

CHAPTER 2 — DIRECT EXCHANGE

CHAPTER SUMMARY

Direct exchange involves trades where the goods received are of *direct use to the recipient*. These “direct uses” can be for production; i.e. a person can engage in direct exchange of higher-order goods. However, if a person desires a good with the intention to trade it away to someone else, then he is engaged in *indirect exchange*, the subject of the next chapter.

A voluntary exchange involves a *reverse valuation* of the goods: each party values what he is giving up less than what he is receiving in exchange. This principle underscores the fact that value is subjective: if goods had an objective, intrinsic value, then there could be no reverse valuation (except through error). If this were the case, then traded goods would be equal in value (and hence there would be no reason to trade them), or one party would necessarily benefit at the expense of the other. But since this is *not* the case—i.e. since individuals value goods differently—then there are mutual “gains from trade.” Both parties (expect to) benefit from a voluntary exchange.

With the possibility of trade, goods are valued not only by their *direct use-value* but also their *exchange-value*. An actor will always value a unit of a good at the higher of these two. (For example, even a non-smoker would prefer a box of cigars over a hot dog, if he thought he could trade the former to a smoker.) Trade also fosters *specialization* and the *division of labor*. By specializing in those activities in which they are relatively most productive (or have the *comparative advantage*), actors greatly increase the productivity of their labor and enjoy more consumption goods than would be possible without trade.

The *price* of one good in terms of another is the number of units of the second good that must be offered in exchange for one unit of the first good. Other things equal, a seller prefers the highest price possible while a buyer prefers the lowest price possible.

Individuals enter a market seeking to exchange goods they value less for goods they value more. There is scope for trade whenever the *minimum selling price* of the seller is lower than the *maximum buying price* of the buyer. The market *supply* relates the quantity of goods that will be offered at various prices, while the market *demand* relates the quantity of goods that buyers will attempt to purchase at various prices. The *equilibrium price* is that which equates quantity supplied with quantity demanded. There is a tendency for actual market prices to approach equilibrium, but new changes in the data constantly interrupt this tendency. *Speculation* (if successful) speeds the move to equilibrium.

In an unhampered market (i.e. one free from violence and theft), all property can be traced back through voluntary exchanges, production, and ultimately to the original appropriation of raw (unowned) land.

CHAPTER OUTLINE

1. *Types of Interpersonal Action: Violence*

The analysis of Chapter 1 was true for all action, but its *applications* were limited to isolated individuals (i.e. autistic exchange). Praxeology is now used to analyze interpersonal action (i.e. interpersonal exchange).

When one person increases his own satisfaction by using another person as a factor of production against the latter's will, we can say that the former person is *exploiting* the latter. Such a *hegemonic* relationship stands in contrast to voluntary arrangements. By definition, a slave does not benefit from his relationship with his master. If the slave *agreed* that he benefited (in terms of relatively reliable food, shelter, etc. in exchange for labor), then coercion would not be necessary to maintain the relationship.

2. *Types of Interpersonal Action: Voluntary Exchange and the Contractual Society*

Unless stated otherwise, the remainder of the book assumes that all exchanges are voluntary, i.e. no one violates the property of anyone else. (This includes the property in one's body.) The analysis is therefore of an *unhampered market*.

Individuals will engage in an exchange only if they have a *reverse valuation* of the goods *and* if they are aware of each other. To understand the first condition, suppose that Smith trades one apple to Jones in exchange for one orange. Because the transaction is voluntary, it must be the case that Smith values the orange more highly than the apple, while Jones must value the apple more highly than the orange. Notice that this alone will not lead to a trade; Smith and Jones must be aware of each other's existence.

In general, an individual will be willing to trade away units of some good *X* in exchange for units of some other good *Y*, so long as the marginal utility of *Y* is higher than the marginal utility of *X*. Notice that as more units are swapped, the marginal utility of *X* rises while the marginal utility of *Y* falls.

The possibility of exchange with others means that an actor will now consider not only the direct *use-value* of a good but also its *exchange-value*. The marginal utility of a given unit of a good is the higher of these two. I.e. a person will continue to trade away units of a good so long as the exchange-value of the marginal unit is higher than the use-value. Because of diminishing marginal utility, owners of large stocks of goods (such as people producing for a market) usually consider the exchange-value more relevant.

A helpful outline of the types of human action is presented on page 94.

3. *Exchange and the Division of Labor*

The opportunities for exchange lead to *specialization* and the *division of labor*. This allows for more consumption for everyone involved. If we consider that each market participant has an *absolute* advantage in the production of a certain good, then it is obvious that specialization will allow for higher total output (and hence consumption per capita). However, even if one market participant has an absolute advantage in every

line of production, he can still benefit by specializing in the product in which he has the *comparative* (or *relative*) advantage.

4. *Terms of Exchange*

The *price* of a good in terms of another is simply the number of units of the second good that must be offered in order to receive one unit of the first good in exchange. Although we are used to quoting prices in terms of money, this need not be the case. For example, if a person can trade two cows for 1,000 berries, then the “berry-price” of one cow is 500 berries.

Other things equal, a seller will always prefer a higher price for his goods and a buyer will always prefer a lower price. Apparent counterexamples (such as someone selling a car to an in-law at a lower price than could be gotten from a stranger) are not comparing the same goods.

5. *Determination of Price: Equilibrium Price*

A sale can occur when the *minimum selling price of the seller* is lower than the *maximum buying price of the buyer*. These minimum and maximum prices can be determined from the value scales of the individuals in the market. If there are only two individuals, usually there will be a *range* of possible prices. Praxeology alone cannot say which particular price will be used; it depends on the relative bargaining skill of the individuals. With the addition of more and more buyers and sellers to the market, the zone of indeterminacy shrinks, so that only a few (or possibly one) price will “clear the market.”

The *demand* for a good indicates the quantity of units that buyers desire at various hypothetical prices. The *supply* of a good indicates the quantity of units that sellers offer at various hypothetical prices. These can be depicted in a table (or *schedule*) or plotted as a graph (or *curve*). One must distinguish between a change in demand (movement *of* the demand curve) versus a change in *quantity* demanded (movement *along* a given demand curve), and the same for supply.

An *equilibrium price* is one in which quantity supplied equals quantity demanded. Graphically, it occurs at the intersection of the supply and demand curves. The market tends toward equilibrium: If the current price is above the equilibrium price, there is an excess supply (“surplus”) and sellers reduce their asking price. If the current price is below the equilibrium price, there is an excess demand (“shortage”) and buyers increase their offer price.

There is a tendency for *one price* to rule over a market. If there weren't, then arbitrage opportunities would exist; a middleman could buy low and sell high.

6. *Elasticity of Demand*

The elasticity of demand is the ratio of the percentage change in quantity demanded and the percentage change in price (the negative sign is omitted). If the elasticity is greater than one, the demand for the good is “elastic,” while if the elasticity is less than one the demand is “inelastic.” Note that a higher price will lead to lower total

spending on a good if its demand is elastic, while a higher price will lead to higher total spending if the demand is inelastic.

7. *Speculation and Supply and Demand Schedules*

Supply and demand take into account all factors influencing people's selling and buying decisions. In particular, someone may refuse to sell a good at a certain price, because he *speculates* that the price of the good will rise in the near future. Or, a buyer may refrain from purchasing a good, because he speculates that the price will soon fall. Such speculation (if correct) "flattens" the supply and demand curves, and speeds the approach towards equilibrium.

8. *Stock and the Total Demand to Hold*

Rather than analyzing traditional supply and demand, we may also understand price formation using the concepts of *total stock* and *total demand to hold*. The stock of a good is the number of units existing at any given time. The total demand to hold consists of the number of units desired by buyers, *plus* the number of units that current owners *refrain* from selling (what is called the *reservation demand*). The equilibrium price equates the stock and the total demand to hold.

One drawback of this approach is that it obscures the volume of exchange in a market; one cannot tell if the people ending up with units of the good are the same as the ones who started out with them. However, the approach is very useful in illustrating that ultimately supply and demand are *both* determined by utility considerations, rather than "real cost."

9. *Continuing Markets and Changes in Price*

In the real world, markets are continually upset by changes in the data. Production and consumption can be handled using the appropriate shifts in the supply of a good.

10. *Specialization and Production of Stock*

With specialization, the use-value of goods to their original owners declines. In practice, a producer's reservation demand is purely speculative, i.e. the producer will only refrain from selling at the current price if he or she believes a higher price will obtain in the future.

11. *Types of Exchangeable Goods*

The principles of supply and demand explain price formation for any type of good, whether tangible commodities, services, or claims. (A partial outline of the possible exchanges is listed on page 163 and is completed on pages 168-169.)

12. *Property: The Appropriation of Raw Land*

In an unhampered market, the origin of all property is traceable to voluntary exchanges and ultimately to the appropriation of unowned nature-given factors. An actor legitimately *homesteads* a piece of previously unowned land by “mixing his labor” with it. Note that a person does not need to *continually* “use” a piece of land, once he has established ownership.

13. *Enforcement Against Invasion of Property*

This section analyzes the precise meaning of an “unhampered market” (the major subject of study in the book) by defining what is, and what is not, a violation of property rights.

NOTABLE CONTRIBUTIONS

- Unlike the positivist, model-building approach of the mainstream, Austrian economics seeks to explain the formation of *actual market prices* in the *real world*.
- Figure 7 (p. 99) helps the reader visualize specialization under barter.
- Rothbard follows Mises (pp. 100-101) by arguing that feelings of community and altruism are the result (not the cause) of social cooperation and the higher productivity made possible by the division of labor.
- The depictions of value scales are extremely helpful in the analysis of price formation.
- Rothbard’s discussion of property rights in the radio spectrum and waterways (pp. 173-174) was quite advanced for its day.
- Packed into the section, “Enforcement Against Invasion of Property” (pp. 176-185), Rothbard offers unorthodox (and perhaps shocking) insights on issues such as fraud, negotiable instruments, externalities, libel and slander, and blackmail.

TECHNICAL MATTERS

- Some of the conditions claimed sufficient for an exchange are only strictly true if we rule out errors in bargaining ploys. For example, on page 86 Rothbard says that a reverse valuation between A and B over a vase and a typewriter, plus the mutual awareness of the assets, will lead to an exchange. But it is possible that B might insist on a vase *plus* 10 berries (say), thinking that A will agree to this. If A calls B's bluff, then it is possible that no trade will occur, despite the reverse valuations and awareness of the assets.
- The literal case of "log-rolling" (pp. 101-102) illustrates a subtle point concerning the division of labor. Certain tasks require the cooperation of several individuals (such as rolling logs or moving furniture). Cooperation raises the productivity of each participant's labor. However, this is not a case of specialization or the division of labor, since each participant is performing the same type of labor. Rather than considering two neighbors helping each other move couches, a better example of specialization would be one neighbor doing the yard work for both while the second neighbor replaces the gutters on both houses.
- In footnote 20 (p. 102), Rothbard says that specialization in a particular *stage* of production (rather than in a consumption good) requires "the adoption of *indirect exchange*, discussed in the following chapters." Recall that under direct exchange, each individual seeks to attain goods that he or she can actually use (rather than merely to trade away to other individuals). Therefore, it is impossible under direct exchange for people to specialize in particular stages of production, because (by definition) higher order goods are not suitable for immediate consumption. If everyone specializes in one stage, then Smith (who mines ore) can have at most one buyer, Jones (who smelts ore). But Smith can't directly use the smelted ore that Jones has to offer, because Smith (by assumption) specializes in mining.
- An individual always seeks to maximize his psychic revenue (p. 104), *not* his psychic profit. Remember that value rankings are always ordinal. It would make no sense to gauge the "difference" in utility between the first and second most highly ranked uses for a good (and hence to try to measure the psychic profit).
- Figure 15 (p. 123) may confuse the reader because it apparently ranks additional horses higher on the actor's value scale. However, as the text makes clear, these are successive horses that could be *sold*. Thus, if the actor initially possesses ten horses, then we could replace "A horse," "A second horse," and so on with, "Nine horses," "Eight horses," etc.
- Although Rothbard disparages the practice in footnote 27 (p. 130), the "elasticity of supply" can be defined even without resort to calculus; it is simply the percentage change in quantity supplied divided by the percentage change in price. Many mainstream economists use this concept to study such things as the relative

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burden of excise taxes. They could also say that speculation causes the supply curve in Figure 20 (p. 132) to become more elastic, just as Rothbard says that speculation causes the demand curve in Figure 19 to become more elastic.

STUDY QUESTIONS

- (1) Do different praxeological laws apply to situations of isolation versus society? (p. 79)
- (2) What is Rothbard's definition of *society*? (p. 84)
- (3) Give an example of *autistic exchange*. (p. 84)
- (4) Suppose someone says, "In order for an exchange to be just, each person must give up an equal value for an equal value." What do you think Rothbard would say about this? (p. 85)
- (5) What are three sources of ownership? (p. 93)
- (6) What is the law of association? How does it relate to Boulding's example of the doctor and his gardener? (p. 98)
- (7) In Figure 16, how many horses will Smith demand at a price of 85 berries? At that price, how many total berries will Smith offer in exchange? (p. 125)
- (8) What will happen to the price if the total demand to hold is higher than the stock? (pp. 137-140)
- (9) How can the principles of this chapter be applied to shares of ownership? (p. 166)
- (10) What is Rothbard's response to Henry George? (pp. 171-172)