question. The modern subjective theory of value starts with the realization that people trade goods precisely because they value them differently. When Joe gives up his apple for Mary's orange, this doesn't prove that each fruit has

equal value. On the contrary, it shows that Joe values the orange more than the apple, while Mary values the apple more than the orange.

The Theory of Value and Socialism

The socialists, Institutionalists, and Historical School attack the economists' attention to the problems of the isolated individual, commonly referred to as "Crusoe economics." Although it is necessary to first understand autarkic exchange before proceeding to interpersonal exchange, nonetheless there is some validity in the charge. Ironically, the Crusoe approach is inadequate because it cannot illustrate economic calculation, which is what vitiates the entire program of the socialists and other critics of the economists.

3. The Problem of Economic Calculation

Technology is quantitative; it tells actors how many units of various inputs are necessary in order to yield a definite quantity of output. However, this type of knowledge (of technical recipes) would solve the problem of economic calculation only in the artificial world where either (a) all means of production could be perfectly substituted for each other in definite ratios or (b) each means of production were suitable for one end only.

But in the real world, neither *a* nor *b* is true. Instead, each means of production is more or less suitable for a wide range of ends, and thus each means is substitutable for others but to varying degrees, depending on the task. This fact makes the problem of economic calculation too complex to be solved through engineering knowledge alone. Technology can tell us how many inputs of various kinds will yield a certain output. It cannot tell us which of several possible combinations of inputs is the most "economical" to use when producing a good.

Only money prices can solve the problem of economic calculation. With the use of money, every transaction has one particular good—the universally accepted medium of exchange—on one side, and this gives a common denominator to aid actors in their conduct. A man can look at the infinity of possible ways of taking various combinations of inputs to yield a given output, and he can determine which method is the cheapest. The natural sciences alone cannot provide this type of information.

4. Economic Calculation and the Market

The money prices established in a market are not measurements of value. They are historical facts, recording the ratio at which two items (the money good and some other good or service) exchanged in the past. Even though they are malleable (unlike, say, a chemist's belief in the fixed nature of the charge of an electron), market prices still provide a guide to future action. Without them, all of the subsidiary concepts in accounting (capital and income, profit and loss, spending and saving, cost and yield) would be metaphorical.

Why It Matters

The issue of economic calculation is one of the central themes of the entire book, and Mises breaks up the discussion over several chapters. In this chapter he focuses on what economic calculation is not—that is, he shows how there are quantitative relationships (in the natural

sciences and in our technological know-how) that intersect "economic life," but that these pieces of information alone do not suffice to solve the central problem of economic calculation. Mises briefly states that the solution is money prices, but he doesn't elaborate in this chapter.

Technical Notes

- (1) Mises singles out the varying specificity of factors of production as the key issue in economic calculation (pp. 207–208). For example, if a particular output good could always be produced by either n units of a , or $2n$ units of b , or $3n$ units of c , etc., and moreover this pattern were true of all output goods (with possibly different values of n for each consumer good), then it would be easy enough to value the factors of production. One unit of factor a would have the value of 2 units of b and of 3 units of c , and so forth. And we also know that a would have the same value (disregarding the time lag needed for production) as n units of this particular consumer good. Thus, starting with the valuation placed on the final consumer goods, the completely nonspecific factors of production could be valued quite easily.

On the other hand, if all factors were completely specific—meaning that factors a_1 and a_2 could only be used to produce consumer good A , higher-order goods b_1 , b_2 , and b_3 could only produce consumer good B , and so forth—then it would be easy enough to value the factors: disregarding the time lag involved, a_1 and a_2 would be valued as much as A ; b_1 , b_2 , and b_3 would be valued as much as B , and so forth. But things are not so simple when the factors can be used in varying combinations to yield many different types of consumer goods.

- (2) On pages 210–211 Mises alludes to the fact that even the physicists may have to drop the idea of a fixed standard against which to measure absolute quantities. For example, the famous Heisenberg uncertainty principle states that it is impossible to pin down the position and momentum of a subatomic particle beyond a certain degree of accuracy; the very attempt to determine the position of an electron (by firing light at it) will itself change its momentum.

Even so, Mises says that on a macroscopic scale, natural scientists can certainly continue to believe that it makes sense to talk of length, without worrying that meter sticks themselves might change their size unpredictably. Yet this is precisely the problem with economic calculation. Money prices aren't a measurement of subjective value, because money itself is an economic good, subject to changing preferences and diminishing marginal utility as one acquires more units of it.

Study Questions

1. The Gradation of the Means

- How is the gradation of the means similar to that of the ends?

2. The Barter-Fiction of the Elementary Theory of Value and Prices

- Why is it necessary to use money prices in order to engage in economic calculation?
- Why does the economist need to first explain the direct barter economy before analyzing the monetary economy?
- What are two principal errors that emerged from the unsatisfactory examination of direct exchange? What were the consequences for the understanding of money and its influence on exchange?
- Is money neutral?
- Does exchange imply that the goods or services involved have equal value?
- Can we measure value?
- What can we say about the valuations of units of a homogeneous supply?
- In what way did the classical doctrines provide a basis for Marxian theories?

3. The Problem of Economic Calculation

- How is the allocation of means influenced?
- Acting man wants to know how he must employ means in order to obtain the best possible outcome. In what way can technology be useful?
- Why are money prices necessary for evaluating and comparing the different alternatives and plans that serve at removing uneasiness for the acting man?
- Do economic quantities imply money prices?

4. Economic Calculation and the Market

Comment: "The distinctive mark of economic calculation is that it is neither based upon nor related to anything which could be characterized as measurement."

- Why do exchange ratios permanently fluctuate?
- Why do economic calculation and the estimation of the expected outcome of future action go hand in hand?
- What is the meaning of economic calculation for human action? How is the concept of economic calculation related to "quantitative sciences of economics"?