

Capitalism and Morality

“LUDWIG VON MISES ON PROFIT, LOSS, THE ENTREPRENEUR, AND CONSUMER SOVEREIGNTY”

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The insights of Ludwig von Mises (1881-1973) into the function of real-world market processes help explain why, in seeking to serve their own interests, market entrepreneurs must abide by the wishes of consumers. Mises's idea of consumer sovereignty clarifies the manner in which markets determine what is produced, and his analysis shows profits and losses to be dynamic, disequilibrium phenomena resulting from entrepreneurs' attempts to adjust economic production to consumer demand. Mises uses his positive economics to refute fallacies concerning profit and loss—including the zero-sum and exploitative views of profit. Mises's ideas were taken in new directions by Israel M. Kirzner, who originated the idea of entrepreneurial alertness and made a case for the necessity of profits as incentives for using entrepreneurial alertness to maximize consumers' economic well-being.

Capitalists, Entrepreneurs, and Capitalist-Entrepreneurs

A discussion of Mises's view of the market presupposes a classification of the various economic functions of agents in the marketplace. These economic functions can coincide in the same person, but they are distinct roles in the market process. Gains from the production process accrue in the form of payments to laborers who work on the process, capitalists whose capital goods are used in the process, and entrepreneurs who make the decision of what to produce and take the initiative to actually produce and market it. Sometimes the same person can perform all three functions. Mises writes, “The excess of gross receipts over expenditures which the classical economists called profit includes the price for the entrepreneur's own labor employed in the process of production, interest on the capital invested, and finally entrepreneurial profit proper” (Mises 1949, p. 535). In order to earn interest, no entrepreneurial activity is necessarily required; interest is a “ratio in the mutual [market] valuation of present goods as against future goods” (Mises 1949, p. 528) which, according to Mises, originates from the universality of positive time preference. Interest payments earned by capitalists are their incentive to “abstain from employing [their capital goods] for consumption” (Mises 1949, p. 531). In addition, the capitalist earns rents on the capital goods he owns that are more productive than other goods of a similar kind employed in the economy: “Control of a better tool yields ‘rent’ when compared with the returns of less suitable tools which must be utilized on account of the insufficient supply of more suitable ones” (Mises 1949, p. 635). Entrepreneurial profit is neither interest nor rent, however.

It is not necessary that the same person both own the factors of production and direct their use, but it is often the case. Murray Rothbard termed the person who combines the ownership of capital goods with entrepreneurial initiative “the capitalist-entrepreneur” (Rothbard 1962). Aside from getting interest and rent on his capital goods, the capitalist-entrepreneur seeks profit as well: “The capitalist-entrepreneur buys factors or factor services in the present; his product must be sold in the future. He is always on the alert, then, for discrepancies, for areas where he can earn more than the going rate of interest” (Rothbard 1962). In real-world markets, most entrepreneurs are also capitalists; from this fact stems the difficulty, often encountered by theoretical economists, of accurately determining which part of the capitalist-entrepreneur's payment is interest and which is profit. Mises acknowledged this issue in *Human Action*: “It is more difficult to sunder entrepreneurial profit from originary interest” (Mises 1949, p. 535). In the real world, lenders of money are also necessarily entrepreneurs, because each loan runs a risk of non-repayment. In the face of this uncertainty, “in every act of lending... there is an element of entrepreneurial venture” (Mises 1949, p. 536) and thus “[e]very interest stipulated and paid in loans includes not only originary interest but also entrepreneurial profit” (Mises 1949, p. 536). Only through the use of the imaginary construction of

the evenly-rotating economy—where profits are absent, but originary interest and rent persist—can a clear distinction between originary interest and entrepreneurial profit be established (Mises 1949, p. 536).

Consumer Sovereignty and Mutual Gain

Mises recognized an essential element of the market order that often remains unseen at first glance. In *Human Action* (1949), Mises noted that the market economy has the following predominant characteristic: “Everybody in acting serves his fellow citizens. Everybody, on the other hand, is served by his fellow citizens. Everybody is both a means and an end in himself and a means to other people in their endeavors to attain their own ends” (Mises 1949, p. 257). Without coercion, the market steers each economic agent’s self-interest toward benefiting his fellow men; nobody is forced to choose a given line of work or to produce a given good or service—and yet individuals undertake these endeavors of their own free will; Mises even went as far as agreeing with Karl Marx that the market was characterized by “anarchic production,” though Mises and Marx disagreed on their normative evaluations of this phenomenon (Mises 1949, p. 257).

How does the market system enable producers both of direct consumer goods and factors of production to work for the benefit of others? Mises explains this phenomenon via the idea of consumer sovereignty: “Neither the capitalists nor the entrepreneurs nor the farmers determine what has to be produced. The consumers do that” (Mises 1949, pp. 269-270); the consumers care solely about their own satisfaction when they purchase goods on the market. They are not concerned with the personality, past merits, or success of a given entrepreneur, but rather with the ability of his product to satisfy their desires; if they find a different product that fulfills their needs more effectively, they will shift to purchasing that product (Richman 2005). The capitalist-entrepreneur can only stay in business and earn profits as long as he pleases consumers and his product passes the consumers’ “stern test: will the satisfaction rendered by that product exceed the satisfaction rendered by an alternative use of the money? If the answer is no, the capitalist’s pleas will fall on deaf ears” (Richman 2005). The consumers can be sovereign because, in a market economy, they have the choice to purchase or not to purchase the goods offered by any given producer. Mises writes: “The consumer is not at the mercy of the shopkeeper. He is free to patronize another shop if he likes. Nobody must kiss other people’s hands or fear their disfavor” (Mises 1949, p. 286).

According to Mises, consumers are not only sovereign with regard to goods they directly purchase, but also with regard to all the inputs that go into those goods. The inputs have no value outside of the value to consumers of the final product they contribute toward; “[d]emand at the retail level shapes demand at the earlier levels of production” (Richman 2005). Hence, entrepreneurs in every industry—no matter whether they produce direct consumer goods or inputs—must respond to consumer tastes and preferences in order to stay in business. Serving his fellow man is not a mere option for the market entrepreneur; it is vital to his economic survival.

Using the idea of consumer sovereignty, Mises refutes Marx’s dichotomy between “production for use” and “production for profit.” Indeed, writes Mises, “[p]roduction for profit is necessarily production for use, as profits can only be earned by providing consumers with those things they most urgently want to use” (Mises 1949, p.299). Only when the consumers benefit from using the capitalist-entrepreneur’s product can the capitalist-entrepreneur make money selling it.

Yet consumer sovereignty does not mean consumer tyranny. In fact, Mises writes, “[t]here is in the range of the market a very substantial and effective right to resist oppression” (Mises 1949, p. 286). A man is perfectly free to defy the tastes of consumers—for instance, in not selling or using goods and services to which he objects morally; however, he must also be willing to pay the price of such defiance, for “there are in this world no ends the attainment of which is gratuitous” (Mises 1949, p. 286). If an entrepreneur could have sold weapons or alcohol at a profit but does not wish to do so out of ethical considerations, he is free to follow his conscience, but he must also forgo the profits he could have gained from those ventures.

Furthermore, consumer sovereignty on the market does not mean merely the sovereignty of the majority of consumers or of the most popular tastes and preferences. Mises writes that “on the market no vote is cast in vain” (Mises 1949, p. 271), as there exist goods to suit minority preferences; for example, “[t]he publishers cater not only to the majority by publishing detective stories, but also to the minority reading lyrical poetry and philosophical

tracts” (Mises 1949, p. 271). Unlike a political democracy, where only the majority or plurality gets what it voted for, a market gives every consumer what his money can purchase.

The Source and Nature of Profits and Losses

Mises does not consider profit to be a function of an entrepreneur’s capital stock; “[p]rofit is not related to or dependent on the amount of capital employed by the entrepreneur. Capital does not ‘beget’ profit” (Mises 1949, p. 297). Neither interest on capital, nor dividends, nor monopoly gains, nor gains from technological innovation can be described as profit proper (Mises 1951). Rather, shifts in consumer demand are responsible for profits’ emergence. When these shifts occur, production must be adjusted, and the entrepreneur who adjusts it most effectively to fulfill consumer preferences will get the largest profits (Mises 1949, p. 297). Indeed, Mises recognizes that alterations in consumer preferences inevitably occur in periods of economic change: “Some goods are valued higher than previously, others lower. These alterations are the source from which entrepreneurial profits and losses stem” (Mises 1949, p. 534).

Mises contends that entrepreneurial profits and losses “have no place in an imaginary world of normalcy and equilibrium” (Mises 1949, p. 297). Profit is inherently a *disequilibrium* phenomenon, caused by the introduction of new economic conditions—changes in consumer tastes and preferences—to which entrepreneurs must adjust. The adjustment process is always temporary, and any given profit opportunity tends to diminish as the adjustment gets underway and to disappear once the adjustment is complete. Thus, an entrepreneur cannot expect to take advantage of a profit opportunity and benefit from it indefinitely; rather, “[t]he fleeting nature of entrepreneurial profits spurs constant innovation and efficiency” (Richman 2005), an unceasing need for entrepreneurs to seek new ways in which consumer satisfaction can be optimized.

Uncertainty of future economic conditions is necessary for profits to come about; if everybody in an economy could fully anticipate the future, the entrepreneurs “would neither earn any profits nor suffer any losses. They would have to buy the complementary factors of production at prices which would, already at the instant of purchase, fully reflect the future prices of the products” (Mises 1951). In the face of this uncertainty, profits give an incentive to entrepreneurs who judge the future correctly and provide the quantity and kind of goods that consumers want. The profitable entrepreneur purchases inputs at present prices that are *lower* than what he could sell the finished product for in the future; his profit is the difference between the price he receives for the goods he sells and his total costs of production—of which Mises considers interest on capital invested to be a part (Mises 1951).

If, however, the entrepreneur judges the future state of consumer demand wrongly, he will incur a loss by paying more for current factors of production than the revenue he could get by selling the finished product in the future. The difference between his higher total cost and lower total revenue is the entrepreneur’s loss (Mises 1951). But one need not be in the position of an owner of factors of production in order to be an entrepreneur or to experience profit and loss. Ultimately, according to Mises, profits and losses are *psychic phenomena*: “They are intensive magnitudes. The difference between the value of the end attained and that of the means applied for its attainment is profit if it is positive and loss if it is negative” (Mises 1951). In this broad, psychic sense, every acting individual is an entrepreneur in that he hopes to reap greater rewards from his activities than the total opportunity cost of engaging in them. The entrepreneur need not be a capitalist who owns factors of production; he be a simple laborer or just a man seeking to maximize his psychic enjoyment of his leisure time.

Only where monetary calculations enter the picture, however, can profits and losses be quantified; the original psychic profits and losses, on the other hand, remain impossible to reduce to a single objective standard of measurement: “Profit and loss are computable as social phenomena. The psychic phenomena of profit and loss, from which they are ultimately derived, remain, of course, incalculable intensive magnitudes” (Mises 1951).

The phenomenon of profit reinforces consumer sovereignty; “The behavior of the consumers makes profits and losses appear and thereby shifts ownership of the means of production from the hands of the less efficient into those of the more efficient” (Mises 1949, p. 299). The entrepreneurs who gained profits in the past now have more economic resources to devote to their businesses, thus making them more influential agents in the market economy. On the other hand, the entrepreneurs who incurred losses in the past now have fewer economic resources and are less able than previously to decide which goods and services will be provided.

Furthermore, profits and losses are necessary for entrepreneurs to serve consumers in the marketplace: “In the absence of profit and loss the entrepreneurs would not know what the most urgent needs of the consumers are. If some entrepreneurs were to guess it, they would lack the means to adjust production accordingly” (Mises 1949, p. 299). Without profit and loss, there would be no way for entrepreneurs to know if their past actions were in line with the needs and tastes of consumers. For those entrepreneurs who tried to guess consumer preferences by other means, there would be no feedback mechanism to tell them if they guessed accurately.

Mises’s Refutation of the Zero-Sum and Exploitative Views of Profit

Two common fallacies regarding profits are the zero-sum view that one man’s profits must necessarily equal to the losses of others—and the exploitative view that the entrepreneur takes unfair advantage of workers and/or consumers in order to generate profits. Mises’s insights on the nature of entrepreneurial profit provide firm refutations of both these fallacies.

To refute the zero-sum fallacy, Mises discusses three kinds of economies: the stationary economy, the retrogressing economy, and the progressing economy. It is only in a stationary economy that “the average rate’ of profits and losses is zero” (Mises 1949, p. 298). In a stationary economy, “the per head quota of the income and wealth of the individuals remains unchanged” (Mises 1951). The evenly-rotating economy—where profit is zero for everyone—is a stationary economy, but a stationary economy need not be an evenly rotating economy. Any economy in which there is *on net* no saving or dissaving and no profit or loss is a stationary economy; particular individuals can still save or consume capital or incur profits and losses in any non-evenly-rotating but stationary economy. Furthermore, consumer tastes and preferences can still change in a non-evenly-rotating stationary economy, and uncertainty about the future—including the future consumer demand—remains. If consumers spend more on some one item in a stationary economy, they must necessarily spend less on some other items; the profits of some entrepreneurs as a result of this shift in consumer preferences will necessarily equal the losses of other entrepreneurs. Only in a stationary economy does the zero-sum view of profit hold.

But the zero-sum view is false for both retrogressing and progressing economies. In a retrogressing economy, there is an excess of capital consumption over capital accumulation, and thus “the per head quota of capital invested is decreasing” (Mises 1951). On average, consumers are becoming less wealthy and have increasingly less to spend on goods of all sorts. Thus, in a retrogressing economy, the sum of all entrepreneurial losses exceeds the sum of all entrepreneurial profits (Mises 1951). But this does not mean that entrepreneurial activity and the pursuit of profit ceases under such conditions. Mises writes: “The fact that in a retrogressing economy the total amount of losses exceeds the total amount of profits does not deter a man who has confidence in his own superior efficiency” (Mises 1949, p. 299); individual entrepreneurs can still succeed where the majority fails.

Everybody in the economy benefits “by the entrepreneurial action that directs... additional capital toward the satisfaction of the most urgent wants on the other hand” (Mises 1951). If there is net capital consumption in the economy—i.e., if the economy is retrogressing—there is ever less capital for entrepreneurs to try to direct to the satisfaction of consumer desires. The less capital there is, there fewer opportunities exist to use capital profitably.

In a progressing economy, on the other hand, there is an excess of capital accumulation over capital consumption, which increases consumer incomes and wealth on average and augments nearly everyone’s economic well-being in the long run. Mises emphasizes that “[i]t is... saving that is the vehicle of economic improvement, that makes the employment of technological innovations possible and raises productivity and the standard of living” (Mises 1951). Once the additional capital is saved, the economic function of the entrepreneurs is to see to it that the capital is put to its most effective uses in fulfilling consumers’ demands. In a progressing economy, the sum of all entrepreneurial profits *exceeds* the sum of all entrepreneurial losses, and it is by no means the case that one man can only profit at another’s expense. New wealth is continually created through saving and capital accumulation, and the entrepreneurs generate profits by finding better ways to utilize this wealth to suit consumer preferences.

Nor are profits exploitative; they are not, as socialists claim, “unearned income” that entrepreneurs get by deriving workers and/or consumers of their rightful shares. In order for the exploitative view to hold, it would have to be the case that entrepreneurs deliberately increase the prices of the various factors of production so as to keep some of the proceeds. But, as Mises’s positive economic analysis points out, “[t]he excess of profits over losses is

not a consequence of the rise in the prices of the factors of production” (Mises 1949, p. 302). Rather, the two phenomena are both effects of the same root cause: the accumulation of capital and technological improvement. The rise in wage rates and other factor prices happens first during the economic adjustment, followed by the excess of profits over losses—and the excess only occurs “to the extent that the other strata of the population are enriched by this adjustment” (Mises 1949, p. 303). Thus, not only is profit *not* exploitative, but entrepreneurs can only obtain it to the extent their activities during the economic adjustment *benefit* workers and consumers. Moreover, while gains to virtually every other group in a progressing economy—including workers, consumers, and owners of capital goods—are permanent, the entrepreneur’s profits due to the adjustment are temporary and will inevitably disappear, to be subsumed by gains to the other groups.

Similarly, in a retrogressing economy, the excess of losses over profits is the inevitable result of capital consumption—just as the excess of profits over losses is the inevitable result of capital accumulation. In a retrogressing economy, entrepreneurial activity is thus a negative-sum game, whereas it is a positive-sum game in a progressing economy.

Israel M. Kirzner’s Development of Mises’s Ideas

The work of Israel M. Kirzner (b. 1930) developed and expanded upon Mises’s insights into profits, losses, and the role of the entrepreneur. Kirzner delved further into the nature of the entrepreneurial faculty itself and posited the idea of “alertness” as the entrepreneur’s distinguishing characteristic. An entrepreneur is not just another factor of production, like land, labor, or capital; his faculty of alertness is distinguished from the above because it “cannot be bought and sold like other goods or resources for a certain price” (Ebeling 2001). An entrepreneur’s alertness is his ability to notice economic opportunities and possibilities for improvement that no economic actors have detected before; the entrepreneur spots not only what all others did not know, but also what they did not know that they did not know. Alertness enables the entrepreneur to discover insights that were never available before (Ebeling 2001). Furthermore, the entrepreneur has the unique and exclusive ability to *actually take initiative* and undertake the project he discovers via his alertness: “Either the entrepreneur is prepared to take the initiative or he is not. If he is not prepared to take the initiative, the would-be entrepreneur simply sees the project as, on balance, one not worth undertaking—he does not see it as a project for which a needed resource is unavailable” (Kirzner 1973). The entrepreneurial initiative is not a characteristic that the entrepreneur can transfer to somebody else, nor would anyone consider it a factor in the production of anything, “since the very notion of attribution [of a product to factors of production] presupposes the decision to produce” (Kirzner 1973).

But, although he is not a factor of production in himself, the entrepreneur is indispensable for anything to be produced. Kirzner notes that “until a product or technique has in fact been introduced, possession of all necessary means of production (including relevant knowledge) guarantees nothing without the presence of entrepreneurial initiative” (Kirzner 1973). As the person who spotted the opportunity to make a profit and made the decision to engage in production, the entrepreneur is responsible for the entire production process and thus, according to Kirzner, is ethically justified in claiming ownership of the profits that result; indeed, it is precisely the entrepreneurial element of his activity that entitles him to ownership of the profits: “To the extent that an entrepreneur was also a factor-owner, he is credited with the creation of the product only in the sense that he ‘purchased’ his factor services from himself, so to speak, rather than permitting them to serve alternative purposes” (Kirzner 1973). According to Kirzner’s reasoning, it is the entrepreneurial part of the capitalist-entrepreneur’s activities that ultimately creates his product; his “rights rest strictly on the vision and initiative with which, at the time he owned *no* productive resources, he undertook to marshal them for his purposes” (Kirzner 1973).

In exchange for acting on his alertness to adjust production to changes in consumer demand, the entrepreneur is rewarded with profit. According to Kirzner, “the possibility of earning profits is desirable because it pragmatically acts as the incentive mechanism to help bring supply and demand into balance and to bring productive innovations to market” (Ebeling 2001). Furthermore, the profits are the just reward of entrepreneurs for discovering new economic opportunities and actualizing them; “every discovery of a new opportunity is the appropriation of that which had not existed before a human mind had seen the potential for gain in a particular situation or in the use of some object or resource in a new and different way” (Ebeling 2001), and the entrepreneur receives profits as payment for his useful insights.

Kirzner has heavily criticized standard neoclassical economic theory, which leaves no room for the entrepreneur due to unrealistic assumptions of “perfect competition,” where “it is assumed that all market participants already possess perfect knowledge, that producers all are manufacturing a product exactly like their rivals in the same market” (Ebeling 2001). Entrepreneurship, profit, and loss can only exist in the face of uncertainty and imperfect knowledge—universal phenomena in real-world economies, but aspects which are assumed away by neoclassical economic models. But assuming them away does not answer questions about how actual economies work and how, despite immense uncertainty about the future, economic actors are able to allocate resources, plan for the future, and innovate so as to generally satisfy their desires. Mises’s views on the role of the entrepreneur and Kirzner’s developments of these ideas do shed some light on the function of real-world markets and on why, in seeking to serve his own interests, the entrepreneur must necessarily try to maximize consumer satisfaction.

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