

## MISES, ROTHBARD AND SALERNO ON COSTS

*William Barnett, II\**, *Walter Block\*\**

### Abstract

This paper is an attempt to wrestle with the concepts of costs, causality, subjectivism, derived demand, inflation, supply and demand, and with the views of three Austrian economists on all of them: Mises, Rothbard and Salerno. In our view, in contradistinction to theirs, the choices of both buyer and sellers, in the consumer *and* producers goods markets, contribute to price determination. Our claim is that they give too short shrift to the latter markets.

**Keywords:** costs, causality, subjectivism, Austrian economics, derived demand, inflation

\* Associate Professor of Economics, Loyola University New Orleans, 6363 St. Charles Ave., New Orleans, La. 70118, (504) 864-7950, [Wbarnett@loyno.edu](mailto:Wbarnett@loyno.edu)

\*\* Harold E. Wirth Eminent Scholar Endowed Chair and Professor of Economics, College of Business Administration, Loyola University New Orleans, 6363 St. Charles Avenue, Box 15, Miller 321, New Orleans, LA 70118  
c.v.: <http://www.cba.loyno.edu/faculty.html>, office: (504) 864-7934  
dept: (504) 864-7944, fax: (504) 864-7970, [wblock@loyno.edu](mailto:wblock@loyno.edu), [WWW.WALTERBLOCK.COM](http://WWW.WALTERBLOCK.COM)

### Introduction

“Thus when economists, business forecasters and Alan Greenspan scrutinize indexes of input prices such as the PPI or indexes of raw commodity prices, they do so because they incorrectly believe that changes in these indexes are harbingers of future changes in general consumer prices, as if input prices determined product prices rather than the other way around” (Salerno, 2003, p. 83).

“According to Austrian theory, the value of money, which is the inverse of overall consumer prices, is determined like the individual prices of its component consumer goods by supply and demand” (Salerno, 2003, p. 83).

Let us call the first of these two statements A, and the second, B.

Each of these has something to be said in its behalf.

### I. Statement A

There is a grain of truth in A. It stems from the insight of Rothbard (1970, 1993), to the effect that we value factors of production because they are necessary preconditions or causal agents, of the consumers' goods we value for their own sakes. The direction of causation of prices is, so to speak, all in a backward direction: from the final goods back to the factors of production. Or, to put this in another way, there is a *direct* demand for consumers' goods, but only a *derived* demand, from them, back to their causal agents, the factors of production.

However, Salerno goes too far. There is all the world of difference between saying two superficially similar things. First, correctly, that product prices are

the dog, and input prices only the tail, in that the former comes first in the causal-genetic sense, and the latter appears only secondly in time. We do not value diamonds because diamond mines and jewelers' labor are so expensive. Rather, the very opposite is the case: diamond mines and the labor of diamond refiners are very valuable because we set such great stock on diamonds

It cannot be denied that we value resources because we value the output they to the production of which they contribute. But it is an entirely different matter to say that, therefore the value of the output is the sole determinant of the value of the inputs. That would only be true if the owners of the resources themselves placed no value on the resources; i.e., if they had no reservation demand/price. Moreover, the greater the value placed on the resources by their owners, the higher will be their prices, *ceteris paribus*. So, we reiterate: diamond mines and the labor of diamond refiners are very valuable because we set such great stock on diamonds. However, even if the value placed on diamonds dropped a great deal, the resource prices would rise if the demand for them to be used to produce, say, gold jewelry went up sufficiently, or if the reservation value/price of the owners increased suitably. We need to distinguish between the sources of subjective value of goods and resources and objective exchange values; i.e., prices thereof. If, tomorrow, we determined that these baubles were the spawn of the devil, and renounced them utterly, the market price of raw diamonds and labor that serve as inputs into this consumer good would drop like a stone. On the other hand, if the day after that we decided that diamond mines and jewelers were evil personified, but still

valued diamonds (don't ask), the latter would still have great value.

Rothbard (1993, 118-133) articulates this perspective with a strange analysis. He shows that the price as determined by the intersection of the standard demand *and* supply curves is the same as that determined by the intersection of the *total* demand curve and the extant stock. The key here is that Rothbard adds the reservation demand<sup>1</sup> of the owners of the stock to the standard demand to arrive at the total demand.<sup>2</sup> Thus when he says that price is determined solely by demand, he is including the reservation demand as well. There is nothing (logically) wrong with such a stance; the difficulty lies in the fact that when words such as demand are used with subtly different definitions than usual, errors are likely to creep in unless extra care is taken. Gentle reader, please take another look at statement A. Surely that is not what Greenspan meant. It is no more correct to say that input prices determine output prices than it is to say that output prices determine input prices. Both are determined by their relative scarcities, in turn determined by the values of the relevant parties. The price of a final output is determined by the valuations placed on it by the marginal buyer and the marginal seller. The price of a resource is determined in precisely the same way: by the value placed on it by the marginal buyer and the marginal seller. In the case of an ongoing market for a flow, the seller of the output, "the firm," is also the buyer of the resources. In effect, the firm is a middleman, attempting to buy low in the relevant resource markets and sell high in the markets for its outputs. What determines the prices then are the valuations of the sellers of resources, the buyers of the outputs, and the middleman.

Consider the case, where, for whatever reason(s), the buyer(s) of a certain output value it more; i.e., the demand increases; i.e., shifts to the right. Its price will be bid up. As a result it will be more profitable to produce and sell more of that good. In turn, that will lead the firm(s) to place a greater value on the relevant resources; i.e., the demand for them also rises. The firm(s) will bid up their prices. In that case, the rise in the price of the output will lead to a move in the same direction in the price of the relevant resources. Note, however, that neither the augmentation in demand for the output nor for the resources is fully determinative of their prices; rather, in both cases the prices are

merely bid up from their prior levels. Both the prior output price and the prior resource prices were determined in part by the relevant supplies. And, how high the various prices will be bid up for any specific increase in valuation, and, therefore, increase in demand, by the buyers of output, will depend in part upon the relevant supply considerations; i.e., the valuations of the sellers. Thus we see that resource prices are not determined *solely* by the demand for outputs<sup>3</sup>. Moreover, if we consider the case where, for whatever reason(s) the seller(s) of a certain resource value it more; i.e., the supply decreases. Its price will be bid up. As a result it will be less profitable to use that resource in production and less will be sold. In turn that will lead the firm to place a greater value on the relevant output; i.e., the supply decreases. Its price will be bid up. In that case, the increase in the price of the resource will lead to a rise in the price of the relevant outputs. Note, however, that neither the decrease in supply of the resources nor the decrease in supply of the outputs is fully determinative of their prices; rather, in both cases the prices are bid up from their prior levels. However, both the prior output price and the prior resource prices were determined in part by the relevant demands. And, how high the various prices will be bid up for any specific increase in valuation, and, therefore, decrease in supply, by the sellers, will depend in part upon the relevant demand considerations; i.e., the valuations of the buyers. Thus we see that output prices are not determined solely by the supply of resources.<sup>4</sup>

## II. Statement B

Now let us consider B. This statement is completely acceptable to us. After all, it can hardly be denied that supply and demand, or rather the valuations upon which supply and demand are based, are necessary to an analysis of price.<sup>5</sup> It is not for nothing that if you teach a parrot to say "supply and demand" you will at one fell swoop given it a strong hint at solving virtually all economic problems. We mention B in conjunction with A not because we see anything wrong in the former. This is done, rather, in order to further impeach A.

<sup>1</sup> At any price, the reservation demand is the difference between the stock and the standard quantity supplied at that price.

<sup>2</sup> This is quite similar to standard "excess demand" analysis, where, at any price, the excess demand is the difference between the standard quantities demanded and supplied at that price. We have three cases, then. The standard case where the market price is that at which the standard demand and supply curves intersect. Rothbard's case, where the market price is that at which the total demand curve intersects the extant stock. And, the excess demand case, where the market price is that at which the excess demand curve intersects the vertical axis; i.e., at which quantity is zero.

<sup>3</sup> Had we considered the case in which the buyer(s) of a certain output value it less, the analysis would be analogous.

<sup>4</sup> Had we considered the case in which the seller(s) of a certain resource value it less, the analysis would be analogous.

<sup>5</sup> In a barter transaction there is neither supply nor demand in the usual meaning of these terms. Supply relates to the actions of the seller(s), who give up non-money goods in order to acquire money and demand relates to the actions of buyers who give up money in order to get non-money goods. The objective exchange ratios in such transactions are money prices. Money is the only good that has no (non-trivial) money price. As such there is no market for money. Rather, there are as many markets for money as there are non-money goods that people wish to exchange for money. Thus, in a real sense there is neither a demand for, nor a supply of, money; rather, in each market there is a demand for, and supply of, the non-money good

The first thing to note about these statements is that there is a tension between them, not to say a logical inconsistency. According to A, consumer-goods prices fully determine prices of the factors of production that go into their creation. However, based on B, the prices of *all* commercial items, whether consumers' goods or capital goods, including money, are determined by supply and demand. The difficulty, here, is that the supply of the consumption good is based on the supplies of the relevant inputs. Without the latter, there is none of the former. When the former decreases (increases), so does the latter.

Another problem is that A necessarily implies that if the price of a factor of production changed dramatically, it would have *zero* effect on the final good which eventually encompasses it. For example, suppose that a bomb destroyed half the oil capacity of the world, *ceteris paribus*. Is there any doubt that gasoline prices, a final consumers' good, would rise? Or, posit that a frost ruins half of the entire orange crop? Can it really be doubted that the price of orange juice would catapult upward? But if these deductions are true, it is difficult to credit Salerno's claim to the effect that "they incorrectly believe that changes in these [factor price] indexes are harbingers of future changes in general consumer prices..." (material in brackets supplied by present authors). The increased oil price, in this case *would* be a harbinger of later rises in the cost of gasoline. Similarly, the increase in the price of oranges *would* foreshadow subsequent boosts in orange juice prices. This is not to deny that if the initial price increase was that of gasoline or of orange juice, the subsequent increase in the price of crude oil or of oranges, respectively, would stand in relation to the prior increase in the consumers' goods as effect to cause. However, this is not at all the import of Salerno's statement A.

### III. Conclusion

We are in entire accord with Salerno's statement B. Indeed, enthusiastically so. Our problem is not with it, but rather with A. Nor do we deny there is a grain of truth in this problematic statement, as adumbrated by Rothbard. Our claim is that Salerno makes too much of a good thing, far too much, and is thus led into his error.

The point we are making in this article is akin to the one Rothbard (1993, 561) made against the term "consumers' sovereignty and Hutt (1940) and, who is credited with originating the term in 1934 (Rothbard, 1993, 903, n. 3). The latter talked in terms of "consumer sovereignty." Rothbard objected on the ground that this ignored the sovereignty of the producer. His "friendly amendment" to Hutt was to characterize what the latter was addressing as "individual sovereignty" not "consumer sovereignty." In like manner, we object to Salerno and Mises focusing on the consumer, only, at the expense of the producer, in general, or, in this case, the owners of the factors of production, in particular.

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