An Introduction to Austrian Economics

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4. The Subjective Theory of Value

Satisfaction and Valuation

The explanation of all economic activity that takes place in the market economy ultimately rests on the subjective theory of value. The value of various consumer goods and services does not reside objectively and intrinsically in the things themselves, apart from the individual who is making an evaluation. His valuation is a subjective matter that even he cannot reduce to objective terms or measurement. Valuation consists in preferring a particular increment of a thing over increments of alternative things available; the outcome of valuation is the ranking of definite quantities of various goods and services with which the individual is concerned for purposes of decision and action. Theory resorts to the hypothetical concept of the scale of values in seeking to explain and understand the nature of human valuations. The ranking of alternative ends is determined by the person's expectations of satisfaction from each specific choice faced by him at any moment of decision. He will invariably select the alternative that he believes will yield him the greatest satisfaction.

The subjectiveness of valuation rests in the nature of satisfaction--satisfaction is subjective and not open to numerical measurement. The extent to which a thing gives satisfaction is always personal. People derive satisfaction from different goods and services; that is, all people are not alike in terms of the types of things that please them. Experience also demonstrates that a person's preferences vary from time to time. His ranking of alternative choices may undergo a reshuffling at any given moment. His scale of values may also be altered by deletions or additions.

To relate the matter of valuation to the individual person is not to suggest that each individual is concerned only with the satisfaction of his own appetites and needs. A person may find satisfaction or relief in helping another person. Satisfaction can be and often is derived from the attainment of altruistic as well as "selfish" motives. But the point remains that regardless of the form the satisfaction is to take, each choice arises from subjective valuation on the part of the particular person who is doing the choosing. The uneasiness that he seeks to remove is in his own mind, whether such uneasiness pertains to an immediate problem of his own or to a problem faced by someone else. His choice stems from the preference that he has for the removal of a particular uneasiness over another problem to which he could devote his attention.

The Principle of Marginal Utility

Valuation is always directed toward a definite quantity of a particular good or service. Choices and decisions are not concerned with the whole supply of a certain good or service. This marginal orientation was lacking in the classical economists' groping with the so-called paradox of value. They were unable to resolve the intriguing question of why diamonds had a higher price per unit than water when everyone knew that water was more useful and valuable than diamonds. Only through the principle of diminishing marginal utility could this conceptual dilemma be eliminated. Each additional unit of a particular good is devoted to a use that is less important and urgent than the use to which the preceding unit was applied.

To establish this principle one does not have to resort, as is sometimes done, to explanations of psychological or physiological satiety. The principle that a person will always apply a given unit of a good or service to the most pressing desire or need to which it relates is inherent in the concept of purposive action. Since each person prefers more satisfaction to less satisfaction, each succeeding unit obtained will be devoted to less and less important aims, given his scale of values at that time.

From the principle of diminishing marginal utility is derived an important law relating to the value of a unit of any good possessed in any particular quantity. The value of a unit of a given quantity of a particular good is determined by its usefulness in its least important use. To put the rule another way, the value of any unit of several units held of a given good is equal to the satisfaction that would be sacrificed if one unit were lost. Bohm-Bawerk illustrated the law by imagining a pioneer farmer who has reaped five sacks of grain from his harvest. [1] In planning carefully the use of this food supply, he first recognizes the essential need for a minimum amount of food to keep him alive until the following harvest. To this purpose he allots one sack of grain. A second sack will contribute to his enjoying full strength and complete health. A third sack will enable him to add some variety to his diet by using it for raising poultry. He decides to assign a fourth sack to the distillation of brandy; and finally, a fifth sack is to be devoted to the feeding of a group of parrots "whose antics give him pleasure."

The example depicts the operation of the principle of diminishing marginal utility. The farmer's plans for the sacks of grain proceed from the more important to the less important uses. The value of each sack of grain equals the satisfaction that the farmer expects to derive from being able to feed and enjoy his parrot friends. This is the satisfaction that he would surrender if he suffered the misfortune of losing one sack of grain. Since his sacks of grain are a homogeneous commodity, he does not have to go without any of the four more important uses because of his loss. He will simply select the least important use in determining which part of his original plan cannot be effected. The value of a unit is determined by its marginal utility or satisfaction.

The principle of diminishing marginal utility and its complementary law of value resolve the paradox of value as exemplified by the discrepancy between the price of diamonds and the price of water. The element of scarcity in controlling the extent to which a particular commodity can be used holds the key. The relative abundance of water as compared with the availability of diamonds means that increments of water can be devoted to less and less important uses than those to which the limited amount of diamonds can be put. No one is ever in the predicament of having to choose between all water and all diamonds; thus there is no meaningful paradox. Prices arise in connection with definite amounts of goods and not in connection with whole categories of various goods.

If the amount of a good with which one is concerned is enlarged to encompass several of the smaller "units," the value theory is no less applicable. In this case, the larger amount becomes the marginal unit, and its valuation equals the sum of the various satisfactions that the larger amount would yield if broken down into incremental usages. For example, if our farmer is faced with giving up in one stroke three sacks of grain, his valuation of this package is not equal to three times the valuation or satisfaction attached to the maintenance of his parrots. He is not in the situation of valuing just one sack of grain. He will sacrifice the three least important uses of his sacks of grain, thereby devoting his remaining two sacks to meeting his essential food needs. The value of a "unit" of three sacks of grain equals the total satisfaction expected to be obtained from raising poultry, distilling brandy, and feeding parrots. This is the marginal satisfaction pertaining to the marginal unit of three sacks.

The size of the unit used is not important for the operation of value theory. It can be seen that if one were in the impossible position of having to rank all water and all diamonds, one would rate the former first and the latter second, disproving the existence of any paradox of value. It also follows that if the supply of a particular good is so large that some units go unused, the marginal utility of the good is zero; in such case, no value would be attached to any particular unit. The good would not belong to the realm of economics and could be expediently termed a "free" good. This is the case with the ordinary air that we breathe (although problems with air pollution have created certain situations that involve costly, not free, clean air).

Value and Exchange

In a modern economy the purpose of production is to yield goods and services to be used by people other than the producers themselves. This is the essence of specialization and division of labor. In a developed society, production for exchange overshadows production for immediate use. As a result, units of goods and services take on exchange value in addition to the use value that they may have for the producer. And with the overwhelming emphasis on production for exchange, the exchange value of produced goods looms as the value that is of real significance and relevance for most producers, while the use value of goods is the meaningful value for consumers.

It may appear that the concept of exchange value introduces a departure from the subjective theory of value, yet this is not the case. A unit of a given good derives its exchange value from the subjective value that is identified with the amount of some other good that can be obtained in exchange for it. This is true whether the good is to be exchanged directly for some other consumable good or for a certain amount of money. People wish to obtain other goods, including money, because they place a subjective valuation on such acquisitions. The value of a good as a means of exchange is based on the greatest satisfaction that the owner expects can be derived by giving up the good in exchange for some other good. The subjective value of the most desirable good or service that can be obtained in exchange is the basis of the value imputed to the possessed good.

Thus any particular good takes on both a use value and an exchange value. Each of these values reflects the satisfaction that can be expected to come by way of employing the good; the good can be employed either for direct use or as a means of obtaining some other good through outright exchange with another person. The controlling valuation for decision and action is always the greater of the two alternative satisfactions. If the good's use value exceeds its exchange value, the good will be put to direct use or held for eventual direct use, and its exchange value will be forgone. On the other hand, if its exchange value exceeds its use value, the good will be utilized for exchange purposes or held for possible exchange at some time in the future.

It should be understood that exchange value here refers to the *subjective* valuation placed by the owner on the good as a means of exchange. The expression "exchange value" is used frequently in the sense of the money price that can be obtained for a given good through its sale. In the context of the subjectivity of value, however, this objective money value would be evaluated subjectively in the same way that a noncash good obtainable through exchange would be evaluated.

Uses of Money

In most modern economies, money is primarily fiat money, and its use value in the sense of being employed for consumption purposes is virtually zero. However, where specie is used, money can have a considerable use value. For example, gold and silver can be melted down for jewelry, decoration, and dental applications. Incidents of converting money into other useful products are not common in modern economies; money is valued almost invariably for its exchangeability. Its great service is that is obviates the requirement for a coincidence of product wants among the parties to an exchange, as is required in cases of direct barter. [2]

There are three ways that a specific quantity of money can be put to immediate use. It can be used for the expenditure necessary to acquire another good or service to be used for consumption purposes. It can be spent for another good or service that is to be used in the productive process of effecting or fabricating a new good. In such case, an investment expenditure is made that is designed to yield future consumption or investment benefits through subsequent disposal or consumption of the produced good. Even wholesalers and retailers who bring about no change to the physical good itself effect a new good by placing it at a more accessible and convenient location. They are thereby engaged in the productive process, and the money spent to acquire the goods stocked is expended for production as opposed to consumption purposes.

The third use is to add the money to one's cash balance to help pay for future exchange transactions. The fact that a person holds a certain amount of money at a given moment indicates that he values the money more than those things that he could obtain in exchange for it. Yet holding an amount of money at a given moment does not alter the fact that money is valued for its exchangeability. It merely shows that being prepared for later exchanges is valued more highly than making exchanges now. The satisfaction arising from an increased cash supply is often manifested in a feeling of greater security. This valuation springs from the belief that in the future one will be better able to meet his needs by spending his accumulated cash balance. That a money asset yields a service or satisfaction and thus is not sterile and unproductive--as has been widely held in the study of economics since the days of Aristotle--has been elucidated by Professor W.H. Hutt. [3]

The principle of diminishing marginal utility is no less applicable to money than to other commodities. Units of money are utilized in such a way that the most urgent goals or needs are met first. Because of the particularly easy divisibility of money, such allocations are made in more incremental steps than is the case with any other commodity. The marginal utility of money, then, equals the least highly valued use that the given unit serves. Just as in the case of the farmer's five sacks of grain, the satisfaction derived from a unit of money is the satisfaction that would be sacrificed if a unit were lost. The incidence of the loss will always be on the least important use that a unit was intended to serve. Yet this sacrifice is the most important use to which the marginal unit could be put. A person will thus allocate his money among consumption expenditures, production expenditures, and increases in his cash balance in terms of his scale of values or preferences.

Use and Exchange Value in the Market Economy

An important characteristic of the use of commodities, including money, in the productive process under a system of social cooperation is that the user is not concerned only with his own satisfactions or preferences. Since he is engaged in the generation of goods and services that are to be used by other people, the exchange value of the commodities depends on the relative preferences of the other people after the completion of the production process. The number of dollars that the producer anticipates will be the result of his productive efforts hinges ultimately on his perception of the values of other persons.

In a world of certainty, there would be no difficulty in arriving at a money appraisal for the group of employed goods and services. In the modern market economy, however, only in the few cases of guaranteed and contracted sales is the money outcome of certain productive efforts relatively certain. And even in those few cases the invested resources are usually of a scope exceeding what would be required to meet the contracted sales, indicating that the producer is banking on the occurrence of sales not yet contracted. The whole task of having to produce to suit the wants of other persons in the face of an uncertain future is the essence of entrepreneurship.

It can be seen that in the market economy, characterized by the production of goods and services for subsequent exchange by a common medium of exchange, both use and exchange values are a vital part of the economic process. For the ultimate users of goods and services, the consumers, the satisfaction arising from consumption is the source of value or utility. For producers, the goods and services devoted to production are meaningful only in terms of the money and its exchange value, which they expect to generate from the sale of their product. But the crucial point to remember in distinguishing between these two values is that the exchange value of any productive good tends to be connected with the use value that the consumers attach to its end product. The amount of money that consumers can be expected to allocate to various consumer goods and services is strongly influenced by their subjective preferences. It is this anticipated money inflow that provides the basis for arriving at an exchange value for goods and services devoted to production. An explanation of how the prices of productive resources tend to be derived from the prices of consumer goods will be offered in a later section.

The Pervasiveness of Subjective Valuation

Subjective valuation underlies all economic activity. Money is not a measure of value; quite the contrary, money is imputed a subjective value as a means of possessing other things. Any subjective valuation is immeasurable and is manifested only through specific choices and actions. Any particular choice is indicative of the decision maker's preference over all alternative courses of action considered during the time of decision. That this preference can be inferred from his actions does not mean that anything more than a preference is implied. As Rothbard has stated, "We deduce the existence of a specific value scale on the basis of the real act; we have no knowledge of that part of a value scale that is not revealed in real action." [4]

There is no way to measure quantitatively the satisfaction that the actor associates with his choice. Every choice requires rejection of the expected satisfaction from other possible choices; the highest ranked alternative forgone is the cost of any given decision. Benefits and costs are ultimately subjective. Every decision is predicated on the assumption that its benefits will exceed the advantages of the next best course of action; this is the background of every exchange. There is no such thing as an equal exchange. At the point of exchange, both buyer and seller consider themselves to be better off as a result of the exchange. In a system of extensive specialization and division of labor, most goods are produced for exchange. Specialized producers have little, if any, direct use for the goods they have produced; under the principle of diminishing marginal utility, the marginal utility of a unit of production is virtually zero as far as they are concerned. They place a higher valuation on the money that they can get for their goods. On the other hand, consumers or buyers value the goods obtained more highly than the money spent to acquire them. Exchanges can occur only when there are differences between the subjective valuations expressed by the parties of the exchanges.

The failure to consider this subjective orientation led to the unfortunate notion of the "economic man," which depicted every participant in the market economy as relentlessly seeking at every turn to maximize his monetary position. This idea is unrealistic because what people actually seek in every action is a maximum psychic or subjective profit.

There are numerous examples of people forgoing additional monetary wealth because they deem the "cost" to be greater than its worth. There are investors who resist monetarily rewarding investments in industries whose products they find objectionable. Marketers have recognized that consumers sometimes consider factors besides the purchasable good and its related price. The availability of parking, the courtesy of clerks, and "store personality" now receive attention in discussions of merchandising. Wealthy entrepreneurs who continue to involve themselves in profit making even in their old age are undoubtedly motivated in many cases by something besides money. People often consider factors in addition to wages in deciding on a career or particular job.

The point of these examples is to demonstrate that people are not "economic men" in the classical sense and that money is not the ultimate basis of valuation. Even when dealing with money matters, people do not calculate monetarily in utmost detail every step and decision. They maximize subjectively but not monetarily, because monetary calculation must be sacrificed when its requirements on time and energy are recognized. Bohm-Bawerk dealt with this point:

> If anyone insisted on deliberating with maximum scrupulousness every one of the economic acts he undertakes every day, if he insisted on rendering a judgment of value throughout to the last detail concerning the most trifling good that he has to deal with by way of receipt or expenditure , by utilization or consumption, such a person would be too much occupied with reckoning and deliberating to call his life his own. The correct maxim and the one which would be observed in economic life is "Be no more accurate than it pays to be." In really important things, be really exact; in moderately important things be moderately exact; in the myriad trifles of everyday economic life, just make

the roughest sort of valuation. [5]

It can be stated, however, that, other things being equal, people do strive to maximize their monetary position in choosing among alternative courses of action. A person will choose the alternative that promises to maximize his monetary position as long as he is indifferent to the nonmonetary factors pertaining to the alternatives. In a money economy it is through the common medium of exchange that people are able to acquire most of those goods that yield them satisfaction. By maximizing their monetary position, they are able to command more goods and services from the market than they could with less money. This should not be misconstrued as meaning that all individuals ultimately seek maximum monetary wealth. The fervent pleas of participants in fund-raising endeavors whose stated objectives are to help the crippled surely are not symptoms of greed. Money is the means by which many desired ends can be achieved.

A person will accept a less than maximum monetary position only when the satisfaction obtained from nonmonetary factors relating to another choice more than offsets the satisfaction associated with the money. The role of nonmonetary factors is likely to be greater with regard to the decisions of employment than with regard to those decisions relating to investment and consumption expenditures. Investors generally desire to maximize the financial return on their investment; consumers generally desire to acquire goods at the lowest possible prices.

Thus, despite the subjectivity of benefits and costs, the terms *money revenues* and *money costs* are meaningful references to the monetary inflows and outflows that arise in connection with productive activities. Regardless of the nonmonetary factors that are important to a given producer, his monetary position or outcome is also important to him insofar as he desires to continue to purchase certain goods and services. This means he must give more than cursory attention to money costs and money revenues.

However, it must be stressed once more that these money calculations are not in any way measurements of value in the subjective sense. Rothbard has stressed the need to use the term value with care: "It is important to keep distinct the subjective use of the term in the sense of valuation and preference, as against the 'objective' use in the sense of purchasing power or price on the market." [6]

Suggested Readings

Kirzner, Israel M. *Market Theory and the Price System,* pp. 45-62.

Menger, Carl. *Principles of Economics* (1871). Trans. Dingwall and B. Hoselitz. Glencoe, Ill.: Free Press, 1950, pp. 114-174.

Mises, Ludwig von. ***Human Action: A Treatise on Economics,*** pp. 92-98, 119-142.

[1] Eugen von Bohm-Bawerk, *Capital and Interest,* vol. 2, book 3 (South Holland: Libertarian Press, 1959), pp. 143-145.

[2] In a later section the explanation of modern day inflation as the result of governmental debasement of money through credit expansion will be presented.

[3] See his essay, "The Yield from Money Held," in *On Freedom and Free Enterprise,* ed. Mary Sennholz (Princeton: Van Nostrand Co., Inc., 1956), pp. 196-216.

[4] Murray N. Rothbard, *Man, Economy, and State* (Princeton: Van Nostrand Co., Inc.), I, 224.

[5] Bohm-Bawerk, *Capital and Interest,* p. 202.

[6] Rothbard, *Man, Economy and State,* p. 271. Mises has chosen to make the distinction by using the term valuation with the subjective meaning and the term appraisement in the "objective," monetary sense. Cf. ***Human Action,*** pp. 331-33. The terms value and valuation have been employed in the subjective sense throughout this section.