

## The Basic Economic Functions and Roles in Mises's Economics

### Outline

- A. [Interdependence and Complexity of Market Phenomena](#)
- B. [The Image of Integrated Functions and the Vocabulary of Market Interaction](#)
- C. Three Ideas in “Traditional Economics” that Mises's Contemporaries had not Digested
  - 1. [Direct and Indirect Exchange](#)
  - 2. Passive and Active Roles
  - 3. [Two Classes of Factors of Production](#)
- D. The Integrated Functions
- E. More on the Role of the Entrepreneur
  - 1. Money Capital and Uncertainty Bearing
  - 2. [The Entrepreneur Role's Inventive Character](#)

A critical step in an economists' climb to a position where he can employ the special knowledge of economics to evaluate intervention arguments is to produce a vocabulary that will enable him to represent the function of causing material consumer goods to be produced.<sup>1</sup> To build this vocabulary, he must identify the most important functions and assign roles to perform them. Mises did this with an imaginary construction that he called the “functional distribution” (Mises 1966 – HA). In this essay, I explain how he used this construct and his related knowledge of what he regarded as the tradition in economics to produce this vocabulary.

Part One introduces the problem of depicting market interaction under the conditions of capitalism by. Part Two introduces the construction from which Mises extracted the functions and roles. I assign this construct a new name – the image of integrated functions. Part Three shows how Mises's description of the functions employs ideas that Mises regarded as part of the tradition that had been established by economists who preceded him but which, in fact, had been digested by a tiny few. This helps explain why his new vocabulary was not well understood or appreciated and therefore, why his contributions were largely overlooked by the profession of economics and also by those who considered themselves his followers. Part Three elaborates on the most critical of the roles – the entrepreneur.

For the most part I confine my documentation to footnotes. performance of the functions that must be performed for individuals to take advantage of the higher physical productivity of the division of labor under the conditions of capitalism. The economist produces this vocabulary by conceiving of the functions that must be performed under the conditions of capitalism and identifying roles that perform the functions.

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<sup>1</sup>This special knowledge is discussed in my essay “[The New Science of Economics in Mises's Treatise](#).”

### Interdependence and Complexity of Market Phenomena

The phenomena of pure capitalism are the composite results of the choices of uncountable individuals who are related through their money exchanges. Each person is a specialist in the overarching division of labor that characterizes capitalism. Each chooser is different. In addition, the choices are *interdependent*. As choosers observe each others' actions, they reassess the actions that they previously planned to take. Many may change their plans. The later individualist economists used the term "entrepreneur" to refer to such interaction. Then they characterized the interaction by assigning the words "interdependence" and "complexity."<sup>2</sup> Complexity in market interaction refers to the inability of the economist to identify all of the actions that contribute to the market phenomena that results from those actions.

### The Image of Integrated Functions and the Vocabulary of Market Interaction

To evaluate intervention arguments, the economist needs a vocabulary that he can use to communicate how individuals deal with scarcity and how they take advantage of the higher physical productivity of the division of labor in the face of interdependence and complexity. The *image of integrated functions*, as I call it, provides the foundation for this vocabulary.<sup>3</sup>

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<sup>2</sup> Such complexity cannot be represented by mathematical models. A mathematical model can represent the endpoint that entrepreneurial action causes a tendency toward. But this endpoint is hypothetical only. Mises introduces his commentary on the use of mathematics to represent pure capitalism at HA: 250 in the context of his discussion of the endpoint of the "evenly rotating system." This imaginary situation is discussed in my essay "[The Imaginary Constructions of Economics](#)." He presents a more extensive analysis of mathematical economics at HA: 350-357.

The term "complexity" can also be used to characterize the phenomena of the natural sciences. Natural science phenomena can also be called complex. However, the source of complexity in economics is categorically different from that in the fields of the natural sciences. In economics, it consists of purposeful action of distinctly human actors. When I use the term "complexity" in this book, I am referring exclusively to the complexity of the market phenomena that are caused by entrepreneurial interaction.

<sup>3</sup>Mises called this image the *functional distribution* (HA: 254).

In the context of economic theory the meaning of the terms concerned is this: Entrepreneur means acting man in regard to the changes occurring in the data of the market. Capitalist and landowner mean acting man in regard to the changes in value and price which, even with all the market data remaining equal, are brought about by the mere passing of time as a consequence of the different valuation of present goods and of future goods. Worker means man in regard to the employment of the factor of production human labor. Thus every function is nicely integrated: the entrepreneur earns profit or suffers loss; the owners of means of production (capital goods or land) earn originary interest [pure market interest]; the workers earn wages. In this sense we elaborate the imaginary construction of *functional distribution* as different from the actual historical distribution (HA: 254).

His aim in introducing this image is to identify the functions and roles, which is required by the economist in order to deal with the complexity of market interaction. Regrettably, he did not tell his reader this. All that he said is that economics, or economic theory, has used the imaginary constructions. Thus he writes as if he is merely reporting on what previous economists have done without showing his approval or his own real aim.

Moreover, he did not introduce this functional distribution construct until after he had described the evenly rotating system and states of rests. Although this may be consistent with the way he decided to organize his chapter – by presenting an orderly exploration of the imaginary constructions that economists use – it is not part of an orderly presentation of the method economists use to build economic theorems. I have taken a

In his brief description of this image, Mises seemed to assume that his audience had digested the most advanced of the ideas of the individualist economists. In fact, the audience of the 1950s and on seems to have completely lost touch with three crucial ideas that he incorporated into this image. As a result, the image seems to have been, for all practical purposes, ignored by subsequent interpreters. To avoid the same fate here, I state the ideas first. Then I describe the image.

### Three Ideas in “Traditional Economics” That Mises’s Contemporaries Had Not Digested

The three ideas that Mises’s readers had not digested are the following. First, although the economist aims to build an image of an economy that contains a demand for and supply of money, the tradition in economics prior to Mises’s 1912 book did not contain such an addition. The builders of the consumer utility theory of market phenomena assumed what Mises called a barter fiction. To represent this fact, Mises introduced the new terms “image of direct exchange” and “image of indirect exchange.” The direct exchange image is the barter fiction. The second idea is that due to complexity, market interaction under capitalism must be conceived as an interaction between the role of the consumer who passively receives utility and the role of the entrepreneur who possesses the knowledge and performs the action required to produce the material consumer goods that yield that utility. The third idea is that in employing factors of production to produce those goods, the entrepreneur role distinguishes not between the three classes of factors of land, labor and capital identified by the classical economists but between the human factors and non-human factors identified by the later individualist economists. I discuss each idea in turn.

#### *Direct and Indirect Exchange*

The first step toward producing economic theorems is to build an image of market interaction under the conditions of pure capitalism for the case of direct exchange. Direct exchange, strictly speaking, means barter. In a barter society, by definition, a person exchanges a good or factor for a good or factor without the use of the medium of money. As opposed to this, indirect exchange refers to a person’s exchange of a good or factor for money and then the person’s exchange of money for a good or factor. In *indirect exchange*, a person must hold money for some period of time.<sup>4</sup>

**Image of pure capitalism under direct exchange:** an image of pure capitalism in which all exchanges are direct yet in which there are money prices. The money prices are signals of demand and willingness to supply. They enable individuals acting in the entrepreneur role to calculate the money profitability of embarking on various production projects.

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different approach by first introducing this image, which I call the image of integrated functions, and explaining why the functions and roles are necessary.

<sup>4</sup>When Mises used the term “indirect exchange” in his 1912 book, he referred to Knut Wicksell (TMC: 30).

The image of pure capitalism under direct exchange that Mises builds is not a barter society. It is an image in which all exchanges are direct yet in which there are money prices.<sup>5</sup> The economist assumes that the money prices are employed by market participants to send and receive signals about their demands for consumer goods and factors of production and about their willingness to supply those demands. These signals enable individuals acting in the entrepreneur role to make decisions about whether to undertake a production project on the basis of expected money revenues and money costs. In other words, it enables them to engage in monetary calculation.<sup>6</sup> Thus, the economist says that signaling and monetary calculation by entrepreneurs, or economic calculation, are characteristics of the image of pure capitalism under direct exchange.

**Choices based on monetary calculation:**

Choices in which individuals decide which actions to take by comparing expected money revenues with expected money costs.

When the economist builds theorems about market interaction under direct exchange, he assumes a division of labor. He also assumes that supply chains exist for at least some of the factors of production. For example, the flour used by a baker can be traced up a supply chain to wheat grain, and to raw wheat produced by the farmer. The factor, raw wheat, has a supply chain that leads to baked bread. In addition it has supply chains that lead to pancakes and spaghetti pasta. Due to profit-seeking by the entrepreneur role, the prices of the factors are related to the prices of the consumer goods they help to produce. Individuals acting in the entrepreneur role have incentives to shift from projects that they expect to earn lower profit to projects that they expect to earn higher profit. If entrepreneurs change one price, they tend to change every price of every factor of production and every product.<sup>7</sup> The assumption of supply chains also opens the way toward a theorem that there is

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<sup>5</sup>Mises called this image the “barter fiction” (HA 201). This is probably not a wise use of terms. There is no need to employ an historical synonym.

<sup>6</sup>Monetary calculation is important because it enables a decision maker to employ the powerful tools of arithmetic and more complex mathematics.

<sup>7</sup>The division of labor is represented by the proposition that entrepreneurs who produce each material consumer good and factor of production at each juncture along the supply chains possess specialized knowledge that may not be possessed by anyone else. Mises writes that the inventors of this theory used the barter fiction to show how “to trace back the phenomena of the market to the universal category of preferring *a* to *b*...” (HA: 201). What he means is that by focusing on the relative prices at which goods are exchanged instead of the absolute prices, the economist can easily recognize that the entrepreneur’s profit incentive can be traced to the demands for material consumer goods which, in turn, can be traced to the use of means – earning income and buying material consumer goods – to attain the end of removing the felt uneasiness associated with consuming fewer goods. He neglects to say, however, that the profit incentive can also be traced back to the specialized knowledge that the economist assumes is possessed by entrepreneurs at each “junction” along the various supply chains. In other words, he neglects in this statement to refer to the specialized knowledge possessed by the entrepreneur role.

Mises used the term “connexity” to express this relationship among the various prices (HA: 391-4). The term did not attract a following and I will not use it here.

a tendency for the sum of the prices of the factors of production required to produce each product to equal the price of the product.<sup>8</sup>

Another way to say the same thing is that building the image of pure capitalism enables the economist to present the [law of consumer sovereignty](#). In building this image, Mises disregards changes in the demand for and supply of money balances. He assumes “neutral money.”<sup>9</sup>

The overarching function of the image of direct exchange is to enable the economist to depict two essential characteristics of market interaction in the simplest possible way. These are the [division of labor law](#) and the actions required to [deal with scarcity](#). Scarcity is represented by the proposition that as the entrepreneurs bid more of a factor of production away from a particular use, *ceteris paribus*, its price in that use tends to rise.

### *Passive and Active Roles*

By designating the entrepreneur role as responsible for causing all consumer goods to be produced, the economist separates the distinctly human, activating character of market interaction from its passive character. The roles of the capitalist, landowner, and worker possess only passive character. In the vocabulary of the image of integrated functions, the economist assumes that they passively provide services to the entrepreneur role in exchange for income. The capitalist and landowner have command over property that they rent out in return for market interest. The worker commands his work. He passively supplies the labor factor and earns wages.<sup>10</sup>

### *Two Classes of Factors of Production*

The individualist economists of the 20th century made a contribution to economics that was never incorporated into modern professional economics. They replaced the classical distinction between three types of factors of production with a two-factor type distinction. Specifically, they rejected the three-factor typology of land, labor and capital. They replaced this typology with one that distinguished only between human and non-human factors.<sup>11</sup>

In the newer typology, the human factor – labor, or work – must be owned by the person in whom it is embodied. The material factor can be owned by anyone. More accurately, the final decision

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<sup>8</sup>Thus Mises writes that the “prices of the goods of higher orders are ultimately determined by the prices of the goods of the first or lowest order, that is, the consumers’ goods” (HA: 333). A higher-order good is a factor of production that is farther up the supply chain than (raw wheat) some other factor and that is used to help produce the lower-order factor (baking flour).

<sup>9</sup>HA: 416-9; 534; 538.

<sup>10</sup>Mises does not emphasize the fact that his presentations divide the roles into passive and active. But he uses the active-passive distinction repeatedly in building economic theorems.

<sup>11</sup>Mises writes that the “modern theory of value and prices...distinguishes within the class of factors of production...the nonhuman (external) factors from the human factors (labor)” (HA: 636). Regrettably, he does not explain why and he provides no references. He makes it clear, however, that individualist economists corrected the classical economists error by recognizing that appraisals of all factors are made on the basis of the same principles (*ibid.*). One surmises that in his EP discussion of the matter, he had not yet considered the usefulness of the new classification system (EP: 17).

regarding how work will be employed and whether it will be employed must rest with the human being in whom the resource is embodied, while ownership of the material resource can be transferred.

The owner of a human resource can transfer control over her work within limits. She can do this by making an employment agreement. The owner of a material resource can also transfer control within limits by renting out his resource, subject to restrictions. However, he can also transfer complete control.<sup>12</sup>

That a human resource must ultimately be controlled by the person in whom it is embodied is not deduced from a view of which rights are natural or inalienable.<sup>13</sup> It is an implication of the free enterprise condition of capitalism. To control another person's labor is a characteristic of slavery. Slavery is incompatible with the legal rights required for an unhampered capitalism to prevail. The performer of work must have the final veto over whether his work will be performed.

### The Integrated Functions

The image of integrated functions is not designed to represent an economy or economic system. The economist produces it in order to represent the profit-seeking entrepreneur's actions that maintains and expands the division of labor under scarcity. Such actions embody all of the knowledge of how to produce consumer goods and factors of production.

To complement the entrepreneur role, the economist invents the consumer role to represent the satisfaction of consumer wants. The consumer role passively expresses the utility obtained from material consumer goods. The expectation of such utility ultimately motivates entrepreneur action to cause goods to be produced. The entrepreneur role is the driving force responsible for producing all consumer goods.

These two roles are complemented by the role of the factor supplier. The factor supplier role embodies the ownership of the factors and the desire by their owners to maximize income from supplying these factors. Individuals in this role passively respond to offers of income for supplying their respective factors.

To distinguish between the owners of material factors and the owners of human factors, the economist further divides this role into two components: the capitalist and the worker. The worker role – the owner of the human resources – may also embody the disutility received from supplying labor.

**Image of integrated functions:** a skeletal image of market interaction in which the economic functions of causing material goods to be produced to satisfy consumer wants are performed by hypothetical individuals who act exclusively in the specific roles of the consumer-saver, entrepreneur, and factor supplier.

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<sup>12</sup>In real capitalist economies in some cases, individuals may not be able to gain complete control. For example, the government may have established usufruct rights.

<sup>13</sup>This is worth mentioning because Rothbard expresses such a view indirectly in his *Man, Economy and State* (1962) by analyzing slavery from the point of view of the actions that are allowed in the noninvasive society (*ibid.*: 164). Later he treats slavery as the violation of what he calls the “first principle of justice in property” (Rothbard 1974: 98).

## More on the Role of the Entrepreneur

### *Money Capital and Uncertainty Bearing*

The entrepreneur role is a profit-seeker. Yet it possesses no money capital to buy or hire the factors of production needed to finance production. Without money capital, an individual acting in the entrepreneur role cannot get into a position to bet on his superior knowledge of the material goods that people want to consume and her knowledge of how to produce those goods. This limitation of the image of integrated functions is overcome by introducing the role of the *capitalist-financier*. In real market interaction, a project can be financed by consumer-savers who lend money to the entrepreneur or by owners of factors of production who agree to wait for their payments until after the product is produced and sold. In either case, the financiers must bear uncertainty. The capitalist-financier role or, more simply, the capitalist is always an entrepreneur even though she does not direct production because she cannot avoid bearing uncertainty. If the entrepreneur's project fails, she must bear a loss.<sup>14</sup>

The role of the capitalist is not part of the image of integrated functions. However, the economist must employ it when economic theory is applied to reality, either in the evaluation of intervention arguments or in interpreting historical events.

### *The Entrepreneur Role's Inventive Character*

I use the phrase "inventive" to refer to the character of an actor that enables him to identify profitable and previously undiscovered means of producing a material consumer good. The inventive character can only be explained by referring to the individuality of the actor. It is responsible for the employment of new factors of production and new ways to employ existing factors. Similar terms are "imaginative" and

**Inventive character of action:** the capacity of the actor to identify a previously undiscovered means of producing a material consumer good.

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<sup>14</sup>To isolate the capitalist-financier, Mises tries to build an image of what he calls a *pure entrepreneur*. A pure entrepreneur would possess no financing. Suppose, he says, that the pure entrepreneur speculates on behalf of the capitalists and takes "100 per cent share in the net profits." The capitalist would be left to bear any losses. He neglects to say that no capitalist would be satisfied with such a situation. But he implies this by writing that the "capitalist is always also virtually an entrepreneur and speculator" (HA: 253).

His aim is to emphasize the fact that in the task of describing real market interaction, the functions of driving market interaction and bearing uncertainty cannot be separated in reality. They can only be separated by the theorist who aims to distinguish different functions.

“creative.”<sup>15</sup> The result of such employment is that individuals in the consumer role tend to receive superior consumer goods or the same goods at lower prices.

Inventiveness is one of two contributors to the increase in humankind's capacity, *ceteris paribus*, to produce consumer goods. The second is saving.<sup>16</sup>

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<sup>15</sup>Mises uses the term “inventive” in two different ways. First, he writes that we call the mind inventive “because we are at a loss to trace the changes brought about by human action farther back than to the point at which we are faced with the intervention of reason directing human activities” (HA: 141). Referring to the entrepreneur, he writes that his restlessness and “eagerness to make profits as large as possible” is “the element tending toward unceasing innovation and improvement” (HA: 255). This is the meaning adopted here. Second, he associates it with what he calls the creative genius. The creative genius is compelled to produce creative works without regard to the income he expects. For such people, “to live means...to create” (HA: 139).

The achievements of the creative innovator, his thoughts and theories, his poems, paintings, and compositions, cannot be classified praxeologically as products of labor. They are not the outcome of the employment of labor which could have been devoted to the production of other amenities for the ‘production’ of a masterpiece of philosophy, art, or literature (HA: 139-40).

He mentions Newton and Mozart (HA: 89).

<sup>16</sup>Thus Mises writes that

the preliminary conditions of economic improvement are an achievement of those whose saving accumulates the additional capital goods and of the inventors, and that the utilization of these conditions for the realization of economic improvement is effected by the entrepreneurs (HA: 298).

Mises tended to emphasize saving. The reason, one speculates, is that many intervention arguments disregard the effects on current saving and on the consumption of previously accumulated capital goods. In building the image of pure capitalism, it is important, however, to also emphasize the relationship between entrepreneur action and progress through innovation. That Mises appreciated this is evident:

The market economy is essentially characterized as a social system in which there prevails an incessant urge toward improvement. The most provident and enterprising individuals are driven to earn profit by readjusting again and again the arrangement of production activities so as to fill in the best possible way the needs of the consumers, both those needs of which the consumers themselves are already aware and those latent needs of the satisfaction of which they have not yet thought themselves. These speculative ventures of the promoters revolutionize afresh each day the structure of prices and thereby also the height of the gross market rate of interest (HA: 543).



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