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The Praxeological Foundations of the Employment Compact: Where the Firm Fits Into Austrian Economics

A number of neoAustrian economists have recently become interested in the employment compact. Austrian economics, they contend, lacks a theory of the firm. They point out that the modern theory of the economic firm, which derives mostly from Ronald Coase's 1937 paper, is not only compatible with Austrian economics but may enrich it. This paper agrees with this thesis. Its contribution is twofold. First, using the Misesian, praxeological-based economics based on a *price-quantity approach* to the market economy as a reference for mainstream Austrian microeconomics, it proposes a more comprehensive *transactions approach*, which includes a theory of the employment compact. Second, it explains why Mises did not use this approach and tells why it should be used today. In the process, it also tries to explain why the Coasean employment compact was not integrated sooner into the Austrian theory of value and cost.¹ Correspondingly, it attempts to provide some guidance on how future professional economics may contribute to the development and enrichment of the Austrian economics program.

The paper is organized into five parts as follows. Part 1 describes praxeological economics by reiterating two crucial methodological points made by Mises: (1) that the goal of economics is to evaluate arguments concerning market intervention and (2) that praxeological economics uses logic to accomplish this, although it directs it logic to the conditions of reality that are assumed in the argument being evaluated. It is necessary to appreciate these methodological points in order to understand why Mises did not take a transactions approach to markets and, accordingly, why the employment compact played such an insignificant role in his economics. His attention lay elsewhere.

¹It is well known that Coase's original article was published in *Economica*, a journal edited by F. A. Hayek.

Part 2 explains why a transactions-based approach to markets is more suitable to the praxeological economics of today. Part 3 presents the praxeological theory of market transactions in general form and tells its origins. Part 4 describes the special status of the employment compact in this theory. Part 5 ends with a brief conclusion.

1. Methodological Points

Mises argued that the aim of economics is to use economic logic and considerations of relevance to evaluate ideologies and policies that proponents claimed would benefit certain individuals, or a large majority, by means of market intervention. By doing this, economics could remain value free. Men "must fight error by unmasking spurious doctrines and by expounding truth" (*ibid.*: 185).²

The Goal of Economics is to Evaluate Interventionist Arguments

"The main objective of praxeology and economics," Mises declared, "is to substitute consistent correct ideologies for the contradictory tenets of popular eclecticism" (Mises 1966: 185). Ideology goes beyond the study of things as they are. It is "about the ought, i.e., about the ultimate ends which man should aim at in his earthly concerns" (*ibid.*: 178). Ideology can be distinguished from the broader concept of a *world view*, which is

an interpretation of all things, and as a precept for action, an opinion concerning the best means for removing uneasiness as much as possible...Religion, metaphysics, and philosophy aim at providing a world view. They interpret the universe and they advise men how to act" (*ibid.*).

Ideologies may be of many types. Mises distinguished two classes: (1) asceticism and (2) non-ascetic ideologies. Economics is irrelevant to asceticism. It is relevant only to non-ascetic ideologies since these "must pay heed to the fact that *society* is the great means for the attainment of earthly

²Also see his statements on p. 93 about exposing "erroneous doctrines in the field of social action" and on p. 192 about the explosion of errors in current ideologies.

ends" (*ibid.*: 179, italics added). Given his definition of society, Mises asserts here that anyone who aims, through giving advice on public policy, to attain earthly ends -- or from a different point of view, any proponent of a non-ascetic ideology -- must recognize the gains of specialization and the division of labor.

Economics is intended to study whether such non-ascetic ideologies and the interventionist polices proposed by their advocates will achieve the "earthly ends" (*ibid.*: 182-5).

Regarding the evaluation of interventionist arguments, Mises provides a formula, or blueprint:

An economist investigates whether a measure *a* can bring about the result *p* for the attainment of which it is recommended, and finds that *a* does not result in *p* but in *g*, an effect which even the supporters of the measure *a* consider undesirable. If the economist states the outcome of his investigation by saying that *a* is a bad measure, he does not pronounce a judgment of value. He merely says that from the point of view of those aiming at the goal *p*, the measure *a* is inappropriate (*ibid.*: 883).

Regarding the specific case of government interference with prices, he writes:

Economics does not say that....government interference with the prices of only one commodity....is unfair, bad, or unfeasible. It says...that it makes conditions worse, not better, *from the point of view of the government and those backing the interference* (*ibid.*, p. 764, emphasis in original).

Logic and Relevance

The tool that one must use to evaluate interventionist arguments is logic. For the economist, the construction of logical arguments is not a simple pastime. Its aim is to help one deal with reality.

Logical thinking and real life are not two separate orbits. Logic is for man the only means to master the problems of reality. What is contradictory in theory, is no less contradictory in reality. No ideological inconsistency can provide a satisfactory, i.e., working, solution for the problems offered by the facts of the world. The only effect of contradictory ideologies is to conceal the real problems and thus to prevent people from finding in time an appropriate policy for solving them (*ibid.*: 185).

How do economists achieve the goal of combining logic with relevance in economics. To answer this question we must discuss the procedure that Mises recommended economists use to evaluate policy arguments. He begins by discussing the theory of action in general, since economics is a branch of praxeology (*ibid.*: 885). He writes that "[t]he first task [of praxeology] is to extract and to deduce...the concepts and theorems [that are] implied in the category of human action...to expound their implications and to define the universal conditions of acting" (*ibid.*: 64). The second is to "go further and define -- of course, in a categorial and formal sense -- the less general conditions required

for action" (*ibid.*). Because "the end of science is to know reality," praxeology "restricts its inquiries to the study of acting under those conditions and presuppositions which are given in reality" (*ibid.*: 65).

Now turn to economics. To present its results, economics "adopts...a form in which aprioristic theory and the interpretation of historical phenomena are intertwined" (*ibid.*: 66).

From the unshakable foundation of the category of human action praxeology and economics proceed step by step by means of discursive reasoning. Precisely defining assumptions and conditions, they construct a system of concepts and draw all the inferences implied by logically unassailable ratiocination" (*ibid.*: 67).

Mises writes that the method of building theories is that of imaginary constructions.

The specific method of economics is the method of imaginary constructions...This method is the method of praxeology. That it has been carefully elaborated and perfected in the field of economic studies in the narrower sense is due to the fact that economics, at least until now, has been the best-developed part of praxeology...The method of imaginary constructions is indispensable for praxeology; it is the only method of praxeological and economic inquiry (*ibid.*: 236).

The method of imaginary constructions is full of dangers. The method

is difficult to handle because it can easily result in fallacious syllogisms. It leads along a sharp edge; on both sides yawns the chasm of absurdity and nonsense. Only merciless self-criticism can prevent a man from falling headlong into these abysmal depths (*ibid.*: 236-7).

One must read this in conjunction with an earlier statement in his book about avoiding error in praxeology and economic theory. The way to avoid error in the use of an imaginary construct is to "trace back all theorems to their unquestionable and certain ultimate basis, the category of human action" (*ibid.*: 68).

Finally, Mises provides a very broad guide concerning how to proceed. The starting point is to build the imaginary construction of the pure market economy. Once this is done, the economist can proceed to evaluate various interventionist arguments:

Starting [with the conditions assumed in building the image of the pure market economy], economics tries to elucidate the operation of [this] economy. Only at a later stage, having exhausted everything which can be learned from the study of this imaginary construction does it turn to the study of various problems raised by interference with the market on the part of governments and other agencies employing coercion and compulsion (*ibid.*: 238).

Value Freedom

The goal of using logic to evaluate arguments enables economics to remain value free.³

[The] postulate of *Wertfreiheit* can easily be satisfied in the field of the aprioristic sciences -- logic, mathematics, praxeology [of which economics is a branch] -- and in the field of the experimental natural sciences. It is logically not difficult to draw a sharp line between a scientific, unbiased treatment of these disciplines and a treatment distorted by superstition (*ibid.*: 48).

2. The Price-quantity Approach of the Austrian Theory of Value and Cost

The aim of this paper is to show (1) whether a theory of the employment compact can enrich a praxeologically-based Austrian economics and (2) if so, how. The argument will turn on the kinds of interventionist arguments we aim to evaluate. Let us suppose that Mises's images of the pure market economy were exactly suited to evaluate the arguments with which he was concerned. Then, it stands to reason that if we aim to evaluate arguments different from those with which Mises was concerned, we may have to start with an image that is different from his. Of course, in such an image, every concept, including the employment compact, must be traceable back to the category of action. And, of course, we must demonstrate the relevance of such an image.

This paper contends that Mises confined his images to those that contain only price-quantity relationships because of his desire to evaluate the logic of two types of interventionist arguments: socialist-Marxist arguments and arguments for monetary intervention. He also found an image of only price-quantity relationships useful in clarifying an existing conundrum in economics -- the problem of separating profit from interest. Since his major use was to evaluate the socialist-Marxist arguments, this section focuses primarily on these. In the process of demonstrating how the price-

³Many authors in neo-Austrian economics have failed to appreciate the value freedom of Mises's economics. Many have mistakenly claimed that Mises used the welfare criterion of utilitarianism to support his evaluation of policy arguments. I discuss this failure in three papers (Gunning, 1998b, 2003a, 2003b).

quantity approach images helped Mises refute socialist-Marxist arguments, we shall also learn something about the praxeological method.

The Austrian Theory of Value and Cost

The image of the market economy used by Mises was based on the ATVC.⁴ It is a modern extension of what Mises labeled the theory of value, or subjective theory of value, which is a theory of the relations between the prices of goods of various orders. Mises described this theory in Chapter 4 of his 1933 book. It is worth quoting him at some length.

Mises writes that an important stage in the development of economics was the realization by classical economists that

every allocation of goods -- even those in the processes of production -- is an exchange, and consequently the basic law of economic action can be comprehended also in the conduct of the isolated farmer. Thus, the foundation was laid for the first correct formulation and satisfactory solution of the problem of the delimitation of "economic" action from "noneconomic" action. (Mises 1981: 146)

⁴A term that is more familiar to historians of economic thought than ATVC is the "marginal productivity theory of distribution." If one is writing about the period before Herbert Davenport's *Economics of Enterprise* (1914) and Frank Knight's *Risk, Uncertainty and Profit* (1921), they are virtually the same. Although a full comparison is beyond the scope of the present paper, some confirmation of this thesis is provided by Mises's reference to the methodological underpinnings of ATVC. The American originator of the marginal productivity theory was J. B. Clark, while the expert on the Austrian theory of value and cost during the same period was E. Bohm Bawerk. In describing the foundation of the procedure of economics, Mises refers to both in the same footnote. See Mises 1966: 254.

Some neoAustrians might scoff at the idea that ATVC is the same as the marginal productivity theory of distribution. Such skeptics should read Mises's statements about the theory of value beginning on p. 147 of his *Epistemological Problems*. Specifically, Mises writes:

The fact that production is discontinued beyond the point at which it ceases to be profitable means that production takes place only as far as the goods of higher order and labor required to produce one commodity are not more urgently [wanted] to produce other commodities (*ibid.*: 164).

It was this "opportunity cost" theory that made the Austrian theory superior to that of Walras and Pareto.

Within the field of modern economics the Austrian School has shown its superiority to the School of Lausanne and the schools related to the latter, which favor mathematical formulations, by clarifying the causal relationship between value and cost...The Austrian School must also be credited with not having stopped at the concept of cost, but, on the contrary, with carrying on its investigations to the point where it is able to trace back even this concept to subjective value judgments (*ibid.*: 165).

The term "exchange" as Mises uses it here, means "tradeoff." In this passage, Mises is mainly interested in helping his readers understand the history of the subjective theory of value. However, there is also an important methodological lesson. It is that to avoid error in building the image of the market economy, one should always be ready to show the analogy between the market economy interaction one is describing and the action of the isolated actor in using means to achieve his ends. It was only because Menger and others recognized this that they were led to make this "first correct formulation."

Mises wrote that in order to build on this foundation, economists had to overcome two problems. First, they had to recognize that the value of a transaction to a businessperson is derived from the value of the consumers' good to the marginal consumer. In other words, they had to recognize that costs and therefore the incomes received by owners and rentiers of the factors of production are ultimately based on the subjective valuation of the marginal consumers good via the appraisal of factors by business people who employ the factors to supply consumer demand (*ibid.*: 147). Second they had to overcome the materialism of their reasoning. One way to understand the materialistic influence is to consider the doctrine of "real cost." According to this doctrine, human beings are limited in their ability to satisfy their wants because of a limit to the material factors of production. According to the subjective theory of value, however, costs are nothing other than the subjective value of foregone alternatives. The limit to satisfying any particular want is not the lack of materials but the fact that businesspeople recognize that the materials can be used to satisfy a variety of wants.⁵ This "opportunity cost" theory made the Austrian theory superior to that of Walras and Pareto (see footnote #4 above).

In his later work, Mises referred to the theory of action and interaction in a market economy as *catallactics*, which he defined as "the theory of exchange ratios and prices" (Mises 1966: 327). The prices in this theory include those of goods and the factors of production. The developers of the

⁵See Mises, 1933, p. 164. A limit to satisfying wants in general is the want for leisure.

theory, according to Mises were Gossen, Carl Menger and Bohm Bawerk (*ibid.*: 334). This is the Austrian theory of value and cost referred to earlier in the paper.⁶

Error

ATVC contained no error because its purpose was to refute the socialist and Marxist arguments, which also assumed no error. As Israel Kirzner (1979 Chapter 4) and Eric Streissler (see *ibid.*: 55, note 9) have pointed out, however, Menger, the school's founder, was well aware of the potential for error, recognizing that market interaction in reality is always uncertain. Later expositors of the theory were also aware of this.

Use of the Theory by Austrians

Imputation

The original use of the ATVC theory was to refute the socialist and Marxist hypothesis that workers were exploited by capitalists. The error of the hypothesis is its focus on a single market for labor, while disregarding other markets. To refute the hypothesis, one needed to accomplish two tasks. The first was to recognize, as Menger had, that an isolated actor would only produce goods at higher orders in order to more economically obtain goods of the first order. The second was to build a grand image of an economy containing many goods markets and many factor markets. The latter need was satisfied by the grand image of the marginal productivity theory of distribution, which contained various homogeneous goods of different orders, each with a price. The result is the theory of imputation and, correspondingly, what Clark referred to as the functional distribution of wealth (Clark 1899; Mises 1966: 254). Once these tasks were accomplished, a skilled economist like Bohm Bawerk could show that any known difference between the revenue that could be generated by a worker and the worker's pay would provide an incentive for some businessperson to profit by bidding

⁶Mises's own contribution to this theory is discussed in Gunning (1997).

the worker away from his current employment and switching him to the one that yields the additional revenue. Through this reasoning, economists could begin to demonstrate that incomes in the kind of capitalist system that the socialists and Marxists had in mind depend not on *class* but on the *function* a person performs -- i.e., on the service he helps to provide to consumers. An example is Bohm Bawerk 1894. In Bohm's explanations, there was no need to mention error, the other characteristics of transactions besides price and quantity, or innovation. The ATVC was sufficient.

Entrepreneurship and Monetary Calculation

This grand image was necessary but not sufficient. In the early 20th century, proponents of socialism presented a new argument, namely, the notion that the market economy could be simulated by central economic planners. To deal with this argument, economists had to develop images of the specialization and competition among employers that would exist under freedom of enterprise in a private property system. In these images, the role of the entrepreneur as both a leader in the satisfaction of consumer wants and as an employer of factors became a central part of the explanation.

Herbert Davenport (1914) and, later, Frank Knight (1921) made important contributions to the explanation.⁷ Mises's concept of the market process partly incorporated these. But Mises went a step beyond to discuss the unrealism of the simulations with respect to money. The planning models contained no real money. Yet entrepreneurship relies on money to make appraisals and calculations.

⁷See Gunning (1993, 1998a). One might say, however, that a solution was in the wind, at least in U.S. economics. The hot topic around the turn of the century was capitalization. When a person calculated his wealth, he had to predict the money he would receive at various times in the future. And he had to compare the money received at one time with the money received at another. To make a proper comparison, he had to convert all the figures into a value at a specific time. This required the assumption of an interest rate. When thinking about the wealth of everyone, the economist was compelled to consider the question of which interest rate would be appropriate and about the parts each wealth holder would play in the grand scheme of wealth production and calculation. (See Fetter 1900 and Davenport 1904.) Thus, in paying attention to appraisal under uncertainty and to capitalization, the economist was logically led to develop a clearer conception of entrepreneurship.

The different entrepreneurs also must use prices to signal each other of their specialized appraisals.⁸ Like Bohm Bawerk, Mises could make this contribution without discussing error, other characteristics of transactions, or innovation.

Profit and Interest

Another deficiency in the grand image concerns finance. A particularly vexing question was whether people could earn income from their investments even though they made no contribution to the production of the product. If this was possible, one could argue that financiers took some of the gains that might otherwise go to workers. Workers would not be paid according to their contribution to the production-sales plan. Is it possible to earn interest without making a contribution to production? We can call this the problem of the relationship between profit and interest.

To solve this problem, Mises followed others (1) in defining profit as the income of the entrepreneur function and (2) in recognizing that profit was absent from Clark's static equilibrium (Mises's evenly rotating economy). But he went on to add a methodological insight about a function, in a value-free economic theory, of the evenly rotating economy construct. He pointed out that a function of this image is to simulate non-entrepreneurial behavior that the economist plans to employ to help him build the image of the market economy. What the economist includes in this construction depends on the nature of the interventionist argument he aims to evaluate. To deal with arguments involving a distinction between profit and interest, it is necessary to build an evenly rotating economy that contains interest. In such an image, interest simulates a return to owners of capital goods for their simulated decisions to use these factors of production to produce capital goods instead of consumers goods. Thus, by taking the only step possible to deal with the problem of profit and interest in a complex market economy, he provided a rationale, based on action, for an income that was neither an income to a factor of production or profit. Interest, he asserted, was a return to saving in a form that

⁸ See the discussions of socialism in *Human Action* on pages 205-211 and 701-715.

enabled others to temporarily gain command over the factors of production. Saving helped producers extend the periods of production by producing capital goods.

The association of interest with a decision to produce capital goods instead of consumer goods implies time preference. Recognizing this, Mises concluded that interest is not only an income, it is a ratio of the prices of capital goods to prices of the consumer good they are used to produce. He was now prepared to refute the argument that some capitalists are parasites. He did this by arguing that interest is necessary in the static equilibrium to entice the production of capital goods.

Accordingly, a policy that confiscated that income would halt investment.⁹ The price-quantity approach of the ATVC in a pure market economy was sufficient to deal with this problem also.

⁹It is worth highlighting Mises appreciation for the methodology that economists employed when they build the image of the evenly rotating economy to deal with interventionist arguments. Unless we recognize this profound methodological understanding, we would find his statements in *Human Action* on interest virtually incomprehensible. Consider first his recognition that an important stage in the development of economics was the realization by classical economists that "the basic law of economic action can be comprehended also in the conduct of the isolated farmer" (Mises 1981: 146, as quoted above). Viewed in light of the method of imaginary constructions that Mises elucidated in *Human Action*, this realization put economists on the track of developing an image of the market economy by means of an analogy with an image of a single "isolated farmer." Just as the farmer must make a decision about whether to use his factors to produce goods for his consumption in the near future or in the more distant future, so must individuals in the market economy. And just as the farmer who chooses to devote some of his factors to produce goods at a later time instead of at an earlier time receives a utility return for his decision, so do owners of capital goods in a market economy receive returns. By this means Mises was able to reason about the difference between profit and interest in the market economy by making the following cognitive transition. He begins with what he called "originary interest" -- a category of action (Mises 1966: 527-8, 639). (Even the isolated farmer would have to make a choice to produce capital goods or consumer goods. Next he conceives of originary interest in the evenly rotating economy. Then in writing about the return to saving and investing in a market economy, he recognizes that, like all economic decisions under these conditions, it entails appraisal and uncertainty and, thus, an element of profit or loss. By definition, a praxeological economist requires that all saving and investment be entrepreneurial and, therefore, associated with profit. But it also must contain an element of originary interest (*ibid.*: 530-1). This implies a problem of separating out "entrepreneurial profit from originary interest." "It was only the elaboration of the imaginary construction of the evenly rotating economy that made it possible to distinguish precisely between originary interest and entrepreneurial profit and loss" (*ibid.*: 535-6).

Money Prices and Communication: the Trade Cycle

The ATVC was also put into service in helping Mises present the Austrian theory of the trade cycle. Because goods in the ATVC are homogenous and there is no innovation, it is a simple matter to reason that their prices amount to signals. When we add the idea of ordinary interest, we are led to recognize that one of those signals relates to the division between capital goods and consumer goods. An increase in the quantity of money achieved via a reduction in the market rate of interest distorts that price first and induces malinvestment errors. Similarly, consider those who proposed a centralized planning solution to the socialist problem of causing goods to be produced based on a mathematical solution to the problem of welfare maximization. Use of the ATVC made it easy to deduce that the absence of money in the simulation implies an absence of signaling. Although it might have been more revealing to point out that it also implies the absence of entrepreneurship, the absence of signaling is sufficiently damaging to refute the simulation argument. How can people signal each other of their specialized knowledge about consumer wants and about the means of producing the various capital goods needed to satisfy those wants without a free enterprise and freely fluctuating prices?

Money Prices and Communication: Economization of Knowledge

Finally, we should recognize the use of the ATVC in helping to elucidate the means through which knowledge is acquired, communicated and economized in a market economy. In his 1937 paper especially, Hayek conceived of the ATVC equilibrium as the endpoint of a process of knowledge acquisition. Indeed, he asserted that the concept of equilibrium was primarily if not only useful because it enables one to elucidate the process through which individuals come to acquire knowledge.

His 1945 paper dealt with communication and economizing on knowledge. He pointed out that producers, consumers, and factor suppliers can use prices to communicate the results of changes of which they alone are aware or expect. By making commitments to buy or sell at various money

prices, they show their confidence in their “knowledge of the particular circumstances of time and place.” Their price-quantity interaction enables them to gain without revealing their knowledge or the cause of their expectations.

Hayek illustrated this interaction by imagining a structure of production with numerous orders. At each order was an entrepreneur who possessed specialized knowledge about the demand and supply conditions related mainly to the particular good or factor which he took responsibility for producing. The entrepreneur communicated his knowledge to others by means of price offers and acceptances. By this means, people could benefit from each others’ knowledge even though they possessed only the knowledge of the particular circumstances pertaining to the production of a single good or even of only a part of that good. In Hayek’s imagined structure of production, each person produced a specific good or factor and offered it for sale at a specific price. The price-quantity approach was sufficient to enable him to elucidate the knowledge communication and economization in a market economy.

The New Interventionism

The multiple uses to which Austrian economists put the ATVC helps to explain why Mises used a price-quantity approach in praxeological economics. However, as he himself recognized, a new kind of ideology emerged in the 20th century – the ideology of interventionism. Proponents of this ideology aim to identify rationale for government intervention in markets and, therefore, for particular restrictions on free enterprise. Among professional economists, this ideology appears to have had its beginnings in the arguments made by welfare economists like A. C. Pigou (1912, 1938). These arguments are not about substituting socialism for capitalism. They are about piecemeal government interventions such as blocking "monopoly practices;" regulating prices of goods and services; requiring products to meet safety standards; regulating wages, working conditions, or the conditions under which employment compacts and contracts can be made; subsidizing or taxing this and that business action or property owner; granting patents and other monopoly franchises;

controlling advertising; providing various public goods and services; reducing externally harmful effects; changing liability laws; allowing people to escape contractual responsibilities; and so on. To deal with arguments relating to government intervention in cases like these, economists must build images of interaction that are more realistic and detailed than those used in ATVC.¹⁰

A major source of arguments favoring intervention in the market economy is the recognition that market transactions entail not only prices but also other characteristics. Two other broadly-specified characteristics of a transaction are (1) the nature of the good or factor exchanged (as viewed by the exchanging parties) (2) and conditions of exchange, such as implicit and explicit promises of future actions. To deal with arguments based on the assumption that these characteristics are present (or absent), we must move beyond the phenomena that are suggested by the term "theory of value and cost" or "catallactics," as Mises defined it. We must develop a *theory of transacting*.

3. The General Thrust of A Praxeological Theory of Market Transactions

A praxeological theory of transacting has two characteristics that distinguish it from the Austrian theory of value and cost. First, it includes more variables than only price and quantity. Second, it directs one's attention to pre-transaction actions, and especially to the variety of errors that individuals may make and to the ways that others may take advantage of their errors. We discuss each in turn.

¹⁰It is true that Mises dealt correctly with some of these interventionist arguments. See especially Mises 1988. The argument here, which is elaborated below, is that by beginning his theory of the pure market economy with a theory of prices and quantities only, he set a precedent that led his followers to think of the "market process" as having mainly to do with prices and quantities. In the real market economy, as will be argued shortly, prices are only one of three general characteristics of transacting. Mises did not take sufficient care in building his theory to guide those who wanted to deal with more complex interventionist arguments.

Transaction Variables

The praxeological theory of transactions is broader in that it deals not only with prices and quantities but also with characteristics of goods and conditions of exchange. Conditions of exchange refer to such things as time of delivery, timing of the payment for sale, guaranty for credit, collateral requirements, warranties, maintenance and service contracts or compacts, contingencies, hours of employment, work responsibilities at different times and under different circumstances, and so on. In a praxeological theory of market transactions, we assume that trading parties aim to determine each of these transaction characteristics.¹¹ For any given transaction, all of the characteristics may, at one extreme, be set on a take-it-or-leave-it basis by a producer-seller. At the other extreme, they may each be a subject of negotiation and, consequently, be the outcome of haggling.

A buyer or seller who does market research expects ultimately to make a *transaction announcement* or to decide whether to accept such an announcement. A transaction announcement is a price offer of \$X for a specific good and corresponding set of sale conditions. By using the term "transaction announcement" instead of "price announcement," we remind ourselves that we must always be in a position to describe the nature of the good or factor and conditions of sale for which the price is announced.

A transaction announcement is relevant only when it corresponds to a *commitment* to sell the announced item at or around the announced price and under approximately the announced conditions. The commitment may be fully enforceable or it may be subject to a number of contingencies, including a right to withdraw the offer at any time. Whatever the contingencies, it will be irrelevant to the prospective buyer unless she believes that the seller is committed, to some degree, to selling at or around the announced price and under approximately the announced conditions. A transaction announcement need not be a verbal communication of a specific price. A person who merely rents a

¹¹Mises, of course, recognized, other characteristics of transactions. In his critique of statistical descriptions of past prices, he writes that "it is a serious blunder to disregard differences in the quality of the commodity in question" (*ibid.*: 331). The problem is that in presenting his theory of prices, which he treats as the foundation of economics, he ignores these other dimensions.

booth at a local market or who visits a department store also may signal a commitment. The same is true for a person who incurs the expense of advertising. Whether a particular act is a relevant transaction announcement, or part of an announcement, depends on whether the act is perceived as such by the person or persons at whom the announcement is aimed.

The commitment associated with a transaction announcement implies that the announcer is imposing a penalty on herself in the event that she does not keep the commitment. Such a self-imposed restriction deters or even blocks her from availing of a larger range of options that she would otherwise have. To help her in this, she may avail herself of contract law by, say, writing a contract in which she agrees to pay a sum of money in the event that she does not act as advertised.

At any given time, the individuals in the market economy are making uncountable transaction announcements. If such announcements ever ceased, the cost to each person of calculating profit and loss from any action would be greatly multiplied. It would mark the end of monetary calculation; since the calculation by any single individual depends on the announcements made by others. Monetary calculation could start again only if someone broke the silence and made a transaction announcement. Then others could use this as a starting point for their own calculations and announcements.

Pre-Transaction Actions

To the Isolated Actor

To help elucidate pre-transaction actions, we make an analogy with the isolated actor.¹² We begin not with the decision to employ factors to produce a good but with pre-production actions which, from the viewpoint of the actor, are performed because of her uncertainty. We assert that

¹²This method of beginning with an action of an isolated actor and then using it as an analogy, or benchmark, for building images of market interaction is the same method used by Menger and the other early subjective value theorists to satisfactorily solve the problem of delimiting economic from non-economic action. We use this method, quite simply, because we want to avoid inadvertently including non-economic action in our image of the market economy (see the reference above to Mises 1933, Chapter 4).

during the pre-production period, an isolated actor may learn what her wants are, she may learn to identify the means at her disposal to help satisfy her wants, and she may learn to employ those means in what she believes to be the most efficient way.

In learning what her wants are, a person often comes to decide that the items she initially believed she wanted are either less or more important to her. Similarly she may learn that items she initially believed were unimportant as factors of production or of which she had no knowledge at all are important factors after all. Like all actions, learning entails costs and, to carry it out, a person may employ different methods. A characteristic of such learning is the production of *habits*. Habits are decision-making shortcuts. The production of habits is an ongoing process. The prospective benefits are calculated in terms of expected time saved. There are two kinds of costs. The first are the time and energy costs of creating the habit. These are largely personal in the usual case, although it is possible to buy personal services of this type. The second are calculated in terms of potential regret as the result of future choices that the chooser comes to habitually ignore.

New habits can be produced and old habits can be discarded. However, discarding habits is costly. If a person believes that the prospective costs of continuing to employ a pre-deliberation habit are sufficiently greater than the prospective benefits, she will change it. The choice of a habit is also a pre-production action.

Recognizing and taking account of pre-production actions enables us to broaden our image of action. We can add to what Mises called a "period of provision." Mises defined the period of provision as a period of production that takes account not only of the fact that it takes time to produce a good but also of the fact that a produced first order good may not be fully consumed until some time after it is produced (Mises 1966: 481). In defining this period he aimed to take account of durable consumer goods. Either such goods provide services over a period of time or their owners have the option of using them in the near or distant future. We can add to this a pre-decision period.

More accurately, we assert that there is a *deliberation period*, during which learning occurs and choices are made among alternative methods of learning, including choices to adopt habits.¹³

To the Actor in the Market Economy

We now use this description of the isolated actor as a starting point for understanding pre-transaction actions in a modern market economy.¹⁴ Some individuals may believe that they already know enough about the wants of others to make a decision about which goods or factor to specialize in producing or helping to produce. Others, however, will regard learning about others' wants as a means of ultimately making the specialization decision. They will have a demand for "market research." Market research aims to acquire two types of knowledge: (1) knowledge of the various characteristics of transactions that prospective future trading partners would like to make and (2) knowledge about the costs of making transactions that have such characteristics. A person may produce all of the knowledge he needs or wants by himself; or he may employ specialists or teachers to help him. Once a person has acquired what he regards as a sufficient amount of market research knowledge, he may proceed to test that knowledge by making transaction announcements or by tentatively accepting the transaction announcements of others (see below). Again, he may do this himself or hire specialists in advertising, marketing and negotiation. Ultimately some transactions are made. Before this can occur, however, all of the transacting parties must possess the necessary market research knowledge. We refer to the time during which these pre-transaction actions occur as a *pre-transaction period*.

¹³The idea that choice entails deliberation and that this is relevant to economics is explored in Gunning 1990: 77-80, 87, 138-141, 167-169.

¹⁴The discussion here and in the subsequent subsections fits neatly into what Eric Furubotn (2001) has labeled the neo-Institutional theory of the firm. Or to say this in a different way, Furubotn's theory is thoroughly praxeological (despite his obvious orientation toward mathematical symbolization).

Price-quantity theorists deal with the pre-transaction actions that take place prior to exchange by writing about price announcements and price acceptances.¹⁵ Because transactions entail the other characteristics, a transaction theorist take a broader view. Prospective sellers and buyers often must communicate very complex transaction characteristics in addition to the price. Moreover, the communication may be exploratory. Its aim may be to determine whether an exchange is possible. The aim of a prospective sellers may be to find out who the prospective buyers are, what the buyers want or will accept, and the conditions of sale that are most desired. Prospective buyers may want to find out the nature of the products offered for sale and the attenuating legal and extralegal rights and responsibilities associated with their purchases.

Communication may not be possible at first; it may require learning. The most obvious case is where the buyer and seller use different languages. Less obvious cases entail teaching about how to use or benefit from buying and owning a particular product. Such learning may entail the use of experts as tutors. Or to avoid some of the learning, a buyer or seller may hire an advisor.

All of these pre-transaction actions are associated with the fact that preferences and costs relating to the nature of the good, its quality, and the conditions under which it is exchanged may not be given and known. They may have to be discovered by one or more parties and negotiated. In other words, they are derived from the assumption of uncertainty under the conditions of the market economy.

¹⁵As we show below, the originator of this transactions view in modern economics is Ronald Coase, his first effort being his 1937 paper on the nature of the firm. Coase's original terminology was clumsy, representing the fact that among his contemporaries, there was no means of expressing pre-transaction actions. Conceiving his work as a contribution to "price theory," Coase wrote of the costs of using the pricing mechanism. He labeled the first class of such costs the cost "of discovering what the relevant prices are" (1937: 390). Obviously, what prospective traders try to discover is not only the offer prices but also the goods that are being offered and the possible conditions of exchange. Although it may be understandable that in 1937, Coase would present his theory by focusing on prices, those organization theorists of today who have followed Coase are unlikely to use this language.

Errors and Interaction Relating to Them

The assumption that people carry out pre-transaction actions in the market economy helps us identify a potentially huge and complex set of actions relating to error during the pre-transaction period. Some of these actions are harmful to others and are performed with full knowledge of this. In other words, individuals in the market economy intentionally harm others with their actions. The existence of such actions are evident in real market economies but are ordinarily neglected by economists. They provide the basis for a number of arguments in favor of market intervention and accordingly must be taken into account by a praxeological economist who aims to deal with such arguments. Here we divide such actions into three classes: deception, fraud and parasitic positioning. All three have the aim of trying to take advantage of another person's transaction decision. In deception and fraud, one aims to do this by supplying false knowledge about market conditions.

In parasitic positioning, one person (the parasite) deliberately positions himself to benefit from the choice of another person (the host). The parasite does not aim to change the host's choice but merely to benefit from it. The parasite knows that his positioning will cause harm to the host. Indeed, he may worry that the host will take evasive or retaliatory action if she thinks that the positioning was deliberate. Accordingly, he may attempt to conceal the fact that his positioning is deliberate. A simple example is the seller of a new car who deliberately diverts a buyer's attention away from the low gas mileage of his car. He suspects that doing so will raise the probability of purchase and increase his profit. Another example is packaging that capitalizes on research about consumer buying habits or absence of habits rather than on the wants for the contents of the package.

Deception, fraud and parasitic positioning are possible because of individuals' propensity to err. Error is, of course, appreciated among Austrian economists. Of special importance is the errors of entrepreneurship that correspond to the a priori assumption of entrepreneurial uncertainty. Yet Mises's image of the pure market economy contained no pre-transaction actions that accompany the

recognition by actors that other actors besides themselves make errors.¹⁶ ATVC, of course, disregards error and such pre-transaction actions.

Deception, fraud, and parasitic positioning are perhaps most evident in the purchase and sale of financial assets, where traders ordinarily base their actions partly on the information of others. It is not possible to deal with arguments that the Great Depression was the consequence of fraud, etc. without taking account of these types of actions. This is also true of arguments in favor of laws relating to the protection of consumers and workers from their own errors and laws making producers of goods liable for the damage from their products that they could have prevented.

Creation of Legal Rights to Control Actions

One of the characteristics of transactions is the broad concept of conditions of exchange. We have given the following examples: time of delivery, timing of the payment for sale, guaranty for credit, collateral requirements, warranties, maintenance and service contracts or compacts, contingencies, hours of employment, work responsibilities at different times and under different circumstances. A close inspection will show that these refer to definite legal rights to control actions, to indefinite norms pertaining to the control over actions, or to both. A written warranty, a contract to deliver at a specific time, and a contract to provide maintenance or service are quite obviously legal rights to control actions that are negotiated by the buyer and seller. Consider a compact in which an employer promises an employee either outright or implicitly that, so long as the employee performs

¹⁶Mises does discuss some pre-transaction actions. Specifically, he devotes an entire section of *Human Action* to "Good Will." The section begins with the following statement: "It must be emphasized again that the market is peopled by men who are not omniscient and have only a more or less defective knowledge of prevailing conditions" (*ibid.*: 379). He writes that catallactics has the problem of investigating "the nature of this peculiar thing called good will" (*ibid.*: 380). Remarkably, although he recognizes that good will is a (higher-order) good (witness his statement on the same page about making a money investment to establish it); he completely disregards the reason for this "peculiar thing." A major reason why good will is a higher-order good is that individuals in a real market economy have an incentive to take advantage of the propensity of others to err. A person establishes good will in order to persuade her customers that she will not deceive, defraud, or position herself parasitically.

according to established norms and so long as business remains satisfactory, he will not be laid off or fired. Such a compact does not have the force of law. However, it is also not an impersonal exchange. An employer who breaks the compact can expect other employees and prospective employees to commit themselves less to the long run well being of the enterprise and to more actively seek more secure employment elsewhere, other things equal, than if he had not broken the compact.

These points are significant when one considers Mises's approach to the property system. Mises speaks of a property system that is incomplete because of loopholes left by legislators. However, it should be evident that many legal rights emerge during the pre-transaction period. In some cases, it would be more correct to say that legal rights are exchanged. For example, providing a warranty can be characterized as giving the buyer control over some aspects of the seller's action that otherwise would belong exclusively to the seller. In other cases, however, such as the case of initially unowned factors, new legal rights may be established. For example, an employee might agree both (1) to not reveal information that is produced through research and (2) to use the information himself in a competing enterprise. In this case, the legal right that is created through negotiation pertains to information that does not yet exist and for which rights to profit from use have not yet been established.

Origin of the Theory

The idea of making transacting the basis for the theory of markets and prices was suggested by Ronald Coase in his 1937 article in which he argued that whether individuals (1) make simple this-for-that exchanges involving money for work or (2) adopt more complex interpersonal forms of organizing the provision of work services depends on the transacting they must carry out to make the simple exchanges. The embryo conceived by Coase was to mature into fields of study labeled "transaction cost economics," the "new institutional economics," the "new theory of organization," etc. These are theories of complex agreements, of their preconditions (including political, legal, and social institutions), and of their consequences. Insofar as the work in these fields is confined to

economic interaction under the conditions of the market economy, it is an integral part of praxeological economics. An understanding of transacting as it has been elucidated in some of the literature in these new fields is essential to deal with many of the modern interventionist arguments.

Because human beings anticipate the consequences of their actions, transacting implies the possibility of pre-transacting actions aimed at facilitating the transacting, at obtaining greater benefits from it, or at avoiding the harm from it.¹⁷ The developing transaction literature has used the term "transaction cost" to refer to the subjective value in alternatives uses of the factors of production used in such pre-transacting actions. This extension of the concept of cost parallels the shift from a price-quantity approach to economic phenomena to a transactions approach.

In his 1960 article, Coase made transacting the basis for a theory of alternative means of dealing with external effects, including government intervention. In this, he differed markedly from Mises. Mises began his study of economic interaction by assuming a pure market economy with a system of complete private property rights in which everyone is fully rewarded for every externally-beneficial act he performs and is held liable for every externally-harmful act (Mises 1966: 655). Coase, however, in his writings that relate to economic policy, began with a system of incomplete private property rights. As he had done in the case of the simple this-for-that exchange, he reasoned that the type of arrangement people invent to deal with acts that have external effects, if any, depends on the transacting they must carry out. Other economists took over from there. The result was "property rights economics," "law and economics," and the "new economic history." This is relevant to praxeological economics because many modern interventionist arguments dealing with external effects assume *realistically* that the private property system is either too costly or impossible to complete.

It is important to realize that there is nothing wrong with building an image of a pure market economy in order to understand many of the characteristics of economic interaction. However, in

¹⁷In speaking of the attempt to avoid harm from a transaction, we are referring to a situation where A expects a transaction between B and C to harm her.

many cases, it is counterproductive to employ that image. Mises introduces the problem of external effects with the statement:

The laws concerning liability and indemnification for damages caused were and still are in some respects deficient. By and large the principle is accepted that everybody is liable to damages which his actions have inflicted upon other people. But there were loopholes left which the legislators were slow to fill. In some cases this tardiness was intentional because the imperfections agreed with the plans of the authorities (*ibid.*: 655).

If one aims to evaluate arguments for market intervention based on the presence of an externality, he should quickly add that some liability laws will always be "deficient" because it is either too costly or impossible to make them conform to the ideal demanded by the concept of the pure market economy.

Coase's approach to the incomplete property rights was praxeological. The evidence of this is his focus not on the traditional factors of land, labor, and capital but on actions (Coase 1960: 27-28). Properly understood, a transaction cost is a subjective benefit that is foregone due to an individual's taking an action that is different from what she would otherwise take in order to facilitate a transaction, to obtain greater benefits, or to avoid harm. Actions that reduce transactions costs fit nicely into Menger's description of higher order goods. However, because the idea of a transaction is broader than the idea of a price-quantity exchange, to employ it as a foundation for praxeological economics requires a rethinking of the procedure of dividing first-order goods into distinguishable classes. We must ask what we can reasonably expect to accomplish with such an imaginary construct. Whatever our answer, we must admit that we cannot reasonably expect to learn how to evaluate arguments which (unlike the Marxist and socialist argument that workers are exploited, which was discussed above) do not assume a fixed set of goods and factors of production.

Once we commit ourselves to developing a theory of transacting in the pure market economy, we can avail ourselves of the explorations of facts and theory building by those who have followed the trail blazed by Coase. Interpreted praxeologically, transaction cost economics amounts to the trunk of a tree of which one branch is ATVC. On the other hand, we must avoid the methodological pitfalls to which many non-Austrian economists have succumbed, such as historicism, positivism, and materialism.

4. The Special Status of the Employment Compact

In this subsection, we describe various aspects of the modern theory of the firm that have relevance to praxeological economics and that derive from the focus on transactions. No effort is made to survey the entire field. We consider only the bare bones of this evolving theory. We begin by describing production decisions by the isolated actor. Then we

Production Decisions by the Isolated Actor

A single decision by the isolated actor, Crusoe, to produce a good may entail a series of sub-actions that Crusoe plans out, more or less, prior to his final production act. Whether he carries out the whole series depends on the conditions that he perceives unfolding as time passes. If conditions turn out to be different from what he predicted, he may alter his plan and decide to perform a different set of sub-actions. Or he may abandon his plan altogether. An important fact is that, if he does not perceive that conditions have changed substantially, whether the production action is completed in the way he expected depends mostly on his *will* to carry out the sub-actions needed to complete his plan. When the time comes, he can choose to perform the sub-actions or choose not to perform them. As an isolated actor, he cannot and need not rely on anyone else in his projects. With these ideas in mind, let us turn to plans to produce a good when, under specialization, an individual acting in the role of the entrepreneur perceives that it is more profitable for one person to be a planner and for others to carry out the actions and sub-actions in accord with the plan.

The Employment Compact as a Means of Economizing on Transactions Costs

Let us state these conditions in a different way. In economic interaction, there are numerous cases in which entrepreneurship believes that the plan for a production action is in the mind of one person while the sub-actions needed to complete the plan can be most cheaply performed by other people. For simplicity, we assume that the person acting in the entrepreneur role is also the person in

whose mind the plan exists. In this case, the entrepreneur will want to decide how best to cause the work needed to complete the plan he wants performed. We assume that the plan is a long term plan and that the entrepreneur expects many sub-actions to be performed, some sooner and some later, before the plan is complete. In many cases, his decision of how to best cause the work to be performed will be based partly on whether he wants to be prepared to change his plan once the actions needed to complete it have begun to occur. If he expects that he may want to alter his plan, he considers whether it would be cheaper (1) to hire people at the time when the need for them arises or (2) to hire people now who agree to follow his commands to perform future sub-actions that are currently not completely specified. Following Coase, economists have labeled the former "independent contracting" and the latter an "employment compact, or "Coasean firm." The entrepreneur may regard forming a Coasean firm as a less costly way to get sub-actions performed if he wants the flexibility of altering his initial plans. If the entrepreneur knows in advance exactly what work he will need performed, independent contracting can be done in advance. But if he is uncertain, advance independent contracting cannot be done. The entrepreneur would have to incur the costs of communicating his wants and of negotiating each time he wanted a task to be performed. In this event, the costs of communicating wants and of contract negotiation would be high. He can avoid these by hiring workers on a long term basis to follow his commands, within limits.

The main insight in Coase's 1937 paper on the firm was that a demander of work may offer an employment compact if he believes that he can profit from controlling a worker's work, within limits, over time, as compared with hiring independent contractors. Implicit in this idea is that the worker also believes that she can profit and that she makes a commitment to remain in the employment for some undefined period. Coase specified various reasons why the employment compact may be preferred over independent contracting by either or both of the parties. It is not necessary here to discuss such reasons. It is sufficient to explain this fact by referring to (1) the employer's belief that such an arrangement will be profitable and (2) his willingness to pay the

employee a sufficient amount to entice her to make an indefinite commitment and to give up the right to the output she helps to produce. In a free society, this right initially belongs partly to the employee.

The Agency Problem

It became evident in subsequent work that a major characteristic of many employment compacts is the *problem of agency*. This is the problem that, although the employer can give orders to the worker, she must ordinarily implement some kind of monitoring and incentive system to assure that the worker is motivated to follow the orders.¹⁸ In the pure market economy, such a problem does not exist since we assume that each producer has complete command over the factors he employs. To deal with the reality of a free society, however, we must build an image of production in which an employer can purchase a promise from an employee to allow him to control her work within limits. However, because of the high costs of enforcement or some other reason, we assume that the government cannot completely enforcing this promise. In this circumstance, an employer can monitor and threaten to withdraw the pay of a shirking or dishonest worker. However, the ultimate decision to perform a particular task must remain with the worker. Unlike the case of the isolated actor, whether the plan gets completed depends on the will not of the planner but of someone else.¹⁹

¹⁸This was hardly a new idea. Indeed, it must have been evident to anyone who looked closely at the interaction between employer and employee. And, since the employment compact has existed for millenia, it must have been evident to the earliest writers on the subject.

¹⁹The organizational logic of *Human Action* suggests that Mises could have treated the agency problem in his chapter on "The Data of the Market" as a situation in which the private property system is not complete. If this interpretation of the logic is correct, the best explanation for his neglect of the employment compact is a defect in his organization. A chapter is missing, namely, one about situations in which the property system can never be complete. That this is so is suggested by his only direct remarks on fraud. In discussing the relationship between the government and the market, he writes that interventionism is a manifestation of the fact that "government does not limit its activities to the preservation of private ownership of the means of production and its protection against violent or fraudulent encroachments" (*ibid.*: 718). Similarly, he writes poetically: "Beyond the sphere of private property and the market lies the sphere of compulsion and coercion; here are the dams which organized society has built for the protection of private property and the market against violence, malice, and fraud" (*ibid.*: 725). And: "[W]ithin the sphere of private property and the laws protecting it against encroachments on the part of violent or fraudulent action, there is no antagonism between the interests of the individual and those of society" (*ibid.*: 726). How to use compulsion and

The agency problem in the employment compact is a consequence of two elements of real market economies. The first is the political inadmissibility of a contract in which one person can command another to perform an action without the latter's permission. In other words, an employee has the ultimate right to quit a job. She cannot sell herself into slavery. The second is physical impossibility of one person's making a decision that invariably causes the other person to perform some behavior. A cannot decide that B will perform behavior X. B must make the decision.²⁰

Governance

The governance structure refers to interpersonal relationships that are created to make production decisions when the cognitive input of more than one person is required. By this, we mean that entrepreneurship has made an appraisal of the likely profitability of such combined production decisions and determined, tentatively at least, that they will yield higher profit than the production decisions made by a single mind. Our knowledge of the properties of entrepreneurship (Gunning 1990: 86-88) direct us to consider three general yet possibly overlapping classes of such situations depending on the entrepreneurial task for which the combined inputs are required: appraisalment, undertaking, or uncertainty bearing. We discuss each in turn.

It is possible that two or more people would be required to decide whether a particular production project should be started. In other words, it is possible that two or more persons must attach sufficiently high appraisals to the same factors of production before the factors can be hired. The most common instance of this is probably a situation in which a prospective producer seeks partial financing for her enterprise at a sufficiently low cost to her for the enterprise to still be

coercion and when they are appropriate with respect to fraud, opportunism, etc. is the question posed by many modern proponents of market intervention. One of the advantages of a praxeological economics based on transactions is that it helps us deal directly with this question.

²⁰There is another kind of agency problem due to the desire of A to hire another to act in A's interest even though A does not know what specific actions should be taken. We are not concerned with that problem here.

profitable to her. She believes that the production project will not be worthwhile unless she can bring aboard one or more prospective financiers. The prospective financier(s) need not make exactly the same appraisals as the prospective producer. They also need not fully appraise any particular factor. A prospective financier may make her decision entirely on the basis of her estimate of the producer's ability to appraise and of his willingness to make such appraisals and, later, to honestly and competently command the factors that are hired. In other words, the financier may only appraise the competence and trustworthiness of the producer.

A second possibility is based on a requirement for joint cognitive inputs in the undertaking. Suppose that two or more people are required to make ordinary command decisions in the direction of the factors during the period between when factors are hired and when production and sales are complete. Two general cases come to mind. In the first, there is a hierarchy of employees in which the command responsibilities at the top of the hierarchy are ordinarily more general than those of employees at the bottom. The workers are organized into departments, sub-departments, and so on. At the top is the CEO; at the bottom is the "ordinary worker" who follows commands but gives no commands of his own. The project could not be profitable unless workers in each department and sub-department perform their functions in the total enterprise. In the second, there is a group, or team of specialists. The completion of the production-sales project requires each specialist to perform his function adequately. Thus, the value of each in the project depends on others making adequate contributions. The cognitive inputs of each of the specialists must be present for the project to be profitable.

The third possibility is based on a requirement for joint cognitive inputs in uncertainty bearing. Suppose that an enterpriser has determined that a production-sales project is highly likely to be profitable, that he has sufficient funds to finance it, but that he is unwilling to bear all of the uncertainty that future conditions will cause the project to be unprofitable after all. He is willing to invest some amount but his investment is insufficient to launch the production. The project cannot be carried out unless someone else is willing to share in the uncertainty burden. A prospective financier

must again be persuaded to invest in the project. Unlike the first possibility discussed above, we assume that the finance partner must be given a share of the profit in order to agree to bear the uncertainty of loss.

A particular governance structure is chosen partly because the cognitive input of more than one person is required and partly because it helps to solve different aspects of the agency problem. As in the case of the agency problem generally, an understanding of the reasons for and nature of real governance structures is necessary in order to deal with many arguments for and against government intervention in real market economies.²¹

5. Conclusion

A price-quantity image was sufficient to show that general labor, like other factors of production, is paid according to entrepreneurship's appraisal of its marginal value in production-sale projects. Since socialists and Marxists were only concerned with homogenous labor and the price it is paid, the ATVC was perfectly suited to this task. There was no reason to complicate matters by pointing out that labor is not homogeneous. Moreover, since socialists and Marxists were not interested in an incomplete property system, there was no need to take account of the fact that some of the legal rights necessary to make the private property system complete are costly or impossible to establish or enforce. In addition, there was no reason to deal with error and actions aimed at taking advantage of others' errors, since socialists and Marxists were not concerned with deception, fraud, parasitic positioning, or the agency problem. Also, since socialists and Marxists recognized that workers had

²¹Mises discusses some of the problems associated with governance in a section that is designed to distinguish what he calls "the entrepreneur qua entrepreneur" from the managers, technicians and bureaucrats (1966: 303-311). He does not identify dealing with the agency problem or setting up a governance structure as a task for entrepreneurship. A possible reason, albeit certainly not a justification, is that he disregards the possibility that decision-making often requires cognitive inputs from more than one person.

the right to quit their jobs, there was also no reason to deal with the special property rights problem that arises because the constitutional rights of a free society prohibit slavery. Actions such as determining the conditions of employment, supervising workers, investing in "firm-specific human capital," etc. could be safely disregarded. Finally, there was no need to consider the special problems associated with the benefits of cooperative appraisal, cooperative production decisions, and cooperative uncertainty sharing within production organization. The theory could be presented for the case of the so-called stationary system. To deal with an argument, one should use the simplest possible image of an economy. This is what Menger and Mises did.

Unfortunately, in the book that provides the inspiration for a large number of neoAustrians, Mises used this same simplistic image to describe market interaction or what neoAustrians have come to call the "market process." Following Mises, these economists employ a simple price-quantity approach to interaction and, as a consequence, are unable to deal with many of the interventionist arguments that are most popular today. They are effective in refuting socialism and Marxism but ineffectual in dealing with Pigouvian and post-Pigouvian arguments relating to market failure. Instead of adopting the appropriate transaction-based framework, they have typically done one of two things. First, they have resorted to a natural rights perspective, following Murray Rothbard, thereby negating the methodological contributions made by Mises that enabled him to envision a value-free economic science. Second, they have focused on the difficulty of administering market failure policies, thereby shifting away from economics and toward modern political economy, or public choice. The burden of this paper has been to show that modern interventionist arguments can be dealt with from within the praxeological economics perspective suggested by Mises. But not without modification. The price-quantity approach must be replaced by a transactions approach. If this is recognized, the modern theory of economic organization and the employment compact will become an integral part of praxeological economics.

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ABSTRACT

Ludwig von Mises, the 20th century champion of Austrian economics, asserted that the goal of economics is to evaluate arguments for and against government intervention in the market economy. He helped develop an economics that was especially suited for that purpose. Specifically he developed a price-quantity economics to deal effectively with several important arguments in favor of intervention: the socialist-Marxist exploitation hypothesis (the theory of imputation), the possibility of centrally planning an economy (the theory of monetary calculation), the claim that interest is not deserved (the theory of profit and interest), macroeconomic intervention (the Austrian theory of the trade cycle), and price controls. The approach has also been used to show how the use of money prices economizes on the acquisition, communication and use of knowledge. However, many 20th century arguments supporting intervention cannot be handled with a price-quantity economics. A transactions approach is needed. This paper outlines such an approach – one that is based on the recognition of other transaction variables and pre-transaction actions. It goes on to show how the theory of the firm, as first described by Ronald Coase and then elaborated by those who followed, fits neatly into this approach. By this means it shows where the Coasean firm fits into Austrian economics.

The Praxeological Foundations of the Employment Compact: Where the Firm Fits Into Austrian Economics

BY

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