An Introduction to Austrian Economics

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Part 2

The Rationalizing Effect of Monetary Calculation

Max Weber already attributed to the tool of economic calculation the dominant rationalizing influence in the technological development of Western capitalism. The instruments of money and monetary calculation are the means by which versatile and diversified resources can be rationally allocated to the satisfaction of urgent wants and the advances of technology depend on this.

The limits of economic calculation concern things that cannot be bought or sold such as a commitment to good character, human life, objects with sentimental value, etc.

Coordinative Communication Through Market Prices

Money prices functions not just as a common denominator, but also are the medium through which the communication of necessary information is made to coordinate effectively the actions of individual planners. *Example: suppose there is a sudden shortage of some resource. The people who will eventually solve the shortage don't need to know anything about its cause. The price of a unit will be driven upwards as those who employ it in the most important usages, i.e. use it for the generation of products promising the highest returns, outbid the producers who plan to use it for less remunerative products. The higher price causes the curtailment of the employment of the resource in its marginal uses. The higher price also induces a search on the part of the suppliers to increase the available supply of the resource, and if this is successful the price of the good will decrease. So participants only need to know very little (price) in order to coordinate their diverse plans.* Pretty cool.

4. The Subjective Theory of Value

Satisfaction and Valuation

Valuation consists in preferring a particular increment of a thing over increments of alternative things available; its outcome is the ranking of definite quantities of various goods and services with which the individual is concerned for purposes of decision and action (= *value scale*) A person will necessarily select the alternative that he believes will yield him the greatest satisfaction. Satisfaction (and hence value) is subjective and not open to numerical measurement. Satisfaction does not entail "selfishness" and it can change constantly.

The Principle of Marginal Utility

Choice and decisions are not concerned with *the whole supply* of a good, but only with definite quantities. *The law of diminishing marginal utility* says that each additional unit of a good is devoted to a use that is less important than the use to which the preceding unit was applied. This is a logical, not a psychological or physiological law. From this law follows another one: the value of any unit of several units held of a given good is equal to the satisfaction that would be sacrificed if one unit were lost.

This solves the diamond/water paradox (why are diamonds more expensive when water is more important?) The relative abundance of water as compared with the availability of diamonds means that increments of water can be devoted to less and less important uses than those to which the limited amount of diamonds can be put.

If the amount of a good with which one is concerned is enlarged to encompass several of the smaller "units" (say you are required to give up 3 sacks of grain) then the larger amount becomes the marginal unit and its valuation equals the sum of the various satisfactions that the larger amount would yield if broken down into incremental usages (the three uses that the three individual sacks of grain were for)

If the supply of a good is so large that some units go unused its marginal utility is zero and the good can be expediently considered a “free good”.

Value and Exchange
Since in a modern economy most goods and services are produced for other people than the producers themselves units of goods and services take on *exchange value* in addition to the use value they may have for the producer. A unit of agiven good then derives its exchange value from the subjective value that is identified with the amount of some other good that can be obtained in exchange for it. Whichever value is highest of exchange or direct use value is the controlling value for decision and action.

Uses of Money
When money is fiat money its direct use value will be virtually zero (one can burn it for warmth). When it is commodity money it can have considerable use value (e.g. jewelry). A specific quantity of money can be immediately used for:

1. expenditure necessary to acquire another good/service to be used for consumption
2. … to be used in the productive process of effecting or fabricating a new good
3. adding to one’s cash balance to help pay for future exchange transactions

The principle of diminishing marginal utility also applies to money, and because of the particularly easy divisibility of money such allocations are made in more incremental steps than is the case with other commodities. The marginal utility of money equals the least highly valued use that the given unit serves.

Use and Exchange Value in the Market Economy
In the market economy , characterized by the production goods and services for subsequent exchange by a common medium of exchange both use and exchange values are a vital part of the economic process, because for the ultimate users of goods and services, the consumers, the satisfaction arising from consumption is the source of value or utiliyy. The exchange value of any productive good then is ultimately based on the use value that consumers attach to its end product.

The Pervasiveness of Subjective Valuation
As is clear from the above subjective valuation underlies all economic activity. Exchange only occurs because of differences in subjective valuations. The failure to consider this subjective orientation led to the unfortunate notion of the “economic man” that depicted every participant in the market as relentlessly seeking at every turn to maximize his monetary position. But what people actually seek is a maximum of *psychic* or subjective profit.

Not only is money not the only thing that matters for people, people do also not calculate monetarily in utmost detail every step and decision. Time and energy used in monetary calculation are scarce too, so “Be no more accurate than it pays to be”.

It can be stated however that all other things being equal people do strive to maximize their monetary position in choosing among alternative courses of action, because with more money they can acquire more of the goods they want than with less. A person will accept less money only when the nonmonetary factors offset the satisfaction associated with money.

5. The Market and Market Prices

The Nature of the Market
The market is nothing over and above the outcome of purposive action on the part of individuals seeking to improve their own state of affairs. It is a process, not something physical. Prices are the result of subjective valuations expressed by individuals demonstrating their preferences through action.

Price Determination-Consumer Goods
The Demand Side

Suppose an additional unity of a given consumable good will rank higher than 6 units of money on an individual's value scale he will pay 6 units of money for one unit fo the good. Suppose that his value scale says that a second unity of the good is ranked between 4 and 1 money units, and for one money unit he is willing to buy a third unit of the good. Then at a price of 4,5 or 6 he will buy one unity, at a price of 2 or 3 he will buy two and at a price of 1 he will buy three. This way an individual hypothetical demand curve can be drawn for each particular good that he might consider buying at a certain moment. It will, due to diminishing marginal utility, be downward-sloping to the right. The total demand for a particular good becomes the summation of each prospective consumer's individual demand. While the marginal utility of the good continuously falls with each added unit, the marginal utility relating to the remaining money rises.

The Supply Side

Each individual producer with a certain stock of consumer good ranks the units of the good in the same manner that a prospective consumer ranks his money.

The producer can 1) use the good directly, 2) sell it for money, 3) retain the good for future sale. He will place subjective valuations on these different possibilities devoting the various units to the most important usages. If there is little value in not selling his entire supply of goods his supply curve will be more or less vertical. Otherwise it will be upward-sloping to the right, indicating that as some units are sold the marginal utility of the good increases in terms of the value of alternative uses, thereby requiring more money in exchange for additional units. If six units of money is more valuable than each of his eight units in stock he will sell them all at that price. But if at a price of 4 he may only sell 3 of the units as the marginal utility of the good for him in other uses increases and that of money decreases.

The Tendency Toward Equilibrium Prices

Prevailing prices tend toward that price at which quantity supplied and demanded are equal, a movement that attests to the price system's capacity to coordinate the actions of persons engaged in different activities. Any price below or above this *equilibrium price* cannot persist because such a price will result in either a) frustrated sellers or b) buyers who can either a) lower or b) bid up the prices so that they can either a) clear the quantity offered or b) entice sellers to offer a higher quantity.

The same holds for *rents*, prices paid for the service units obtained through the right to use someone else's property over a period of time. There is a connection between the expected rental prices in the future and the purchase price of the good as a whole: if the present value of expected future rental is greater than the price of the good as a whole more peoiple will want to buy, and owners will be more reluctant to sell, so that the price will go upward so as to become equal to the present value of expected future rental.

In all this it should be kept in mind that goods are *subjectively* judged as being of the same type. There is no *objective* way, in physicalist terms for example, to say that two goods are of the same type.

It is also important to note that the movement toward market equilibrium prices is a tendency that seldom reaches fruition because of continuous changes in people's subjective valuations and in the supply of each good. The essence of action is change. The changeability of prices makes inappropriate any reference in the strict sense to prices as *current* or *present* prices. Also, recent past prices are useful starting points in the projection of future prices but it is only the latter that are of significance to each actor and the former convey no direct knowledge about the latter.

The Irrelevance of Past Costs

Economic analysis needs to make no reference to the seller's money costs of production. The individual seller's costs were shown to relate to his subjective value scale (opportunity costs). Once the goods have been produced his past money costs are irrelevant to deciding how to use these goods. So it is wrong to say that prices are determined by demand and by money costs.

The Preeminence of Consumer Valuations

In the final analysis it is the subjective valuations of consumers that are the principal factor in the determination of market prices of consumer goods in the advanced market economy. Since a specialized seller will have little to no direct use value for his products he will base his decision on what to do on the current or future exchange value and his time-preference.

6. Production in an Evenly Rotating Economy

In our economy the decisively preponderant form of economic activity is the production of intermediate (capital) goods as opposed to final consumption goods.

Resource Pricing in an Evenly Rotating Economy