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Reply to Dr. Howden on Opportunity Costs

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INTRODUCTION

Howden (2016) dedicates a large part of his response to criticizing my way of dealing with and classifying the concept of opportunity costs in my book (Braun, 2014). I must start by saying that the main arguments in my book do not depend on my approach to the cost problem. The main reason why I considered it necessary to abandon the opportunity cost concept is that I found it impossible to apply it to the analysis of human action in the passing of time. For this purpose, the concept of costs as employed in business life, where profits are traditionally not calculated on the basis of opportunity costs but as historically incurred monetary expenses,[1] are much more useful. It appeared to me that if "the interest rate expresses itself in

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[1] Though government intervention has partly changed this in recent years (see Huerta de Soto, 2012, pp. xxiv–xxix).

the difference between income and costs at each stage" (Huerta de Soto, 2012, p. 557), the costs must not be understood as foregone opportunities but as historical outlays.

CRITICAL REFLECTIONS ON THE OPPORTUNITY COST DOCTRINE

Most Austrians agree that costs are a praxeological phenomenon. Each action implies the incurrence of costs. In the terminology of Rothbard (1962, p. 104; see also Mises, 1949, p. 97), the objective of human action, i.e., psychic profit, can be expressed as follows:

psychic profit = psychic revenues - psychic costs

When it comes to analyzing the actions of entrepreneurs the term "psychic" is substituted by the term "monetary" as it is the purpose of business enterprises to generate monetary, not psychic income. We therefore get:

monetary profit = monetary revenues - monetary costs

These statements are uncontroversial. The disagreement between Howden and myself consists in that I do not define the costs in these formulas in the same way as do most Austrian economists or, for that matter, mainstream economists. They consider *all costs to be opportunity costs*. Opportunity costs are usually defined as the evaluation placed on the most highly valued alternative or opportunity that was rejected in a choice among alternatives. In the following, I will point out what I consider to be the rather questionable implications of the opportunity cost doctrine.

In his discussion of market calculation, Rothbard (1962, pp. 606ff.) provides an example of an entrepreneur who has invested 5,000 ounces of gold in his business and therefrom earns a net income of 1,000 ounces over a one-year period. According to traditional accounting principles, these 1,000 ounces are profit. Rothbard (1962, p. 607) however argues that the entrepreneur still has to deduct from this net income "his implicit expenses, i.e., his opportunities forgone by engaging in the business." Only then has the entrepreneur arrived at a figure that denotes his profit or loss.

Rothbard gives the following (hypothetical) numbers for these “opportunities foregone”: The entrepreneur could have earned 250 ounces of interest if he had not invested his 5,000 ounces in his business; he could have earned 500 ounces in wages if he had sold his labor on the market; and 400 ounces if he had rented out his land instead of using it in the business. Together, he could have made 1,150 ounces if he had not engaged in the business. Therefore, Rothbard (*ibid*.) argues, “the entrepreneur suffered a loss of 150 ounces over the period.”

In short, although our entrepreneur has earned 1,000 ounces, Rothbard claims that he has made a loss of 150 ounces because the entrepreneur could have earned 150 ounces more if he had invested his resources outside of his business – in other words, because his opportunity costs were higher than his revenues.

I am not the only one who considers this kind of reasoning to be questionable. Reisman (1996, p. 460) gives an analogy to Rothbard’s procedure: “One gains ten pounds, but might have gained twenty pounds. This is then taken to mean that one has lost ten pounds.” Reisman (*ibid*.) then goes on to state the implications of the opportunity cost doctrine as propagated not only by Rothbard, but by most economists:

> It follows from the opportunity-cost doctrine that precisely to the degree that one is confronted with profitable ways to invest one’s capital, and precisely to the degree that one’s services are in great demand, one’s income must be less—in a word, that one must suffer by virtue of possessing the very qualities that create one’s success.

In my book, I drew on Reisman’s critique and formulated my reservations in the following way: According to the opportunity cost concept, “the possibility of choosing between several alternatives—a possibility that one would think to be beneficial from the point of view of the person choosing—appears to be something bad, even destructive” (Braun, 2014, p. 32). The better the alternatives among which one can choose, the smaller the resultant profits.

It is in the context of this argument that I provide the example of the two friends and their apples that Howden (2016) discusses at length. The point of this example is that according to the opportunity cost doctrine there is a great difference between the case where friend A is allowed to *choose* which one of the two apples of his friend B he prefers and the case where A simply *gets* one of B's apples without being asked to choose. If A is allowed to choose between the two apples, the apple he does not pick constitutes the opportunity costs of his decision. If the apples should happen to be very similar, the revenues of A (the apple he chooses) would almost be matched by his costs (the apple he does not choose) and his psychic profit would be minimal. As opposed to that, if A simply received an apple without having to choose, his profit would be much greater because his revenue would not be matched by any offsetting costs.[2]

The purpose of the example is to show that if one takes the opportunity cost concept seriously, having options is worse and leads to less profit than having no options at all. This is the reason why both Reisman and I do not find it helpful.

Reisman's and my criticism of the said doctrine does not imply that we question that the prices of production factors are influenced by the value of the alternative uses to which they might be put (for the following, see Reisman, 1996, p. 461). The price of the quantity of wheat that is employed in the production of bread is not only influenced by the demand for bread, but also by the demand for other products this input, wheat, could have been employed to produce. The money price of wheat emanates from the demand for all the different products which it helps or might help to produce. Alternative uses actually matter, and the choices of consumers between different consumer goods actually determine the market prices of these goods and of the producer goods that help to produce them. But to say that choices and alternative uses matter does not imply that alternative uses constitute costs. Reisman's (1996, p. 461) summary of his argument is well worth reading:

> The supporters of the opportunity-cost doctrine generally recognize the process by which money costs are determined, then confuse the alternative opportunities whose competition in bidding gives rise to the money costs with the phenomenon of cost itself, and thereafter

[2] Howden (2016) objects to this example on the grounds that I have assumed (in my book) that both apples are alike, which in his point of view implies that it is impossible to choose between them. In order to show that this assumption is unnecessary, I have dropped it in the above rendition.

> ignore the necessity of a money outlay actually being present. In other words, they identify a cause of the determination of money costs, confuse the cause with the effect, and proceed to ignore the effect, which is nonetheless essential.

Alternative uses do matter, of course, and it is important to any decision-maker to be aware of the options he has before choosing a certain alternative and rejecting others. But it leads to confusion if these alternative uses are called *costs*. Particularly, as I said above, it becomes difficult to discuss the role of time in human action if costs are supposed to relate to choices. *Choices* are instantaneous, timeless. Only *actions* have a time dimension; and in action, costs must be understood as historical costs. As I show in my book, this approach to costs and action allows for a praxeological explanation of originary interest that avoids the shortcomings of the traditional Austrian analysis of this topic pointed out by Hülsmann (2002).

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