Industrial Organization and *Human Action*

Kenneth G. Elzinga

The year 1999 marks the 50th anniversary of the publication of the first edition of *Human Action*, the treatise on economics by Ludwig von Mises (1881–1973).[1] This book has been called "the essential foundation for the . . . academic movement of Austrian School economists, for which it continues to serve as the primary text today" (Herbener and Hoppe 1998: xix). For half a century, *Human Action* has been the English language magnum opus of Mises, one of the most eminent of the Austrian school economists.[2]

Human Action has a tripartite thesis: the book presents a case for thinking about human behavior from an economic perspective; it presents a case for market processes as the orchestrator of economic activity; and it presents a case for an Austrian view of money and credit.

Given the longevity and prominence accorded *Human Action*, we should examine what influence Mises' capstone book has had, if any, upon the field of Industrial Organization—one of the dismal science's specialties whose boundaries were only recently formalized, not long after the publication of *Human Action*.[3]

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Kenneth G. Elzinga is Professor of Economics at the University of Virginia.

[1]The Ludwig von Mises Institute has published a Scholar's Edition of *Human Action* and it is this edition of *Human Action* that is cited in the present paper.

[2]For an overview of Austrian economics, see Harper et al. (1971), a two-volume collection of essays honoring the 90th birthday of Mises. See also Dolan (1976) and Boettke (1994).

[3]Edward Mason's *Economic Concentration and the Monopoly Problem* was published by Harvard University Press in 1957. In 1958, the American Economic Association commissioned *Readings in Industrial Organization and Public Policy*, edited by Richard Heflebower and George Stocking. In 1959, Joe Bain authored the first prominent textbook with the title *Industrial Organization*. A field that was relatively new in the 1950s was established in most departments of economics by the 1960s.

Human Action's Influence on the Field of Industrial Organization

There is more than one way to assess the influence of one scholar upon a field of study. The impact can be marked by the publication of a particular book that, at least for a season, sets a standard or benchmark for a field of study. Joe Bain's textbook would be an example in the field of Industrial Organization. In other cases, the influence is evident by the sheer number of important publications a scholar has in that field. F.M. Scherer would be seen as influential in Industrial Organization for this reason.[4]

In a very few instances, a scholar's influence upon a field of economics is made through that scholar's students. In Industrial Organization, Aaron Director would be the most famous example.[5] And, on occasion, a scholar's influence is so profound and lasting that later readers might be unaware of the influence because it goes beyond specific acknowledgment.[6] By any of these standards, Mises and his magnum opus *Human Action* have not been influential in the field of Industrial Organization.

The major textbooks in a field of economics are designed to represent and reflect the received wisdom and scholarship in that field. If *Human Action* has affected the field of Industrial Organization, one should find direct or indirect evidence of this in the leading texts.

Jean Tirole's *The Theory of Industrial Organization* represents a mainstream textbook in graduate Industrial Organization education. The *Handbook of Industrial Organization*, edited by Richard Schmalensee and Robert Willig, represents a contemporary survey of the field.[7] If *Human Action* has influenced the field of Industrial Organization directly, the evidence should be in these two sources.

Tirole's book contains no reference to Mises or to *Human Action*. Nor is Tirole's text peculiar in this regard. Furthermore, not a single

[4]Scherer was recently recognized by the Industrial Organization Society as its first Distinguished Fellow. The first edition of his textbook, *Industrial Market Structure and Economic Performance* (1970), marked a paradigm shift in the field from Bain's text, because of its greater use of theory as well as its extensive coverage of the literature in Industrial Organization, much of it subsequent to the Bain book.

[5]While Director himself wrote little, his impact upon the study of Industrial Organization, particularly in the field of antitrust, was enormous through the research he encouraged his students to pursue.

[6]An economics student today might be forgiven for not knowing specifically that Alfred Marshall was the inventor of the concept of elasticity because it is now received doctrine in the field.

[7]Published in 1989, the Handbook consists of 26 commissioned articles on specific topic areas in Industrial Organization.

essay in the *Handbook of Industrial Organization* makes mention of *Human Action* in particular or Mises in general.

Lest the work of Tirole and Schmalensee/Willig be thought to reflect an MIT-Princeton tilt, and not represent Industrial Organization fairly, there is similarly no evidence that *Human Action* plays any role in the study of Industrial Organization at the University of Chicago. In *The Organization of Industry*, a compilation of George J. Stigler's seminal articles in the field of Industrial Organization, no reference is made to either *Human Action* or any other writing of Mises.[8] In the Industrial Organization course at the University of Chicago taught by Sam Peltzman, no entry to Mises appears on the reading list or course outline. Mises also is absent from the reading list and course outline of Lester Telser's course at the University of Chicago on Theories of Competition (see Tower 1990).

Ten other books about Industrial Organization contain no reference to Mises or *Human Action*.[9] An examination of 20 reading lists in Industrial Organization and Regulation assembled by Edward Tower (1990) also suggests that graduate students in the field of Industrial Organization who *are* reading *Human Action* are not doing so because the volume has been assigned.

The place of Mises in the field of Industrial Organization in the works just cited does not reflect a sudden or recent fall from favor. Mises' absence has been continual. For example, in 1958, under the editorship of Richard Heflebower and George Stocking, the American Economic Association gave its imprimatur to a survey volume entitled *Readings in Industrial Organization and Public Policy*. No publication of Mises was included in the volume, nor does any publication of Mises receive mention. Earlier, in 1952, under the editorship of Kenneth Boulding and Stigler, the American Economic Association commissioned a survey on price theory. The volume contains articles that, in the judgment of the editors, comprised the key contributions to price theory at the time as well as a list of articles the editors selected for additional reading. *Human Action* is not mentioned, nor is any other work by Mises.[10]

To put the matter starkly, Mises is not and never has been a line item on reading lists that prepare graduate students in the field of Industrial Organization.

[8]George J. Stigler is the Nobel Laureate in economics whom Industrial Organization clearly can claim as its own.

[9]The authors are: Bain (1968), Carlton and Perloff (1990), Greer (1980), Martin (1988), Scherer and Ross (1990), Shepherd (1997), Shughart (1997), Shy (1995), Waldman and Jensen (1998), and Viscusi, Vernon, and Harrington (1995).

[10]One paper by Hayek is mentioned in the section on German articles.

These findings did not surprise me, for reasons I shall explain shortly. But they raise the question of why Mises' work has been ignored. To raise this question is also to ask two others. First, are there topics pursued by Industrial Organization economists that are simply beyond the scope and coverage of the study of economics as embraced in *Human Action*? In other words, was there something lacking in Mises' work, some topic or topics he neglected to address? Perhaps more important is the question of whether the field of Industrial Organization has paid a price by its neglect of Mises' *Human Action*? And if so, in what ways?

The Field of Industrial Organization and the Contents of *Human Action*

Human Action is a book of vast coverage. Between its covers lie almost 900 pages of dense text on microeconomics, macroeconomics, and the methodology of economic analysis. Because *Human Action* is an apologetic for a particular view of economics, the book has snippets of history, philosophy, sociology, psychology, and political science, which Mises uses as counterpoints to his own theory of human behavior. Notwithstanding the book's length, *Human Action*'s themes are too broad to address fully the detailed interests of any specialty field in economics, including Industrial Organization.

For example, the firm and the market are the "meat and potatoes" topics of Industrial Organization economics. The Schmalensee and Willig Handbook begins with the "Determinants of Firm and Market Organization."[11] Technological determination of firm size, transaction costs and the scope of the firm, and the rationale for vertical integration are discussed in detail. *Human Action* does not examine these topics in any detail.

Part 2 of the Schmalensee and Willig Handbook is "Analysis of Market Behavior," which contains separate papers on noncooperative game theory, theories of oligopoly behavior, cartels and mergers, mobility barriers, predation, price discrimination, vertical arrangements, product differentiation, imperfect information, and the timing of innovation. Here again, there is a wealth of detail about firm and market behavior that is not examined in *Human Action*.

One might conclude that the field of Industrial Organization goes after more topics than are covered in *Human Action*, and delves into them more deeply. But the disconnection between Mises and the field of Industrial Organization is not simply a matter of *Human*

[11]"The Theory of the Firm" is the introductory section in Tirole's textbook.

Action's being broad and Industrial Organization's being deep. There is another element to the gap, and that is empirical.

Human Action is a book almost devoid of statistical data (there is not a table or even a graph). Industrial Organization, however, is a field that, until recently, has been primarily descriptive, and much of that description is quantitative. Edward Mason's graduate students at Harvard marked their entrance to the field of Industrial Organization by doing a doctoral dissertation on the structure-conduct-performance of particular industries. Such studies involved the measurement of firm and industry size across several vectors. Descriptive statistics on merger activity, the extent and trends of industry concentration, and the correlation between profits and market structure were (and still are) important topics of research.

Mises' work is disconnected from this kind of statistical analysis. *Human Action* purports to be a comprehensive treatment of economics. But many of the basic topics Industrial Organization economists have pursued would be off the radar screen of *Human Action*, in part because of the author's aversion to economic measurement.

The anti-empiricism in Mises is cryptic. Mises clearly sees a role for what he calls "economic history" and he recognizes that one can learn lessons from history. He writes: "The information that a certain firm sold at a definite date a definite type of shoes for six dollars a pair relates a fact of economic history. A study of the behavior of shoe prices from 1923 to 1939 is conjectural, however sophisticated the methods applied may be" (Mises 1998a: 328).

Now what is to be made of this sentence? Surely knowing that Mrs. Jones bought a pair of size 5 pumps on June 6, 1925, is not by itself economic history. And just as surely there are effective methods of estimating shoe prices over time. Such procedures are bedeviled by problems of sampling, weighting, and quality changes, but it is misguided to claim that economists with an interest in time-series data on shoe prices should avoid the topic altogether, as if any finding would be mere conjecture.

Nonetheless, Mises distrusts attempts to measure current prices, costs, and profits. This trait puts him outside the field of Industrial Organization, since most articles in the field involve quantitative analysis. Schmalensee and Willig devote much of their *Handbook on Industrial Organization* to empirical methods and results. There is no counterpart to this in *Human Action*. No student could use *Human Action* as a foundation for doing a real-world industry study.

One questions whether the aversion by Mises to empirical work, such as measuring industry prices and output, is based only on estimation problems, of which economists are generally aware. Mises' hostil-

ity goes deeper and may be related to the prospect that such numbers can play into the hands of central planners and rent-seeking coalitions. Perhaps Mises feared not the error terms common to economic statistics but the uses to which such data might be put by the state. The parallel that comes to mind is how careful census rolls maintained by the Dutch were used by the Nazis to seek out Jews when Germany conquered the Netherlands in World War II.

There is, of course, considerable work done by Industrial Organization economists that eschews empirical research. Tirole's text reflects the contemporary tilt toward theory over empirical work; the *RAND Journal of Economics* is the premier outlet for theoretical work in the field. Yet even these Industrial Organization theorists do not draw on Mises' work.[12]

The game theory literature in Industrial Organization shows no imprint from Mises. In like fashion, no student could use *Human Action* as a foundation for understanding Nash-Bertrand-Cournot models. Indeed the mathematical formulation used in the game theoretic literature to understand competition among the few would represent one more example of the mathematization of economics that Mises disliked and disavowed (see Mises' stark language at p. 347).

Human Action and the Monopoly Problem

The field of Industrial Organization extends from administered pricing to zero-sum games. But its heart and soul has been the problem of monopoly. The point of greatest overlap between *Human Action* and Industrial Organization specialists is in *Human Action*'s chapter 16, "Prices," with its section 6, "Monopoly Prices."[13] Mises writes: "There is in the operation of a market economy only one instance in which the proprietary class is not completely subject to the supremacy of the consumers. Monopoly prices are an infringement of the sway of the consumers" (p. 272). Walter Adams or Willard Mueller could have written those words. But Mises' analysis of the monopoly problem is outside the mainstream of Industrial Organization (though not as close to the stream's banks as it once would have been).

Mises sees monopoly prices as emerging only when one firm controls the "whole supply of the monopolized commodity" (or "a group of

[12] I know of no citation to *Human Action* found in any article published in the *RAND Journal of Economics* (formally the *Bell Journal of Economics*).

[13] For a more complete reading of Mises on monopoly, see his "Monopoly Prices" (Mises 1998b). This previously unpublished paper, published now in *The Quarterly Journal of Austrian Economics*, was written by Mises in July 1944 and goes into more detail than the material Mises put in *Human Action*.

sellers acting in concert") (p. 355). But to Mises, controlling the whole supply means that if there are fringe firms (or firms producing close substitutes) that have a positive supply elasticity, the putative monopolist (or cartel) will have its control over price thwarted. Mises, therefore, concludes that "duopoly and oligopoly are not special varieties of monopoly prices" (p. 359) because, *sans* collusion, there will be rivalry between them.[14]

Mises dismisses price discrimination as a policy concern. He writes "that within a market economy not sabotaged by government interference the conditions required for price discrimination are so rare that it can fairly be called an exceptional phenomenon" (p. 388). *Human Action* does not anticipate or incorporate the profound insight that a great deal of actual price *competition* in oligopolistic markets takes place through price changes that, viewed statically, are discriminatory as between the customers of a given seller.

The central reason Mises would dismiss the case for an activist government agenda against monopolies and cartels is the prospect of new entry. Here his reasoning is now conventional wisdom in Industrial Organization. "In the long run . . . a national cartel cannot preserve its monopolistic position if entrance into its branch of production is free to newcomers" (p. 360).[15] Without ever saying so explicitly, Mises' conviction is that, absent government protection, monopolies and cartels cannot survive in the long run. Without ever saying so explicitly, Mises believes that antitrust enforcement in the short run would entail more costs than benefits.

The obvious query about all this is: What is the evidence for eschewing antitrust enforcement, or believing that entry barriers are low or that strategic behavior by oligopolists cannot maintain positions of monopoly power? For Mises and the "logical economist," there is no quantitative evidence necessary to draw the conclusions found in *Human Action*. Mises writes: "The mathematical description of various states of equilibrium is mere play" (p. 353).

[14]In language that remains cryptic to me, Mises adds: "One may wonder whether duopoly and oligopoly are of practical significance" (p. 360). Are there many questions that trump this one in antitrust economics? After raising the question, he asserts: "As a rule the parties concerned will come to at least a tacit understanding concerning their quotas of the reduced sales" (p. 360). But he never advocates antitrust enforcement against noncooperative oligopoly strategies.

[15]"The great monopoly problem mankind has to face today is not an outgrowth of the operation of the market economy. It is a product of the purposive action on the part of governments" (p. 363). "If monopoly prices prevail in the sale of the product of big-size business, the reasons are either patents or monopoly in the ownership of mines or other sources of raw material or cartels based on tariffs" (p. 368).

But such a gloss may not satisfy those who wonder: Are consumers gouged in markets with high concentration? Are such markets impossible to enter? Do such markets generate sustained high levels of profits? These are basic questions in Industrial Organization. And for some time, the conventional wisdom was affirmative on all three questions.

Today, the conventional wisdom is quite different. It lies closer to the Mises position, but the teachings of *Human Action* contributed little if anything to the profound perspective shift. The shift came through empirical work. A number of economists generally but not exclusively associated with the Chicago School of economics cast doubt on the conventional wisdom regarding concentrated markets. The work of what Mises calls the "logical economist" was not a player in this, one of the most central debates in Industrial Organization. It took the work of Harold Demsetz and Yale Brozen, to cite two central players, to gain the profession's attention.[16] And this attention was captured in large part through their working with the same kind of empirical data and statistical analysis that first led to the concentration-really-counts hypothesis.

Human Action's Value Added to Industrial Organization

Human Action's rational actor model is uncongenial to other academic disciplines. But not to the applied price theorist tilling the Industrial Organization vineyard. Economists within the ranks of Industrial Organization already generally are persuaded of the usefulness of thinking of human behavior as responsive to a cost-benefit calculus.

Much of *Human Action* is taken up with a discussion of monetary policy, the business cycle, and the shortcomings of Keynesian economics. Here again *Human Action* would have a sympathetic or at least indifferent audience among Industrial Organization economists. Most Industrial Organization economists echo the prayer of George Stigler, who claimed that every day he thanked the Lord that he was not a macro-economist.

Mises had an unflinching belief in what is paradoxical to so many noneconomists: that self-interested individual behavior generates a higher order of social cooperation than can be found in socialist or communistic states. Most Industrial Organization scholars also share a preference for market solutions over government solutions. The

[16]See, in particular, Demsetz's "Two Systems of Belief about Monopoly" in Goldschmid, Mann, and Weston (1974) and Brozen (1982, especially chaps 7, 8, and 10).

primary policy debate among Industrial Organization economists involves tweaking the market system through such policy mechanisms as antitrust and public utility regulation.[17] Mises could restrain his enthusiasm for tweaking.

The question raised earlier was: Has Industrial Organization paid a price in its neglect of Mises? The answer is yes. What *Human Action* adds to Industrial Organization that the field has not fully appreciated can be summarized in three points.

Point 1: Mises cogently explains in *Human Action* that markets do not equilibrate and then stop. The behavior of markets, in the Austrian view, is always a journey and never a destination. If markets were sentences, they would have lots of commas, an occasional semicolon, and no periods. This is second nature to Austrian economists but not to most Industrial Organization economists working out of the neoclassical paradigm. Even when Industrial Organization economists borrow from the market landscape portrayed in *Human Action* (and in the writings of other Austrians), Mises (and the Austrians) go unrecognized (and unacknowledged).

For example, one of the finest case studies in Industrial Organization is *Folded, Spindled, and Mutilated: Economic Analysis and* U.S. v. IBM by Franklin M. Fisher, John J. McGowan, and Joen Greenwood (1983). This book is an economic analysis of the Sherman Act litigation brought by the U.S. Department of Justice against IBM in 1969. The volume adheres rather closely to the conventional Structure-Conduct-Performance chain of the Industrial Organization economist. But in describing the roiling technological changes in computer hardware, the authors report that "a focus on long-run equilibrium can be a major error in the analysis of a real industry" (p. 19). Mises would have approved.

Because of the absence of an equilibrium, the authors could not easily define the boundaries of a market and calculate market shares. Fisher-McGowan-Greenwood even refer episodically to the market as a process in their analysis of the IBM case (see pp. 19 and 38).[18]

[17]To be sure, the antitrust and regulatory issues about which Industrial Organization economists do research and offer policy advice often involve sizable quantities of resources and consequential decisions about their allocation. But relative to the explicit central direction of economic activity that Mises opposed, the stakes are modest.

[18]It was out of their work on the IBM case that Fisher and McGowan developed their critique of the use of accounting data to infer monopoly profits. Ever since their pathbreaking work on this subject, Industrial Organization economists have been much more cautious in the use of accounting data. That historic accounting records could tell nothing about monopoly pricing is another position that Mises had put forward (see, for example, pp. 343–47), though Fisher and McGowan explore the wedge between accounting data and economic variables in far more detail than is found in *Human Action.*

But, as I mentioned in a review of the book, there is no reference or credit given to Austrian economics in the volume (Elzinga 1983).

Point 2: Along with others in the Austrian tradition, Mises underscores the importance of the entrepreneur. In doing so, he did not underscore the individual but rather a function: that of the economic agent "acting . . . in regard to the changes occurring in the data of the market." This is a function that can be carried out in a market economy by a supplier of capital, a supplier of labor, or a supplier of managerial skills (see especially pp. 253–55). It is the entrepreneur, Mises claims, who gives "direction of all economic affairs . . . in the market society." And yet, as he stresses, it is the consumer who is sovereign (p. 270).

Industrial Organization economists understand the comparative statics of market equilibrium and how profits and losses are the signals that attract or repel resources into or out of markets. But this lens into economic reality does not adequately focus on the entrepreneur who recognizes disequilibrium situations—or more importantly recognizes opportunities for gains from trade by *upsetting* an existing equilibrium situation. As Mises put it, "The entrepreneur is the agency that *prevents* [emphasis mine] the persistence of a state of production unsuitable to fill the most urgent wants of the consumer in the cheapest way" (p. 333). The entrepreneur is not satisfied with the harmony of markets smoothly and efficiently clearing, but instead the entrepreneur breaks through with new goods and services or new production techniques or new distribution channels that disrupt the status quo.

Point 3: Along with others not confined to the Austrian school, Mises shows the nexus between individual liberty in the economic sphere and individual liberty in the political sphere. Those who claim to be able to separate the two, Mises demonstrates, are guilty either of strategic dissembling or of ignorance.

Friedrich A. Hayek's *The Road to Serfdom* and Milton Friedman's *Capitalism and Freedom* are the two best-known books that argue the link between free enterprise and civil liberties. But if one were to commend a trilogy on the nexus between economic organization and individual liberty, *Human Action* (especially Part Five, *Social Cooperation without a Market,* and Part Six, *The Hampered Market Economy*) would be the third compelling literary composition on the theme. Industrial Organization economists rarely pull levers of political power. But Mises instructs those who do that an "economist can never be a favorite of autocrats and demagogues" (p. 67).

The Bluntness of *Human Action*

The most striking feature of *Human Action* is its directness and boldness. This is also the book's most maddening feature. Over and

again, Mises makes a bold claim and I wonder: How does he know that to be true? Mises asserts: "No man is qualified to declare what would make another man happier or less discontented" (p. 19). Yet, my best friend, my accountant, my physician, my pastor, and my spouse all are in a position, on some matters, to declare what would make me "happier or less discontented." That does not make them dictators. It simply reflects specialized knowledge (or insight) about me that they possess.

Regarding advertising, Mises writes: "It is agreed among businessmen that it does not pay to advertise products other than good ones" (p. 318). Have telemarketers of vacation travel and investment scams been wasting their calls?

Mises declares that "No laboratory experiments can be performed with regard to human action" (p. 31). Can Mises prejudge the future contributions of Vernon Smith, Charles Plott, and Charles Holt?

Business schools do not get off lightly. Mises asserts: "These schools train the subalterns for routine jobs. They certainly do not train entrepreneurs. An entrepreneur cannot be trained. A man becomes an entrepreneur in seizing an opportunity and filling the gap. No special education is required for such a display of keen judgment, foresight, and energy" (p. 311).

Regarding demand and supply curves, Mises writes that such representations of economic reality "do not add a whit to our insight. Furthermore it is important to realize that we do not have any knowledge or experience concerning the shape of such curves" (p. 330). Statements like this about one of the most helpful tools in the economist's toolkit either cannot be taken literally or cannot be taken seriously.

The Debt of Gratitude to *Human Action*

And then, in the midst of such frustrations with Mises' assertions, I recall that because of economists like Mises, Industrial Organization economists (like myself) are able to examine micro issues involving beer industry mergers and predatory pricing in the market for less-than-truckload freight, secure in the knowledge that the academic milieu in which we work will not fall sway to grand illusions that the beer and trucking industries should be socialized. Industrial Organization economists can focus their attention on a narrow range of policy options because the policy options of government takeover or government control or government ownership of such industries are no longer on the table. It was not always so.

Because of Mises and others, who were willing to take unpopular positions against socialism and communism, and to win the intellectual battle, Industrial Organization as a field of economics was able to unfold in an intellectual milieu congenial to private property and market exchange. So convincingly did Mises and his allies defeat the advocates of central planning that today it is difficult to find a self-proclaimed socialist or communist. Those sympathetic to central planning now promote their policies under different names.

In light of current concerns of creeping socialism, Mises' unambiguous proclamation of the social cooperation promoted by free markets is a lesson that requires continual relearning.

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Mises, Monopoly, and the Market Process

Frank M. Machovec

Kenneth Elzinga's paper is written in an easily digestible style, and its technical analysis is readily accessible to those who are not specialists in Industrial Organization (IO). Three of his points are especially noteworthy. First, he methodically demonstrates how one would assess, for any field, the impact of a particular scholar. His useful tripartite checklist includes a survey of the indexes of early texts in pure theory, a review of the contemporary reading lists of the graduate courses taught by leading IO professors, and a search for evidence of influence on the great teachers who shaped IO during its infancy, such as Aaron Director at the University of Chicago and Edward Mason at Harvard, whose doctoral students produced empirical dissertations that built the new field's data base and enhanced its models.

Second, Elzinga should be praised for his willingness to criticize Mises' attitude toward quantitative methods. Despite the insightful contributions of Mises in several areas, his position on the value of mathematical and statistical analysis has been counterproductive to Austrian scholarship. If an entire profession totally ignores an individual's work because it is devoid of empirical content, then no debate can be ignited. The great strides in undermining the old conventional wisdom on antitrust activism were accomplished by those who engaged the enemy with their own weapons. Moreover, the "new learning" in IO—which has fueled thinking about competition and monopoly in process terms among equilibrium practitioners—was initiated by empiricists who seem never to have read Mises and certainly would disagree with his unidimensional reliance on pure logic to build theory.

Jevons' approach would have been more fruitful. He coupled his endorsement of the application of equilibrium analysis (to the firm) with a warning that the use of mathematics does not "ensure the

Cato Journal, Vol. 19, No 2 (Fall 1999). Copyright © Cato Institute. All rights reserved.
Frank M. Machovec is Associate Professor of Economics at Wofford College.

attainment of truth" (in Machovec 1995: 9). The profession's monogamous attachment to equilibrium thinking led to a pro-planning disposition that has not yet been fully nullified. Mises was correct, therefore, to pound home the point that "the main deficiency of mathematical economics" is its pedagogically misleading assumption of perfect knowledge, which enables it to abstract from the heart of the market process, namely, the equilibrating actions of entrepreneurs, who recognize "a discrepancy [in utility] between what is [being] done and what could be done," and who profit by redirecting these undervalued and hence misallocated resources (Mises 1996: 336, 355–56). Unfortunately, Mises also made numerous derisive comments about quantitative methods (as on pp. 350–57) that were not helpful in shaping the skills required to influence modern economic thought.

The third and most salient point raised by Elzinga is this: Although the writings of Mises have never been cited in the mainstream IO literature, his work provided a forceful and convincing antidote to socialism, an antidote that had spillover effects in IO. The case for liberty in *Human Action,* plus the ideas Mises inspired in Hayek, created an intellectual countermovement that challenged the interventionist urges engendered by the neoclassical equilibrium paradigm. However, we must not assume that Mises had condemned the general-equilibrium construct per se, for he did not. Mises explained that the idea of "an evenly rotating economy" was needed as a foil to fully understand the final path of a market process in which everyone's plans were consummated, with no further changes in the system's parameters, including agents' expectations (Mises 1996: 248, 256). Thus, as far as pure theory is concerned, there should be no inherent "tension between [the general-equilibrium model] and Austrian economics" (Yeager: 1999: 22).

Mises' criticism was directed at the "error and confusion" created by the equilibrium paradigm, particularly the distorted, entrepreneurless vision that had emerged—a pro-planning vision that had rationalized Joan Robinson's 1935 claim that the real-world economy's failure to maximize welfare (due to informational asymmetries) was correctable via centralized data collection and centralized resource direction: "An all-wise dictator, to whom every utility function was known, could increase the social benefit derived from given resources by revising the constitution of the set of commodities produced under perfectly laissez-faire conditions" (in Machovec: 1995: 77–78). "Because of Mises and others," writes Elzinga, "the policy options of . . . government control or government ownership . . . are no longer on the table. It was not always so."

Mises Confronts Monopolistic Competition

Despite some hard-to-follow discussion (muddled by his refusal to employ the diagrams he eschewed), Mises accurately pierced the soft underbelly of the influential critique adopted by the new mainstream of the 1930s, 40s, and 50s, which had argued that the so-called excess capacity created by monopolistic (or imperfect) competition is inefficient and hence reduces consumer welfare. In a nutshell, the waste theorem was this: If less variety were available (presumably due to central planning), then a smaller number of larger-sized plants, each operating at full capacity under perfect competition, could achieve minimum average cost *and* release capital for other uses, thereby yielding more utility for consumers than the alternative, prevailing regime of monopolistic competition. Mises, in his previously unpublished 1944 writings on monopoly, some of whose points were *not* incorporated into *Human Action,* explained that the equilibrium school's prescription would not enlarge welfare:

> Standardization of products can go as far as the public is ready to buy the cheaper article rather than a more expensive article of another pattern. It was the buying public that forced the Ford plant to substitute cars with various paints for the uniform black painted standard type [that was favored by Henry Ford as a cost-saving measure because it minimized assembly time]. The doctrine of imperfect competition . . . is . . . mistaken in its assumption that the structure of the schedule of physical costs alone . . . should direct [production] in a perfect world [Mises 1998: 15].

The profession eventually moved away from its early embrace of Joan Robinson's charges of inefficiency. As Elzinga has noted, the IO perspective has now incorporated much of the Austrian process perspective, yet neither Mises nor any other Austrian scholar has been cited during the transition. It will be profitable, therefore, to clearly delineate Mises' objections to Robinson's broadening of the concept of monopoly.

For Mises, monopoly is not present every time a state of affairs develops in which price exceeds marginal cost, as in neoclassical theory. Rather, he said that, in nearly every case, a monopoly price can be sustained only when government protection enables a *producer* to restrict output *deliberately,* so as to create profit through a price that exceeds average cost (Mises 1996: 359, 379). For Mises, the power to *engineer* monopoly profit does not exist just because *consumers* purposefully restrict their purchases of a *particular* variant of a given good in order to employ their withheld income to buy other variants of the same good. Therefore, from a Misesian perspective, the phenomenon of product differentiation does not lead to the antisocial

appearance of what Robinson had characterized as a "world of monopolies." For Robinson, but not for Chamberlin, the minimum average cost was optimal. Mises, of course, sided with Chamberlin's view, but, inexplicably, he failed to weave his novel 1944 reasoning into *Human Action:*

> The fact that an enterprise does not use the full capacity of its equipment, although it would reduce average cost of production per unit by doing so, is . . . not necessarily an outcome of a monopolistic policy. It does not render competition "imperfect." As long as there is a more profitable employment available for the capital required for the expansion of production, it is reasonable for the entrepreneur to abstain from such a further expansion. It is at the same time reasonable from the viewpoint of the consumer [Mises 1998: 14].

It must be mentioned that the unending debate over the role of advertising is highly germane to this topic; however, for brevity's sake, this paper will not detour to address it at length. Suffice it to say that, although some of Mises' comments on advertising were foolish, the contemporary advocate of Misesian philosophy would contend that advertising preys upon, but does not create, the generic dispositions (including the desire for invidious distinction) that drive consumer demand. Since advertising is overwhelmingly brand oriented, not product oriented, its *net* effect upon society's what-to-produce decision is practically nil. Moreover, advertising reduces real costs by cutting search time, a process insight appreciated by Chamberlin but not by Robinson and Sraffa, whose pre-Galbraithian vision of producer sovereignty led them to portray advertising as the devil's brew through which product differentiation and monopoly power are created. The appeal of the Sraffa-Robinson-Galbraith position has proved to be enduring because it provides a justification for state vetoes of dollar-vote referenda (Galbraith 1971: 63, 74–79; Ulmer 1973: 24–26; Machovec 1995: 130, 132, 218–19, 326, n. 18).

How did the heirs of Adam Smith become so hostile to the market process? Under the perfect-knowledge postulate of the Walrasian system, no one firm can "see" a better mousetrap unless all its competitors simultaneously have the same vision. Since no advantages can accrue to anyone, alterations in the what and how decisions had to be attributed to exogenous factors. This way of thinking forced neoclassical economists, including IO pioneer Edward Mason, to dichotomize the market into a black-and-white mixture of excess-profit, utility-reducing monopolists and zero-profit, utility-neutral competitors (Machovec 1995: 179–80, 196–98, 269–76). By disallowing informational asymmetries, the appearance of pure profit must

signal antisocial behavior. In other words, the equilibrium paradigm precluded uncertainty, and, thereby, it eliminated "the driving force of the whole market system": the profit-making Darwinian search by entrepreneurs (via trial and error) for improved adaptations in product and method (Mises 1996: 248–49, 293–94; Machovec 1995: 103–4, 175, 191). Therefore, when seen through the eyes of mainstream theory, the market process yields an inferior configuration whose excess profits and inefficient shortfall in output are *correctable* via the known, optimal design (see Boulding and Samuelson, in Machovec 1995: 282). As John Commons sensed early on, "The theory of [perfect] competition developed by economists is not a natural tendency towards equilibrium of forces but is an ideal of public purpose adopted by the courts, to be attained by restraints on the natural struggle for existence" (in Machovec 1995: 203).

Knight had warned in 1942 that "some distinction . . . must be made between temporary profit [derived from successfully facing uncertainty] and permanent monopoly revenue" (in Machovec 1995: 181). But, within the mathematical structure adopted by neoclassical economics, no such distinction is possible. Mises conceded that the neoclassical graph of a firm facing declining marginal revenue is valuable because it allows us to "schematize the deliberations of the monopolists," yet he complained, like Knight, that it fails "to distinguish . . . monopoly gain . . . from entrepreneurial profit" (Mises 1996: 378). After the transformation of economics by the revolutionary victory of the equilibrium paradigm, IO analysis could proceed in no other way, for, as Frank Hahn and Thomas Kuhn have explained, new training tools change our cognition, after which we reinterpret the world (see the quotes from Hahn and Kuhn in Machovec: 1995: 8 and 276, plus the historical evidence on pp. 45–48, 98, 124–31, 298–99).

Mises and the Deadweight Triangle

Mises also rejected the neoclassical position on the magnitude of the presumed welfare losses to consumers from oligopoly (as reckoned at some specified point in time). The profession's original estimates were based on the erroneous assumption that production cuts by the leading firm (to boost price) would *not* be replaced by other producers. Mises argued in *Human Action* that, if the brands of the leading firm's competitors are perceived as relatively acceptable substitutes, then these competitors will boost their outputs at the static moment of analysis and thereby capitalize on the leader's attempt to earn monopoly profit. Nonetheless, said Mises, if the leading firm has a sufficiently

large share of the market (like General Motors, perhaps, in the immediate postwar era), it could still create a monopoly price, but its height would be a function of the reactionary capabilities of its competitors (Mises 1996: 359–60, 362–63). The 1944 paper contained an even stronger and more succinct statement on this topic, a summary that was fully compatible with equilibrium analysis but that did not make its way into *Human Action:* "The question is always: Can an individual gain by restricting production? If someone else is free to increase output, an individual can increase his profits only by increasing output, not by restricting it" (Mises 1998: 6).

For an excellent real-world illustration of Mises' point, see the description of the managerial infighting during U.S. Steel's unprofitable 1904–09 curtailment of production (in Chandler 1990: 134–36). Another example occurred recently in a less visible sector of the American economy: its toy-train industry. The General Mills Corporation resurrected Lionel Trains from bankruptcy in the late 1960s, after which Lionel embarked on a strategy of producing limited numbers of high-quality locomotives and passenger cars of popular railroad names, creating premium prices throughout the 1970s. Lionel had seen itself as immunized from entry by other manufacturers because its customers (mainly collectors) were believed to be nostalgically tied to Lionel's trademark. This assumption proved to be erroneous—and costly. During the 1980s several new firms introduced high-quality electric trains that appealed to collectors and to operator-hobbyists, causing a price softening not only in the market for the new models of all producers, but also in the previously hot resale market of prized Lionel issues from the 1940s and 1950s, which had supposedly been blessed with very low cross-price elasticities of demand.

The Misesian perspective on the extent of consumer welfare losses from oligopoly (with reaction) was finally adopted wholesale in a 1975 article—that employed elasticity data and an effective diagram—in the *American Economic Review*, the profession's flagship journal (Worcester 1975: 1015–22). However, as in the several cases described by Elzinga, not one iota of credit was given to Mises.

Future Policy Implications

Two interrelated questions on IO and *Human Action* remain to be discussed, each of which raises perplexing issues that hopefully will stimulate a fruitful exchange of ideas.

1. Is Mises' sole-source contention for monopoly valid? Or may exceptional conditions evolve within a free market that could result in monopolized restrictions of output *not* instigated by

state protection against competition? John Stuart Mill warned against "the fatal tendency of mankind to leave off thinking about a thing when it is no longer doubtful." Therefore, even when "the received opinion [*is*] true, a conflict with the opposite error is essential to a clear apprehension and deep feeling of its truth" (Mill [1859] 1987: 105, 108).

2. Has the profession's axiomatic favoring of the consumer over the producer, bolstered by Marshall's geometric surplus analysis, caused misleading conclusions to be drawn on the loss of consumer welfare traceable to markets that are not perfectly competitive? Two subquestions arise. First, what is the appropriate time window for evaluating the impact of a new arrangement of capital that, from a neoclassical viewpoint, is monopolistic? Second, if static analysis is prescribed, how is the consumer to be defined? In other words, should we adjust our analyses to reflect the impact of modern savings and investment institutions that have unwittingly enabled consumers (in a general sense) to become the recipients of producers' surpluses? When consumers are taken as an aggregated class, is the market-specific, equilibrium-calculated loss in consumer welfare shorn of its deleterious overtones? Should we therefore challenge, even within a static framework, the profession's heretofore unquestioned acceptance of its traditional interpretation of "consumer" welfare?

As a preliminary to my first question, we should note that, in his identification of the taproot of monopoly, Mises was fully in accord with the classical economists, including Smith, Senior, J.S. Mill, and McCulloch, who tied the monopoly power of a firm to the power of the state to enforce a curtailment of output by coercively repelling entry (see Rothbard 1962: 591–92; Machovec 1995: 11, 16–17, 112–13, 180–81). The onset of equilibrium thinking during the neoclassical era brought a new perspective that obliterated the difference between entrepreneurial profit—earned by fashioning a higher level of utility for consumers, as described by Smith, Malthus, Say, Mangolt, and others (recounted in Machovec 1995: 123–31, 180)—versus the pure, classical monopoly profit garnered by obtaining exclusive production rights through the political system (see, in particular, the public-choice views of Smith, in Machovec 1995: 17). In the latter situation, the artificial rearrangement of prices causes a movement along the endogenously unalterable production-possibilities frontier to a lower (nontangent) iso-utility curve of the social welfare function (due to a constriction of the monopolized good, as in the traditional equilibrium exposition). Whereas, in the former scenario (based on

the process perspective, which transcends the Robbinsian constraint of allocating *known* means among *given* ends), the entire n-space surface of production possibilities is pushed outward by the entrepreneurial discovery of undervalued resources that have been reallocated to create additional opportunities for consumers.

Walter Block has criticized Mises' shorthand description of monopoly (the intentional restriction of production) as insufficiently robust. A producer may withhold output for totally benign motives, such as speculation, conservation, or the desire to enlarge leisure, all of which limit the supply curve and raise price, but none of which are anticompetitive (Block 1977: 271–79). Supply limitations incidental to speculation, conservation, or increased consumption of leisure are independently undertaken actions, consistent with a spontaneous state of natural liberty, and hence differ substantively from a consciously conspiratorial, state-abetted design to boost price by denying others the freedom to supplement supply. Hence Block advocates a single definition for condemning a price as monopolistic, namely, the price must be the result of output restrictions linked solely to "an exclusive government grant of trading privileges." But that argument, which is rooted squarely in the classical writers, was reasserted repeatedly and emphatically by Mises (1996: 358, 361–62), as well as Rothbard (1962: 591–92, 598–99). The basis of Block's critique of Mises, therefore, seems unfounded. It is abundantly clear in Mises that his restriction-of-output criterion is used to explain the simple mechanics of a higher price, the *maintenance* of which requires his governmental-assistance criterion (except for the cases of public utilities and geographically rare minerals). These two criteria are wedded together; to divorce them is to misrepresent the position set forth in *Human Action.*

Now we can turn to my first question: Can monopoly power appear and persist without a governmental contrivance? If the answer is yes, the complete absence of an antitrust arm would create a moral hazard harmful to consumers. Of course, an entry barrier erected by the state is certainly sufficient for monopoly, *but is it necessary?* Two possibilities come to mind, each admittedly a statistical-tail case; nonetheless, their potential existence prevents an unqualified endorsement of the zero-antitrust position of most Austrians.

First, what if the classical view is only *generally* valid? Suppose, for instance, that irregularities in demand (intermittent purchases from a single buyer, with a large dollar variance between purchases), together with the high cost of transporting heavy equipment, serve to limit, perennially, the number of highway-construction firms in any given region. Then it would be easy to boost the price by colluding to control the bidding on contracts. No exclusive construction rights

would have to be granted by any state agency; the technologies of production and consumption may simply "conspire" to enable a *small* number of experienced, far-sighted firms to manipulate the price modestly in their favor, so as not to create an irresistible incentive to enter. Such bidrigging *has* occurred, yet there are no sunk costs or artificial barriers shielding this industry from hit-and-run interlopers; therefore, there may exist natural entry barriers whose peculiarities are not yet fully understood. Similar results have been found in timber auctions from federal forests (Baldwin et al. 1997: 670, 688). Since the current role of the state in road building and Western land ownership is not going to be radically altered, some form of antitrust policy must be on hand to punish collusion; otherwise, a serious moral hazard will be created in certain monopsony markets.

As a second possibility, recall Mises' analysis of oligopoly. Mises explained that *if* the leading firm's market share is sufficiently large, then it might be able to extract pure profit by reducing production, despite output expansions from its rivals. A combination of horizontal mergers and Depression-era bankruptcies, followed by a highly destructive world war that eliminates one's foreign competition for a decade or more, could create an unacceptably long short-run period during which Mises' large market-share situation could prevail—*without any tariffs or other state protection.* Furthermore, the disservice to consumers could be compounded by tacit collusion on output quotas, which Mises himself conceded was likely. An enabling scenario such as I have sketched out here would be historically freakish, but it is not inconceivable.

Finally, should the role of consumer welfare, as usually interpreted, remain sacrosanct? The past debates within the mainstream over the *size* of static losses in consumer welfare seem to have prevented a reconsideration of the *relevance* of the consumer's share of the deadweight triangle. In addition, one must challenge the use of an exclusively static framework, which totally disregards the long-term cost efficiencies to be reaped from a new pattern of specialization in capital and labor.

Block has noted that "the producer, too, engages in consumption." By rejecting the a priori preference given by public policy (and economic theory) to the consumer surplus over the producer surplus, Brock updated Rothbard's challenge to the traditional notion of the consumer (Block 1994: 41–44, 58–59).[1] I concede Block's point that

[1]Block's position is based on Rothbard's refusal to embrace the time-honored maxim of Stuart, Smith, McCulloch, Mill, and Mises, namely, that a market economy's raison d'être is to elevate the interests of consumers over the interests of producers (see Mises 1996: 357, plus the citations from classical texts in Machovec 1995: 124). The founders, of course, would have strongly objected to the employment of their pro-consumer argument to justify

input purchases by firms are acts of consumption (driven entirely by signals from their customers), and I applaud his willingness to confront this definitional conundrum, especially since antitrust action is frequently justified with the so-called burden borne by consumers from equilibrium-defined monopoly. However, the issues I am raising are different from Block's. The problem I want to address has two distinct components: the snapshot-in-time approach to assessing the burden of monopoly soon after its establishment; and the melding of consumers' and producers' surpluses via transfers to pension funds of corporate earnings and stock appreciations, which have enabled the lion's share of the surpluses of producers to be consumed by those who do not usually come to mind when the sociopolitical burden-of-monopoly flag is waved.

The static loss in consumer surplus is measured after an initial rise in price, a rise that is later overwhelmed by new specialization driven by the chastised reorganization of industry, which gradually yet inexorably reduces cost *and* price. For example, during the robber-baron era that fueled the Sherman Antitrust Act, the price of steel rails from Camegie's mills fell about 50 percent between 1880 and 1900, during which time the net change in consumer prices overall was zero. And between 1893 and 1900, when consumer prices had risen nearly 7 percent, the price of a pack of cigarettes declined 25 percent (Chandler 1990: 134–36; Chandler 1977: 386.) Similarly, as a result of Rockefeller-type innovations in extraction, processing, and distribution, a broad spectrum of fuel and mineral prices have been falling for a century in real terms, despite occasional attempts to form cartels (Simon 1996: 28–36). Of course, the very best illustration of the cost and price reductions engendered by the market's "monopolistic" evolutionary process is the ongoing restructuring of the microelectronics industry, one of whose visionaries, Microsoft, was targeted with prosecutorial punishment (as were IBM in the 1960s and A&P in the late 1930s). Regrettably, the neoclassical prism through which mainstream theorists come to understand monopoly and competition fosters a rationale for destroying our economy's most talented and helpful offspring. We all want the cost-saving social benefits of the deepening specialization wrought by the imperfectly competitive market process, but the equilibrium-trained mind does not want to relinquish the emasculated behavior it expects from a perfect competitor.

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the seizure of producers' rents [as facetiously put forward in a reductio ad absurdum argument in Block (1994: 41)]. Adam Smith, for example, approvingly recognized the Schumpetarian "bait" that must exist to induce the entrepreneurial speculations that serve consumers (see, e.g., Smith in Machovec 1995: 90, 101–3, 105–7).

A dynamic perspective is not driving the change-in-consumer-welfare analyses at the Justice Department; therefore, the definition of consumers—and of their *net* benefit/harm, direct and indirect, that has accumulated at any given point in time from neoclassical monopoly—rises to paramount importance. The classification problem is becoming increasingly relevant as more and more retirement accounts flow into equities, thereby making "consumers" (in the broader context) the ultimate beneficiaries of the "monopoly"-enlarged surpluses of producers. As Peter Drucker (1985: 191) has astutely observed, this trend has socialized America's capital without socialism (for the trend data, see Machovec 1995: 339–40, n. 3). The only way to circumvent the misleading policy implications of the static burden criterion is to define consumers narrowly as only those buyers in a given market who are also members of the Marxian proletariat (and who therefore never receive offsetting dividend payments from the profits or capital gains derived from the "burdens" suffered in all other markets).

Conclusion

This paper's purpose was threefold: First, to review and evaluate Elzinga's essay; second, to provide additional discussion of the Misesian critique of the mainstream's redefinition of monopoly and its subsequent charges of productive inefficiency and excessive welfare losses; and third, to pose controversial questions on two presumably settled issues: the source of monopoly power and the segregation of the surpluses of consumers and producers. Such exercises are necessary, said Mill, to test our fidelity to "received opinion." Sometimes the resultant "collision of opinions" leads us to amend our original convictions by revealing lacunae of truth that had been missed in previous analyses. However, even if the conventional wisdom "be not only true, but the whole truth," its future resilience requires that it be "vigorously and earnestly contested"; otherwise, "the doctrine . . . will be in danger of being lost or enfeebled, and deprived of its vital [salubrious] effect" (Mill 1987: 80, 115–16).

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