

# Interest: In Defense of Mises

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## **Abstract**

This paper evaluates Guido Hülsmann's attack on Mises's theory of time preference and market interest. It argues that his article is a mix of misinterpretation, questionable reasoning, and omission. It shows that Mises's theory of time preference does provide a solid basis for explaining market interest, that (consistent with Mises) market interest contains both a time preference and an entrepreneurial component, and that Mises provided a procedure for disengaging these two components.

In a recent paper, Guido Hülsmann (2002) advances the revolutionary idea that Austrian economists ought to base their concept of originary interest on the spread between the value of an end and the value of the means used to achieve the end. He points out that this idea stands in opposition to Ludwig von Mises's argument that the concept should be based on the assumption of time preference, as presented in *Human Action* (1966). He also argues that whereas his idea enables one to link originary interest, as he defines it, to market interest, Mises's idea does not. Hülsmann uses most of his paper to articulate his new idea. The first part of his paper, however, is largely a critique of Mises's theory. The critique reaches particularly damning conclusions. He argues that Mises's claim of the universality of time preference is flawed and that his concept of originary interest is based on an assumption about physical productivity. In addition, he argues that Mises's concept of originary interest based on time preference does not allow one to deduce that entrepreneurial competition will result in a positive rate of interest in the market economy.

The goal of this note is to demonstrate that Hülsmann's criticism of Mises is based on a series of misinterpretations and omissions. I demonstrate, by referring to the Misesian text, that time preference is a praxeological category (part 1) and that Mises's concept of originary interest is not based on an assumption about physical productivity (part 2). Next, I show that regardless of whether Hülsmann is correct about Mises's concepts of time preference and originary interest, the issue is not related to the central problem with which he is concerned – the derivation of market interest (also in part 1). Finally, I demonstrate that, contrary to Hülsmann, Mises did indeed show how entrepreneurial competition leads time preference and originary interest, which are present in all

decisions to consume sooner or later, to become a component of the market rate of interest (and therefore that originary interest in the market economy is positive). Part 3 discusses: (a) the deduction of positive market interest from the assumption of time preference and originary interest in individual action and (b) the disengagement of originary interest in the market economy from what Mises called the gross market rate of interest. Part 4 continues the theme of part 3 by showing how the assumption of praxeological time preference combined with competitive entrepreneurship explains the spread, in a market economy, between the price of a consumer good and the sum of the prices of the resources used to produce it. Part 5 contains a brief conclusion.

## **1. HÜLSMANN'S CRITIQUE OF THE TIME PREFERENCE THEORY**

Hülsmann claims that Mises adhered to “a consumption theory of time preference” in contrast to a praxeological theory. Such a theory, as Hülsmann presents it, “holds that time preference is caused by the necessity of consumption” (Hülsmann: 79). He claims that his view is supported by textual evidence, he presents an argument intended to demonstrate that time preference is not a category of action, and he argues that Mises did not adequately defend his treatment of the cases of people who allow themselves to die. We discuss each argument in turn. Then we point out that the whole exercise is irrelevant to his claim that time preference does not provide a sound basis for comprehending interest in the market economy.

## Textual Evidence

Hülsmann's claim to the contrary, the textual evidence suggests that Mises did not hold a consumption theory. Hülsmann describes this theory as follows:

Fact is that human beings could not survive if they did not consume. Hence, there must be some time preference in human action, lest the human race would perish. This does not mean that human beings must consume through every single action, so that time preference would be the only factor determining their actions. Rather, it means that in order to survive human beings must, at some point, prefer shorter production processes to longer ones, even though the longer ones are more *physically productive* (*ibid.*: 79-80, italics added).

Unfortunately, Hülsmann's interpretation of Mises's words are presented in a way that defies direct verification by a reader who is not conversant in German. First, one set of statements to which he refers is in the 1940 German edition of *Human Action*, but Mises deleted it from the English editions. Second, Hülsmann does not quote any statements from the 1940 edition but merely refers the reader to two pages of text (see his footnote #4 on page 80). (Beyond that, he says that the statements are made in a discussion about the errors made by other writers.) Thus, one who does not have access to the German edition or who does not read German cannot be certain of Hülsmann's references.

Nevertheless, there is an English translation available of most, if not all, of the passages to which he refers.<sup>1</sup> The translation suggest that Hülsmann's claim is not based on what Mises's says about his theory. Indeed, it appears to contradict what Mises says. One assumes that Hülsmann is referring to the following passage, as translated:

Böhm-Bawerk therefore merely arrived at the conclusion that "as a rule" future goods have a lower value than the same kind and quantity of present goods. But that is not a satisfactory

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<sup>1</sup>See Greaves (1974): 156-157.

explanation. Are there exceptions to this rule? If there are, what significance do they have for explaining interest? Might the exceptions not become the rule under certain circumstances and interest than disappear entirely?

No, there are no such exceptions. In acting, one must always, without any exception, value a satisfaction at an earlier point in time more than the same kind and amount of satisfaction at a later time. If this were not so, then it would never be possible to decide in favor of a present satisfaction. Whoever uses or consumes anything, whoever seeks by acting to relieve to a greater or lesser extent a felt uneasiness is always expressing a preference for an earlier over a later satisfaction. Whoever eats and consumes anything is making a choice between a satisfaction in the immediate future and one in a more distant future. If he were to decide differently, if he were not to prefer the earlier to the later satisfaction, he would never be able to consume at all. He could not even eat and consume tomorrow, because when tomorrow became today, and the day after tomorrow became tomorrow, the decision to consume would still call for valuing an earlier satisfaction more than a later satisfaction. Otherwise, consumption would have to be delayed still further (*ibid.*: 156-157).

In reading this passage, one searches in vain for some statement about the necessity of survival or the possibility that the human race will perish. One's search of the pages in *Human Action* also ends in frustration. So far as one can determine, Mises does not say that the necessity of survival is the basis for his theory of time preference. On the contrary, he bases his theory on the assumption that actors space their consumption over time. What Hülsmann appears to do is to infer the requirement of survival from the fact that someone who delays all consumption indefinitely would not consume. But that is not enough to support the contention that Mises's time preference theory is based on the need to survive.

### **Universal Characteristic of Action Versus Universal Characteristic of Choice**

Hülsmann believes that time preference is not a universal category of action. To support his claim, he presents three examples: the warrior, the martyr and those who aim to commit suicide (*ibid.*: 80-81). These people prefer death or action that risks death over consumption and they choose accordingly. The warrior values risking his life in battle higher than not risking his life. The martyr values dying for a cause higher than living if living does not further his cause.

The suicide prefers death to life. Be that as it may, these people still presumably possess the category of time preference. Presumably, they could delay their actions. By choosing the lot of the warrior, martyr, or successful suicide today, an individual indicates that he prefers to die *sooner* rather than *later*.

In citing these examples, Hülsmann makes the error of assuming that every choice must be explicitly related to time preference. Consider a more common example. Every day, I choose tea over coffee without any direct consideration of time preference. But time preference is still the fundamental consideration in my choice to consume one of these at the moment rather than later.

### **Rejection of the Boundary Between Action and Non-Action**

In the process of presenting his argument, Hülsmann discusses cases of individuals who “are not inspired by the desire to survive” (*ibid.*: 80). Mises introduces three examples that he suggests critics might use to try to refute the time preference theory. The cases are (1) a miser who withers away because he saves so much that he does not have enough to eat in the present, (2) a person who is so afraid of morbid germs that he dies from malnutrition either because he thinks that germs are a greater threat to his life than starvation or because he does not correctly compare the risks,<sup>2</sup> and (3) a person who commits suicide because he mistakenly thinks that he will be better off dead than he will if he risks the accidents that will befall him while he sleeps

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<sup>2</sup>Mises does not actually say why he chooses not to eat, but these are the logical explanations from the context.

(Mises: 490). Hülsmann criticizes Mises for maintaining that such choices represent “ a pathological withering away of vital energy” (Hülsmann 80).

The key to understanding Mises’s meaning appears to lie with the concept of “vital energy.” Mises’s statements about this concept suggest that there is no clear dividing line between the exercise of vital energy, which implies action, and the non-exercise of that energy, which implies mere physiological functioning (Mises: 131). By “withering away,” Mises seems to have in mind a being who is on the verge of crossing this uncertain dividing line. What Hülsmann seems to have done is to identify a minor problem with the definition of action used to derive the praxeological categories – a problem that Mises acknowledged. But this is not sufficient grounds for denying the categorial nature of time preference.

### **Irrelevance of the Issue**

A puzzle raised by Hülsmann’s criticism of the time preference theory is why he thinks it is important. The main goal of his criticism of Mises is to support the claim that Mises’s concept of originary interest does not provide a sound foundation for comprehending interest in the market economy. But a consumption theory of time preference can accomplish this just as well as a praxeological theory. To see this, suppose that Hülsmann is correct that Mises held a consumption theory of time preference. So long as the economy is not dominated by warriors, martyrs, and suicides; time preference would have to exist in it; and the market rate of interest would have to reflect the different evaluations of present goods with respect to future goods that people in the market economy exhibit.

Hülsmann's logic goes something like this. Consider a building inspector who hears the claim from a builder that his building will withstand a powerful earthquake because it is built of material X. The inspector inspects the building and judges that it is built instead of material Y. He concludes that the building will not withstand the earthquake but he fails to investigate the strength of the material Y.

In short, not only is the Hülsmann's criticism of Mises incorrect (the builder used material X after all), it really does not matter for his main argument whether it is correct or not. If this paper was an effort to evaluate the full logic of Hülsmann's argument, it would be appropriate to ask why he bothered to discuss Mises's time preference theory at all. However, the concern here is only with whether his critique is valid. The paper has shown that it is not.

## **2. IS MISES'S TIME PREFERENCE THEORY BASED ON THE ASSUMPTION OF PHYSICAL PRODUCTIVITY?**

Hülsmann's second criticism of Mises concerns an example Mises uses to refute those who contest "the universal validity of time preference." Mises writes:

Those contesting the universal validity of time preference fail to explain why a man does not always invest a sum of 100 dollars available today, although these 100 dollars would increase to 104 dollars within a year's time. It is obvious that this man in consuming this sum today is determined by a judgment of value which values 100 present dollars higher than 104 dollars available a year later (Mises: 486; Hülsmann 81).

Hülsmann interprets this by asserting that “Mises thus feels a need to explain why a man should not always prefer the more physically productive choice alternative in the future to a less physically productive alternative in the present.” He notes that Mises does not actually say this, but he believes that it is permissible to infer this from Mises’s statements. He goes on to claim that Mises confuses “the physical aspect of things with economic (value) aspect” (*ibid.*).

Hülsmann is wrong. Mises’s deduction that a person prefers a present good over a future good is based on the assumption that an individual compares things “of the same kind and quantity.”<sup>3</sup> “Of the same kind” means *of identical value in terms of satisfaction*, except of course for the time at which they are available. It is a value definition not a physical productivity definition.

Hülsmann apparently misunderstands the example and its context. The example refers to money because it is an effort to show that the capitalist saver in the market economy would not *always* postpone his receipt of money even though he could receive more money in the future by doing so. Hülsmann’s misunderstanding appears to be due to his failure to appreciate the significance of the term “always.” Mises inserted this term, one surmises, in order to confirm the notion that a person would always prefer *some* consumption in the present regardless of the future payoff, in whatever terms, to delaying consumption indefinitely. He could have been more articulate. He could have written the following: “Those contesting the universal validity of time preference fail to explain why a man does not invest *all* of his dollars for one year even though he

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<sup>3</sup>See Mises, 482-3, 524, and the example on 557. Also see his statement about comparing the values of satisfaction in his discussion of capitalist saving on p. 486.

can earn a positive rate of interest.” Mises’s discussion of a miser is consistent with this interpretation. He writes that the miser “too, in spending some of his means for a scanty livelihood, prefers some amount of satisfaction in the nearer future to that in the remoter future” (Mises: 490). He does not *always* delay all of his consumption to the indefinite future, no matter what the payoff in terms of perceived satisfaction.<sup>4</sup>

Finally, we must note that this criticism, like the one that claims that Mises held a consumption theory of time preference, is irrelevant to the main issue. So long as time preference is present in individuals acting in the role of consumers, it will get reflected in the spread between the market price of the good and the market prices of the resources used to produce it. So let us proceed now to the issue that is of the most concern to Hülsmann.

### **3. DID MISES SHOW HOW TO DERIVE MARKET INTEREST FROM PRAXEOLOGICAL TIME PREFERENCE?**

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<sup>4</sup>That said, I must express my reservation over this example, since Mises is assuming that the investor sometimes chooses not to invest his money for one year because he desires to consume. In other words, he acts as a consumer. He writes about the man consuming his sum of money today. A more appropriate way to deal with capitalist saving is to say that if every capitalist invested in projects that did not yield a return until after one year, there would be no money left to finance projects for which the period of provision is less than one year. This is more appropriate because Mises himself says that he wants to demonstrate time preference for the case of *capitalist* saving, since he has already demonstrated it for the case of *plain* saving.

Hülsmann offers his new theory of originary interest to replace Mises's theory, which he claims does not explain (or, more correctly, is incapable of explaining) originary interest in a market economy. He writes:

[The] great shortcoming [of Mises's theory] is that it does not explain the difference between the price of a product and the sum of the prices of its factors of production, that is, it does not solve the fundamental problem at stake in interest theory. While Mises's time preference theory is valid as far as it goes, it does not explain the origin of money interest, and therefore it can at best be a secondary element of the theory of interest (Hülsmann: 84).

In defending this claim, he argues correctly that time preference, in Mises's writings, is derived from the individual decision to space out his consumption over time. However, the explanation one wants is of interest under market economy conditions. He sees no way to make the transition from the former to the latter.

### **From Time Preference to Market Interest**

Did Mises show his readers how to make the transition from time preference as a praxeological category (i.e., as present in an isolated actor) to the existence of market interest? Contrary to Hülsmann, the answer is yes. I begin by pointing out that there is one set of conditions under which market interest would not emerge even though there are many actors who are allowed to freely exchange. (1) If every actor had identical wants, including time preference, (2) if every actor perceived identical opportunities through time to satisfy them, without exchange, and (3) if no actor perceived advantages from specialization; there would be no markets, prices or market interest. There would be time preference and originary interest, but no market interest.

The presence of time preference, in a market economy context, leads to market interest partly because everyone does not value goods, or the legal rights to those goods, according to the same time frame. Even if every otherwise self-sufficient actor had identical opportunities to consume goods through time, some would give up some goods today because others would pay market interest to borrow them. To express the aspect of market interest that is due to time preference, Mises used the term “discount of future goods as against present goods” (Mises: 527). He writes that discounting differs as among individuals and it is uneven (*ibid.*: 536).

Market interest cannot be logically derived solely from individual time preference or individual discounting. The conditions of the market economy must also be assumed and there must also be differences among individuals in either time preference or in their non-exchange opportunities to consume goods over time. Market interest emerges through exchange – borrowing and lending. Once markets are established (i.e., in established markets), market interest “contains” an element of what Mises called the discount of future goods. The time preference which is present in every individual gets manifest in a form that could never exist in the isolated actor – the “social” discount of future goods.<sup>5</sup> This happens through market interaction; or, in different terms, it emerges through entrepreneurial competition.

## **Disengagement**

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<sup>5</sup>This discount, as it exists in the market economy, is probably best called a “social rate of discount,” although this term is easily misunderstood. Mises uses the term “discount of future goods” in Chapters 19 and 20 of *Human Action*.

This is the logic behind the deduction that the market interest rate contains an element of time preference and originary interest. Originary interest, based on time preference, must exist in a market economy where there is borrowing and lending. This is evident from the fact that a market economy, by definition, contains human actors with different time preferences. But the problem remains of how to disengage the originary interest component from other components of what Mises called the gross market rate of interest (*ibid.*: 539-545). This is equivalent to the problem of showing how entrepreneurial competition plays a role in causing originary interest to be part of the market interest rate. Mises clearly recognizes this problem and regards it as important (*ibid.*: 535-6). To disengage originary interest, it is necessary to understand that the gross rate contains an entrepreneurial component (*ibid.*: 539-541). The originary interest component and entrepreneurial component can only be disengaged by means of a procedure that entails using the imaginary construction of the evenly rotating economy (*ibid.*: 536).<sup>6</sup>

Thus, the existence of praxeological interest does imply the presence of interest in the market economy. Mises outlined a procedure that can be used to demonstrate this and another procedure to disengage originary interest in the market economy from entrepreneurial profit and loss. One might dispute the latter procedure, but Hülsmann claimed that Mises failed to address

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<sup>6</sup>Mises's explanation of why this is necessary seems to me to be incomplete. It refers to an assumption that we must "assign in the frame of [the evenly rotating economy] a role to the operation of forces which bring about [the maintenance of capital goods]" (*ibid.*: 531). But he does not explain why we must assign this role. The reason we must do so, in my view, is that we aim to depict a market economy in which people plan for the future by producing resources. So we need the assistance of an imaginary robot economy in which such planning is simulated by the presence of "capital maintenance." In such a market economy, interest performs the dual function of allocating goods as among the various time periods and of providing an incentive to produce resources ("capital goods"). Mises's incomplete explanation may partly explain Hülsmann's apparent dismissal of Mises's discussion surrounding the gross market rate of interest (Hülsmann: 102n).

the issue. This suggests that he did not carefully examine the Mises text. Further evidence of this is that Hülsmann's paper contains no relevant reference to any of Mises's extensive discussion of market interest.<sup>7</sup>

One final point before concluding this part. In his paper, Hülsmann poses a hypothetical.

He writes:

[L]et us simplify the whole question and assume, for the sake of argument, that Mises...believed there was no value spread between means and ends (Hülsmann: 89).

No one who is familiar with Mises's writings on this issue would make this assumption, even in a hypothetical. Mises stated repeatedly that the spread between the price of the product and the prices of the resources used to produce it are equal, except for time preference or originary interest. A search of the terms "time preference" and "interest" in *Human Action* reveal statements that contradict the Hülsmann's assumption on the following pages: 295, 329, 334, 383, 524, 525, 601, 625, 637, 643. More telling is that Mises states this assumption and explicitly rejects it in his discussion of the imputation procedure (*ibid.*: 334-335).<sup>8</sup>

#### **4. HOW PRAXEOLOGICAL TIME PREFERENCE AND COMPETITIVE ENTREPRENEURSHIP EXPLAIN THE SPREAD**

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<sup>7</sup>As pointed out above in footnote 9, he refers to Mises's passages on the gross rate of interest but does not discuss them.

<sup>8</sup>Incredibly, Hülsmann quotes a statement from this section. He quotes Mises as saying that the price of the consumer good equals the prices of the resources used to produce it only if "due allowance [is] made for time preference." Hülsmann somehow interprets this statement as evidence that Mises did not include a "value spread between ends and means." See his footnote 13 and accompanying discussion.

Suppose that actors in the market economy did not possess time preference in the sense that Mises used this concept. Then they might want to consume all the goods they could possibly consume as soon as possible. Or they might want to delay all of their consumption until the indefinite future. Whatever, they would have no reason to space out their consumption over time. If consumers wanted to consume all possible goods as soon as possible, entrepreneurship would have no incentive to delay any production. It would devote all resources of whatever kind to the production of goods for the immediate future, including goods that would satisfy the wants of those who expect to receive entrepreneurial income. There would be a spread between costs and revenues but the spread would not reflect time preference. This is because there is no time preference to reflect. A consumer sense of “sooner or later” is not present.

Now suppose that consumers wanted to delay all consumption to the indefinite future. In this circumstance, entrepreneurship would have no guidance since it would not have a clue about when consumers would buy goods that it might produce.

In a world with time preference, a guide exists. We can comprehend this guide by assuming time preference and further assuming that all producers initially make the error of employing resources in the production of goods only for the most immediate future. Under these circumstances, a single producer who recognizes that there would be a demand for his product in the future could earn high profit compared with the others. On the other hand assume that all producers embarked on production projects that would yield consumer goods only in the distant future. Then a producer who chose to produce for the nearer future could earn high profit. The

reasons for the profit are (a) the fact that demand reflects time preference which requires that consumption be spaced out over time and (b) the availability or lack of availability of loan funds at an interest rate that makes it profitable to adjust to the social discount rate.

To what element, then, should we attribute the spread between the costs of production and the prices of the product. To entrepreneurship, to be sure. But the specific valuations of market-produced present goods in relation to future goods, (which in conceptual form is what Mises means by originary interest), guide entrepreneurship in its choice to allocate resources as between the production of consumer goods for nearer or farther distant future consumption. These valuations are a manifestation of time preference. The spread thus contains two elements, or components: originary interest and entrepreneurial profit and loss.

## 5. CONCLUSION

In the paragraph that concludes the critique of Mises, Hülsmann writes about the relationship between Mises's time preference theory and originary interest in the market economy:

Mises's time preference theory of interest does not explain why there should be, under any set of circumstances, a systematic relationship between time preference on the one hand, and the spread between selling receipts and cost expenditure on the other hand. It does not explain why the interest rate should ever be positive rather than zero or even negative. It does not even get to the point of explaining why interest does not tend to become eradicated through entrepreneurial competition. And it therefore does not give us any reason to believe that there is a factor that systematically causes interest rates to be positive. By its very nature, Misesian time preference cannot account for price spreads. It can only account for the value differential between the actual use of a good and the counterfactual (unrealized) future uses of the same good (Hülsmann 85).

It appears on the basis of the textual evidence and arguments presented in this paper that nothing in this paragraph is accurate. That Hülsmann would reach this conclusion can be attributed to two factors. First, he employed a non sequitur argument leading him to conclude that an alleged flaw, or limitation, in Mises's time preference theory negated all of Mises's writings about market interest. Second, he did not read Mises's writings about market interest, thereby making it impossible for him to comprehend the procedure Mises recommends for building an image of a market economy that contains time-preference-based market interest.

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