

CHAPTER 9 — PRODUCTION: PARTICULAR FACTOR PRICES AND PRODUCTIVE INCOMES

CHAPTER SUMMARY

This chapter analyzes specific factor prices in light of a changing economy. *Rent* is the price paid for the hire of unit services of a factor; the price for a durable factor in its entirety is (in the ERE) equal to the present discounted value of its future rents. In the ERE, only land and labor factors earn net rents. A *wage* is simply the hire price of a unit of labor service.

Taken as a class, the supply of land-in-general is vertical; there are no reservation uses for it. But the supply curves for *particular* uses of land are upward sloping, reflecting the opportunity costs of using a given parcel in alternative ways.

As with land, the supply curves of labor for particular uses will be upward sloping, due to alternative outlets. It is theoretically possible for the supply curve of labor-in-general to be “backwards bending”; i.e. as wage rates reach a certain point, additional rises in the wage rate lead to a *reduction* in the quantity supplied of labor. In contrast to the charges of Keynes, economics does not “assume” full employment. Economics *deduces* that individuals can always “get a job” if they are willing to work for a sufficiently low (possibly negative) wage rate.

Prices determine costs, not vice versa. The plethora of cost curves in mainstream texts assume fixed factor prices, and cannot explain the emergence of prices because they proceed from the viewpoint of an individual, “price taking” firm.

A business owner’s gross income consists of: (a) interest on capital invested, (b) (implicit) wages for his managerial tasks, (c) rents of ownership-decision, and (outside the ERE) (d) entrepreneurial profit or loss.

If a hypothetical firm were to merge with all other firms, there would no longer be a market for the various factors and hence its owner(s) could not calculate the relative profitability of various lines. Socialism is just a special case of this more general phenomenon.

The same price will emerge for the “same” good, but this is defined from the point of view of the consumers. Thus an orange-in-Florida is not the same good as an orange-in-New-York, and hence the prices for oranges may differ in the two regions.

In contrast to the approach of the classical economists, modern economics recognizes that there is not a two-fold process in which goods are first produced and then “distributed.” Rather, goods are produced *and distributed* at the same time; if one alters the incentives facing producers (such as who gets to consume what), then this may upset the total size of the “pie” overall.

Consumer valuations determine the marginal utility of consumer goods, which ultimately determine the prices of these goods. The rental prices of land, labor, and capital factors are then determined on the basis of these prices by computing the DMVP of a productive factor. The pure rate of interest is determined by the time preference schedules of individuals, and this rate is used to compute the asset prices of durable goods, based on their known future rental prices.

CHAPTER OUTLINE

1. *Introduction*

This chapter analyzes the effects of a changing economy on specific factor prices.

2. *Land, Labor, and Rent*

A. RENT

Rent is the price paid for the hire of unit services of a factor; the price for a durable factor in its entirety is (in the ERE) equal to the present discounted value of its future rents. Net rents are equal to gross rents earned minus gross rents paid to owners of factors (necessary to produce a capital good). In the ERE, only land and labor factors earn net rents, because a capital good's gross rent is entirely imputed to the land and labor factors (plus time) necessary for its construction. A *wage* is simply the hire price of a unit of labor service. The capitalized value of the "whole factor" in the labor market implies slavery, and hence cannot exist on a free market. It is an important empirical fact that labor has tended to be scarcer than land; this is why there are always plots of submarginal land but not submarginal ("unemployable") labor.

B. THE NATURE OF LABOR

There is no difference between "management" and "labor"; both are hired by the capitalists to perform certain tasks. Yet no one suggests unionizing the vice presidents in various firms to protect them from exploitation.

C. SUPPLY OF LAND

Taken as a class, the supply of land-in-general is vertical; there are no reservation uses for it. But the supply curves for *particular* uses of land are upward sloping, reflecting the opportunity costs of using a given parcel in alternative ways. To the extent that land (in the economic sense) is permanent, the only reason for "speculative withholding" is that an owner does not wish to commit the land to a present use that would delay its conversion to a more valuable use in the future. This is precisely what the consumers *want* the land speculator to do, contrary to Henry George.

D. SUPPLY OF LABOR

As with land, the supply curves of labor for particular uses will be upward sloping, due to alternative outlets. However, because labor is the ultimate nonspecific factor, individual supply curves will likely be more elastic than for land factors. It is theoretically possible for the supply curve of labor-in-general to be "backwards bending"; i.e. as wage rates reach a certain point, additional rises in the wage rate lead to a

reduction in the quantity supplied of labor. This could happen if rising wages lead laborers to consume more leisure.

Wage rates will tend toward equality for equivalent labor units. However, a laborer's total compensation consists of psychic elements as well, which may prevent equalization of *money* wage rates.

E. PRODUCTIVITY AND MARGINAL PRODUCTIVITY

If the supply of capital goods increases, *ceteris paribus* this will increase the MPP of labor and ultimately real wages per capita. Thus the rise in real wages over time need not be due to the merits of the workers. For example, an increase in investment in the auto industry will cause the physical product of auto workers to rise (since they work with more and better tools). This will raise wage rates in that industry, which in turn will draw workers from other occupations into it. The reduced supply of workers in, say, the food service industry will raise the equilibrium real wage in it. Hence the cafeteria workers will earn a higher real wage, not because of harder work or training, but because of capitalists investing in auto plants.

F. A NOTE ON OVERT AND TOTAL WAGE RATES

From the employer's point of view, the *total wages* he or she pays cannot exceed the worker's DMVP. Thus an increase in pension contributions, health care premiums, or other perks will decrease an employee's take-home pay, *ceteris paribus*.

G. THE "PROBLEM" OF UNEMPLOYMENT

In contrast to the charges of Keynes, economics does not "assume" full employment. Economics *deduces* that individuals can always "get a job" if they are willing to work for a sufficiently low (possibly negative) wage rate. Thus it is not *jobs* that are the goal, but *high-paying* jobs, and in order to achieve this goal we need capital accumulation (to raise the DMVP of labor), not government "pump priming."

3. *Entrepreneurship and Income*

A. COSTS TO THE FIRM

Prices determine costs, not vice versa. (Recall that the "costs of production" are largely the *prices* of factors.) The plethora of cost curves in mainstream texts assume fixed factor prices, and cannot explain the emergence of prices because they proceed from the viewpoint of an individual, "price taking" firm.

Average costs per unit may vary with the level of output because of indivisibilities in factor inputs.

B. BUSINESS INCOME

A business owner's gross income consists of: (a) interest on capital invested, (b) (implicit) wages for his managerial tasks, (c) rents of ownership-decision, and (outside the ERE) (d) entrepreneurial profit or loss.

C. PERSONAL CONSUMER SERVICE

Certain entrepreneurs (such as doctors and lawyers) sell their labor directly to the final consumer. These people are self-employed and earn a wage only in the implicit sense.

D. MARKET CALCULATION AND IMPLICIT EARNINGS

Implicit earnings can only be computed if there are *explicit* prices on an actual market with which to compare one's gross income from a given activity.

E. VERTICAL INTEGRATION AND THE SIZE OF THE FIRM

If a hypothetical firm were to merge with all other firms, there would no longer be a market for the various factors and hence its owner(s) could not calculate the relative profitability of various lines. Such a chaotic situation would never persist on a free market. Socialism is just a special (important) case of this more general phenomenon.

4. *The Economics of Location and Spatial Relations*

The same price will emerge for the "same" good, but this is defined from the point of view of the consumers. Thus an orange-in-Florida is not the same good as an orange-in-New-York, and hence the prices for oranges may differ in the two regions. Production centers will not be located merely on the basis of technical efficiency; the cost of transporting the goods to the final consumers must also be considered. Also, the money wage rates in an area with a high "cost of living" may adjust accordingly.

5. *A Note on the Fallacy of "Distribution"*

In contrast to the approach of the classical economists (particularly Ricardo), modern economics recognizes that there is not a two-fold process in which goods are first produced and then "distributed." Rather, goods are produced *and distributed* at the same time; if one alters the incentives facing producers (such as who gets to consume what), then this may upset the total size of the "pie" overall. It is true that richer individuals have a greater say in determining the course of production, but their greater wealth is itself a result of prior market activities. On a free market, all wealth is achieved through prior acts of homesteading, production, or receipt of a gift.

6. *A Summary of the Market*

Study Guide to Rothbard's Man, Economy, and State
by Robert P. Murphy

In the ERE, the Austrian economist can explain the height of all market prices in a logical fashion. Consumer valuations determine the marginal utility of consumer goods, which ultimately determine the prices of these goods. The rental prices of land, labor, and capital factors are then determined on the basis of these prices, and the technological recipes of production, by computing the DMVP of a productive factor. The pure rate of interest is determined by the time preference schedules of individuals, and this rate is used to compute the capitalized present value (i.e. asset price) of durable goods, based on their known future rental prices.

Outside the ERE, actual market prices will *tend* toward these final values. Uncertainty due to changing conditions will always leave open the possibility for forecasting errors. Profits will accrue to those entrepreneurs who best deploy scarce resources for the satisfaction of consumer desires.

NOTABLE CONTRIBUTIONS

- Although he mentions his debt to Böhm-Bawerk, Rothbard's discussion of "ultimate-decision-making ability" (pp. 602-603) is fairly unique.
- Rothbard takes care to distinguish the Austrian view of rent and cost from the Marshallian notion of "quasi-rents" (pp. 558-559) and the typical mainstream obsession with cost curves (pp. 588-592).
- Rothbard generalized Mises' calculation argument to show that it applies even to "private" integration of industries. (p. 615)

TECHNICAL MATTERS

- Some economists argue that the case of a backward bending supply curve of labor is an example of the elusive "Giffen good." If we define the price of the good *leisure* as the wage rate, then a backward bending supply curve would mean that (at least in certain regions) a higher price of leisure leads to consumers buying more of it, an apparent violation of the Law of Demand for the leisure good.
- The "market socialists" responded to Mises' challenge by showing how, with the stipulated technologies, resource supplies, and consumer preferences, a central planner could identify optimal production plans using Walrasian analysis. Hayek admitted that this solution was valid in theory, but claimed that practically it would be impossible to implement due to the volume of equations, and the difficulty of actually transmitting the relevant knowledge to the planners. Rothbard and others have rejected this "concession" and insist that even in principle, the central planners could not calculate without market prices for the means of production.
- Someone like Keynes would object to Rothbard's claims (pp. 581-588) that large-scale unemployment is impossible on a free market, and that more workers can always be hired at lower wage rates. Keynes argues in the *General Theory* that this "classical" (his term) view overlooks the empirical fact of widespread "involuntary" unemployment during the 1930s, and that it overlooks the possibility that workers in the aggregate will be unable to lower their *real* wage demands. Roughly, Keynes argues that any individual worker can agree to work for lower money wages (and hence real wages), but if *all* workers agree to, say, a ten percent wage cut, then this lowers the amount of purchasing power in the hands of consumers, and prices may also fall by a large amount; hence the real wage of the workers may not fall. (Of course this note is not meant to endorse Keynes' analysis.)

STUDY QUESTIONS

- (1) Rothbard says that a rising population will, on the one hand, tend to lower wages because of falling MVP, but that this tendency can be overcome by the enhanced division of labor. Does the same apply to capital goods? Is there an “optimum” amount of capital goods? (pp. 561-562)
- (2) Could there be a backward supply curve for a land factor? (p. 574)
- (3) Rothbard says that “*psychic* wage rates will be equalized...being equal to money wage rates plus or minus a psychic benefit or psychic disutility component” (p. 576). Does this principle involve an interpersonal utility comparison?
- (4) Rothbard says that a small scale firm may not be able to compete with a larger one when using a machine below its efficient scale of output. But why isn't there an analogous problem for a big firm forced to operate machinery *above* its ideal output level? (p. 597)
- (5) Why would someone earn a rent for his “ultimate-decision-making ability” even in the ERE? (p. 604)
- (6) Why does Rothbard classify a servant as self-employed? (p. 605)
- (7) Suppose a firm can buy a third-order good for \$100 and sell the *first*-order good two years later for \$121, and that each stage of production takes exactly one year. Suppose further that second-order goods sell for \$115. If the rate of interest is 10 percent, is this firm maximizing its profit? (pp. 610-611)
- (8) Could a certain city be identical to another, except that all money prices were double in the former? After all, doesn't Rothbard argue that money wage rates adjust for differences in the prices of various consumer goods? (p. 619)
- (9) If a certain manufacturing plant is located closer to a population center, does that mean its owners will earn higher profits than the owners of a plant located farther away? What if we further stipulate that the production technologies are identical? (p. 622)
- (10) Why must one *first* determine the rate of interest before computing prices of tractors? (p. 625)