

INSIDE DUMPING THEORY: AUSTRIAN PERSPECTIVES ON THE COST PROBLEM



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Abstract:

Predatory price strategy leads - according to neoclassical cost theory- to resource misallocation and eventually strengthens the market position of the predator until he becomes a monopolist. When the monopoly position is achieved, it is said that output is restricted and prices increase; government intervention is supposedly needed to prevent the so called negative effects of predatory pricing. Neoclassical assumptions in competition theory also serve as basic principles for the legal standards. In the present work, we assume an alternative cost theory, consistent with the Austrian approach in economics. The substance of this theory is that selling below costs can be a perfectly normal business practice and also beneficial for consumers, while outlawing it can determine a negative change in entrepreneurs' incentives structure and induce a disruption between them and consumers.

Keywords: cost, price, predatory price, dumping, competition, methodology

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INTRODUCTION

Dumping is considered to be one of the most dangerous entrepreneurial practices in economic competition. As it is described by neoclassical economics, the *dumper* is the firm that enforces a predatory pricing policy on a certain market, with the aim of cutting off competition. The dangerous side of dumping is seen not only in excluding the competitors but also in relation to the future power of the dumper which can achieve a monopoly position on the market. And the monopolist is seen as a case of imperfect competition, or a situation within which resources are misallocated (Baumol and Blinder, 1979). The neoclassical economic theory of dumping or predatory prices also referred to these practices as selling at prices below the production costs. In other words, firms would engage in selling their goods and services at prices below their economic cost (thus decreasing their profits) to exclude competitors and to reach a dominant position on the market. An important economic concept is brought into discussion: the cost. The focus of the present work will be on the cost problem, as it is explained by the dumping theory and by an alternative approach in economics, specific to the Austrian School of economics. At the core of the study lies the assumption that the Austrian perspective on the cost problem can deliver a more coherent, consistent and realist approach of dumping theory or predatory prices.

An alternative interpretation of dumping theory may be a step not only towards a realist and rational justification of entrepreneurs' actions on the market but also to a more consistent legal approach of dumping. However, this paper has no intention to address public policy; it is after all, only a statement regarding the economic problems of the theory of dumping,

particularly the cost problem. What do economists mean by economic costs? Can they measure them? How are they to explain the costs, and how do they distinguish them from prices? There must be a theory of costs and prices before an investigation of dumping. Or, how can a price that is “too low” or “irrational” – for it implies losses – be judged in the absence of a price theory? Moreover, isn’t it a valid claim that low prices benefit the consumers? If there is a so called economic limit of low prices, other than that specific to every firm, it logically follows that there are also limits of consumers’ benefits; that the consumer does not improve his situation by buying goods at lower prices. But this would be a bizarre conclusion, since economic science teaches that maximization of consumer welfare means a permanent increasing in its purchasing power, which in turn translates in lowering the prices of economic goods.

Legal attempts to punish predatory prices, to be as they are expected to be, socially efficient, must necessarily make a clear distinction between prices that are legitimately “too low” and those which are far “too low”, or unjustifiable from an economic or business point of view (Baumol, 2003). If they fail at this, then by punishing predatory prices, authorities are in fact penalizing consumers for not allowing them to have lower prices and creating a sort of protection for the firms which sell their goods at higher level of prices. Not to mention that in many cases it is the competitor himself that makes use of the legal framework to protect his market position by excluding others, on the false contention of “too low” prices (DiLorenzo, 1992).

The first part of the paper reconsiders some fundamental methodological problems of the cost theory. Its purpose is to show that differences in approaching the cost theory rely on differences in approaching the value theory. The second part points to some

basic elements of the economic theory of costs and prices, with a particular accent on the Austrian approach. The third part is devoted to the practical or legal implications of both neoclassical and Austrian cost theory.

A DEEPER LOOK INTO THE PROBLEM: METHODOLOGICAL ISSUES

From an economic point of view the cost is the opportunity forgone in the choice that leads to a greater satisfaction of the individual in his action on the market. The forgone opportunity is compensated by the *demonstrated preference* for a specific good or service, or generally, for an action. From the very beginning it is clear that economics deals with human rational action, and it is concerned only with the actual choices that individuals make according to their preference scales. Thus economic choices are in fact individual choices, human choices which are necessarily: (1) *different*, in direct relation with human needs, (2) *subjective*, in that it gives information concerning particular preferences of the individuals and (3) *qualitative*, for they imply a subjective evaluation process that individuals make between choices. It follows that every particular economic concept, including costs and prices, must be different, subjective and qualitative. Attempts to refute this praxeological view of economics were made by some classical economists, and also by the logical positivism of the XIX century and its later implications, especially in neoclassical economics. Opposing the praxeological interpretation in economics using the theory of empirical proof as the single clear cut argument for economics to become scientific, developed later in numerous trials to approach economics as a machine, or mechanics. A vast non critical import of methods specific to natural sciences has ultimately lead to interpreting every single

aspect of economic theory as a static machine easily *measurable*. A universalist approach is among the causes for the present state of economic science, as Ludwig von Mises (1998, p. 45) points:

The philosophy of universalism has from time immemorial blocked access to a satisfactory grasp of praxeological problems, and contemporary universalists are utterly incapable of finding an approach to them. Universalism, collectivism, and conceptual realism see only wholes and universals. They speculate about mankind, nations, states, classes, about virtue and vice, right and wrong, about entire classes of wants and of commodities. They ask, for instance: Why is "the" value of "gold" higher than that of "iron"? Thus they never find solutions, but antinomies and paradoxes only. The best-known instance is the value-paradox which frustrated even the work of the classical economists. Praxeology asks: What happens in acting? What does it mean to say that an individual then and there, today and here, at any time and at any place, acts? What results if he chooses one thing and rejects another?

A methodological debate was flourishing in the second half of the XIX century, between logical positivism and marginalism. The so called marginal revolution was intellectually led by three names: Carl Menger (founder of the Austrian school of economics), William Stanley Jevons and Leon Walras (University of Laussane). Marginalism has come with several effects in the study of human action, but for our present work, much more important would be to focus on the problem of price formation. How can we explain the formation of prices as an economic phenomenon and what is the value of economic goods? Writers such as Adam Smith and David Ricardo (classical school) reflected at these questions but their trial did not produce clear and useful results for the economic science. On the contrary, it succeeded in bringing more ambiguities and doubtfulness. For instance, the classical approach on prices states

that the value of a good is *intrinsic* and independent of other goods. Every good has an *intrinsic* and *objective* value but also strictly independent of individuals evaluations. They explained that value is given by the specific utility of a particular good. The main error of this approach resides in the conceptual separation of value and utility; because utility is *per se* a value. The separation of utility and value is nonsense and can determine confusions, such as the notorious value paradox. Classical economists could not explain why abundant goods which satisfy many needs are less expensive than scarce goods, devoted only to some specific needs. From their abundance and utility they erroneously derived that market price should be high. In a similar way, from the fact that other goods are scarce and satisfy less needs, they concluded that market price should be low. What they were not realizing is that goods are subjectively evaluated by consumers, and there is no social (in the holistic sense) utility of goods, but only personal, specific to each individual; therefore the utility derived from the consumption of goods is also subjective. Moreover, individuals act in accordance with their preferences for *marginal* units of goods, not class of goods. For instance, consumer don't buy water, but one measure (gallon or else) of water, and the utility (price, value) of the water, decrease with each unit consumed, because it satisfies less urgent needs of water.

The marginalist revolution separated value theory in two specters: the objective theory of value and the subjective theory of value. According to the objective theory of value, utility and value can be measured. Furthermore, costs and prices, as objective concepts, can be considered not instances of individual choices, but impersonal elements. Objective utility and value have cardinal magnitudes, which erroneously allow for arriving at an aggregate vision of utility. An objective theory of value fails to correctly explain price formation and this fact has three main causes: (1)

value is not something to be determined or measured⁴, (2) it erroneously considers classes of goods, not marginal units and (3) it states nothing concerning the economic role of individuals or consumers, those who act and choose.

We believe the importance of reconsidering the 19th century discussion between the classical and marginal approach on the value problem stems from the implicit modern assumptions regarding different forms of unfair competition. These assumptions support (in spite of the improvements brought into the theory of value by the marginal revolution) the existence of an objective *science* for determination the optimal level of competition (demand, supply, cost, prices, number of firms etc.). On the other hand, the subjective theory of value – the *brand* of marginalism – points out the errors that classical theory (objective theory of value) makes. In the first, it explains why goods do not possess an intrinsic value, independent of the individuals' valuations. They are valuable only to the extent that man is interested in them.

As we cannot speak of the distance of any object without implying some other object between which and the former this relation exists, so we cannot speak of the value of a commodity, but in reference to another commodity compared with it. A thing cannot be valuable in itself without reference to another thing, any more than a thing can be distant in itself without reference to another thing. (Robbins, 1945, p. 56)

Value is not intrinsic, it is not in things. It is within us; it is the way in which man reacts to the conditions of his environment. Neither is value in words and in doctrines. It is reflected in human conduct. It is not what a man or groups of men say about value that counts, but how they act. The bombastic oratory of moralists

⁴ Value is a relation, not a measurement.

and the inflated pompousness of party programs are significant as such. But they influence the course of human events only as far as they really determine the actions of men. (Mises, 1998, p. 96)

Mises attaches to value an individualistic or *personalist* sense. Value is absent in the *absence* of human valuations. Also, according to Samuel Bailey, the value of a good X becomes relevant only in connection with the value of another good Y. Any choice (which implicitly means attaching value) is made with an opportunity cost (the alternative forgone). But choice means a choice in favor of the good which satisfy a more urgent need, while the opportunity forgone meant a good devoted to a less urgent need.

There is no quality in things taken out of their relation to men which can make them economic goods. (Robbins, 1945, p. 46)

“Value” is not some characteristic of particular good. Rather, it is a relation between that good and *another* good, an ordering relation indicating preference (or non-preference) for that good in comparison to other goods. Such a relation manifests itself whenever an actor makes a choice, which occurs with every action. (Mahoney, 2005)

For this reason, the marginalist approach implies subjectivism. Value is a relevant discussion only in relation with individuals.

The fundamental idea of subjectivism is that a certain good has value for a subject, not in absolute sense, impersonal. This subject is only too clear; so are his/her preferences. The immediate implication is that value attached to certain goods is different from heart-to-heart (and, in time, even at the same individual); also, the summation problem does not hold anymore, for the valuations are heterogeneous. (Topan, 2013, p. 68)

The *subjects* are the individuals. Individuals’ action mean choice and preference, and their preferences are not in terms of classes of goods but in units taken separately, marginal units. It is therefore irrelevant to speak of the value of water or bread in general. To

become realist and relevant is to speak about the value of a gallon of water or one piece of bread. Exactly the same rule applies to utilities.

The economist does not know if there is a measurable process of preference formation and even if he knew it existed, he would not see any reason for being interested in studying it. The economic theory can work in the most rigorous manner at this level of relative “ignorance” (Smirna, 2010).

Regardless of whether we are considering a barter or monetary economy, within the marginalist approach prices take form in relation with the subjective valuations that buyers and sellers make on the marginal units of goods. Marginal utility is the *units utility* of a good. And here is how the so called value paradox is solved: an abundant good is expected to satisfy much more and more rapidly, the reason for which its price will consequently be lower to that of the scarce good.

THE ECONOMIC THEORY OF COSTS AND PRICES

Murray Newton Rothbard (1986) holds that cost is a purely subjective concept. The costs of an action cannot be determined otherwise than in relation to their subjective nature. Except individuals, directly involved in the process of valuation, there are no other legitimate entities that can determine their costs.

There is no way whatever that outside observers, be they economists, businessmen, or other experts, can decide what some other firm s “costs” may be. “Costs” are not objective entities that can be gauged or measured. Costs are subjective to the businessman himself, and they vary continually, depending on the businessman s time horizon or the stage of production or selling process he happens to be dealing with at any given time. (Rothbard, 1986)

At the same time, costs are historical concepts. They were registered at a certain moment in past and have no direct

connection with future costs. Thus any cost is a past cost (bygones are bygones). Costs are elements which enter into the process of price formation, but they are not decisive. Because of its indifference to the personalist and teleological character of value, the objective theory of value considers that in the process of price formation, costs and profit margins are decisive elements. Although it is not openly accepted by neoclassical authors, the objective theory of costs is an implicit element of the analysis of competition policies and welfare.

Dominick T. Armentano is consistent with Rothbard's approach on the cost problem, stressing on the importance of subjectivism.

The costs of an action are the subjective values attached to the forgone opportunities by the decision maker at the moment of the decision. Such subjective values can never be known to any outside observer and thus, cannot be objectively aggregated for society as a whole. If social costs and social benefits cannot be known or aggregated, the alleged usefulness of the neoclassical welfare models in support of a rational antitrust policy is now open to the most serious question. In short, how is it to be demonstrated that, say, "restrictive" agreements between business organizations are socially inefficient when the gains and losses associated with such arrangements are incapable in principle of discovery, measurement, or comparison? (Armentano, 1999, p. 28-29)

Interesting questions can be raised here, if we follow the logic of Dominick Armentano. In a similar manner, we can ask how are the predatory prices of the dumper to be found guilty of damaging competitors, since on a free market there is no fixed cost or price. Or, what criteria would be used to determine the social inefficiency of the future monopolist (who in the past

employed a predatory pricing strategy) since, efficiency, like value and utility cannot be measured or aggregated.

Robert Murphy opens a series of critiques to the objective theory of costs, based on four directions. The first is that of *methodology* used by the objectivist school, which does not take into account the subjective valuations of consumers, as a causal aspect in the process of price formation. On the importance of costs as inputs in final prices, Murphy states that:

Even if all memory of previous expenditures were suddenly lost, market prices would still form. Clearly then, the cost theory of value is not the deepest explanation possible. (Murphy, 2006)

In the second critical attempt, Murphy identifies even a limit of the objective theory of costs, through the demonstration of its *inapplicability outside the sphere of reproducible goods*. In other words, if for the goods produced on a regular basis we can identify the implicit costs, it is very difficult if not impossible to do the same in the case of non-reproducible goods.

An entirely different theory is needed if one wants to explain, say, the relative price of a Van Gogh painting and a guitar played by Elvis. (Murphy, 2006)

The third and the fourth critique are focused on time and the nature of prices. Murphy indicates (citing one of the main authorities in this field, Austrian economist Eugen von Böhm-Bawerk) that objective theory cannot explain the existence of interest, the main cause being its impossibility to explain price variations in time. As concerns the nature of prices, Murphy considers (calling an implicit *petitio principae*) that prices cannot be consistently defined as costs (inputs) because the latter are also prices.

But these “money costs” are really nothing but the *market prices* of these particular goods and services (i.e. labor hours, units of glass, etc.) (Murphy, 2006)

Although most of the economists have knowledge of these fundamental critiques that attack the core of the neoclassical theory of predatory pricing, they still persist in searching and possibly delivering objective criteria for evaluating business costs and prices. This again stresses the importance of the methodological issues when debating economic costs and prices.

But if we are to intentionally avoid these critiques, an interesting route of reasoning still shows some insights into the problem. As it was already explained, predatory prices are those prices that firms use to cut off competition, prices below production costs (selling with no profit) which after a while tend to increase the power of the firm, until it reaches the monopoly position. At this stage, the firm encounters no limit in restricting the output sold and increase prices. Is this an economic or an emotional interpretation of price wars? (DiLorenzo, 1999)

If firms take this route of “subsidizing” their sales below production costs, this means that they release some resources from other uses. They sell below costs certain goods, but they cannot afford to also, say, expand their activities in the production of other goods, or simply increasing the number of selling locations. Economically, these resources become attractive for other uses or even other firms, which encounter a general decrease in the prices of those released resources. Thus, the process of competition still functions. If there are no institutional barriers to entry, any new competitor can enter the market. Institutional barriers, such as domestic protectionism (tariffs, quotas, antidumping compensatory measures etc.) have the legal power to keep the market only for the domestic producers, while taxing foreign competitors and consumers. (Stamate-Ştefan, 2012) In contrast with the institutional barriers, natural barriers are those concerning the natural advantages that firms achieve on the market (such as experience, know-how and consumers’

confidence) and can raise the costs of entering for outside competitors. But natural barriers are not impossible to resist, while institutional barriers can literally outlaw competition, thus making impossible entering on the market.

Another fruitful route of discussion would be to reason on the problem of long-term predatory pricing. What kind of firm, in a realist interpretation of entrepreneurship, would possibly start an indefinite strategy of predatory pricing since its resources are limited? It follows that it cannot run such a business forever, but only to the moment where its competitors are driven out of business. However, here is to be seen a connection with the equilibrium analysis, since the assumptions that are made refer to a firm that keeps on going on this road, while no new competitors can attack in the same manner, the present ones are simply devastated not being able to counteract anyhow, prices remains below costs although demand increases, quality is constant so the predator is able to produce the same quality good with less profits and so on. It is true that only in a perfect equilibrium state of affairs things would look alike. However, real markets with real firms are not in equilibrium but in a constantly beneficial state of disequilibrium that allows price formation. In a state of equilibrium – specific to neoclassical constructs such as pure and perfect competition–prices would do not appear. (Costea, 2007; Hülsmann, 1999; Hülsmann, 2000)

Assuming that the predator is able to drive out its competitors, it is still a bizarrely fact why would any outside competitor not enter that market to compete with the predator. Especially, since the latter comes from a period of terrible losses. Anyhow, assuming this fact, let us go further on the moment that the predator achieves a monopolist position on the market. The monopolist is able to restrict output and raise prices. Until here

everything is understandable, things getting confuse in the case of consumers. Why would consumer accept indefinitely higher prices? Aren't the consumers those who accept rivalry between firms, and who also accept dominant firms? (Armentano, 1999, p. 43) Here too, we have no further explanations on the side of neoclassical monopoly theory. Although the present paper does not insist in this direction, there are various studies which show also the inconsistency of monopoly price theory. (Rothbard, 2004; Costea, 2007; Hülsmann, 1999; Stamate, 2011)

Above all, it is important to address the question of consumer welfare or utility, when competitors enforce predatory pricing strategies. Low prices are beneficial for consumers, since they can allocate their resources towards another uses (goods, firms, industries). While paying low prices at some goods, consumers will necessarily save or spend the new available money on other uses, which would allow for the development of some other firms. The monopolist is not having control over the whole market. (Armentano, 1999, p. 43) Its structure of production and prices is still dependent of how consumers decide to allocate their resources. An increase in prices in one part of the economy must necessarily come with a decrease in prices in some other parts. When demand increases for one good, it necessarily decrease for all other goods, and so the prices. Therefore, the monopolist is indirectly in competition with all possible uses that consumers may give to their resources. This makes it inoffensive, if no governmental protection exists.

PRACTICAL IMPLICATIONS OF THE NEOCLASSICAL AND AUSTRIAN COST THEORY

In this part of the paper, being the last part, we dedicate our attention to the practical implication of both neoclassical and Austrian

cost theory. It is a general review of the present legal standards concerning predatory pricing, as this so called unfair business practice is where the theoretical differences between economists lie.

The implications of neoclassical cost theory are more visible, because the present legal standards rest unequivocally their judgments on its suppositions. Thus, economists' views tend to become issues of public policy. (Armentano, 1999, p. 15) Their theories are used as standards in evaluating entrepreneurs' actions on the market, and also in describing the market. Predatory pricing is commonly seen (both in US and EU) as unfair competition. It brings resource misallocation and tends to establish dominant firms on the market, which eventually will abuse of their dominant position. Price cutting is counteracted by antidumping measures, for instances taxes designed by the governments to bring the price of the predator at a so called normal market level. These taxes are paid by the "dangerous" predators but they also have an effect on the consumers' welfare in that it reduces it, for it forces them to buy expensive goods than what the market normally would offer. As Baumol (2003) observed, there are also problems with the incentives structure. By keeping outside competitors with low prices at distance, this can give a wrong signal, incentive to the protected domestic competitors to become inefficient. Government intervention for releasing the external pressure of predatory prices on domestic competitors can truly be a case of resource misallocation (a case of imperfect or monopolistic competition), since they can have total control over production and prices and no outside pressure. In a way of speaking, this can also make the consumer prisoner to the domestic market. Affecting the demand or the consumer preferences would be a start point for developing inefficient firms, since the economic nature of firms is to satisfy consumer's needs.

Firms would lose the most important rational criteria which would assure that resources follow the consumers.

At the international level, competition authorities invested by governments with the power to outlaw the competition which does not corresponds to the neoclassical theoretical views, use a number of five methods to discover predatory prices: (1) comparing home market prices with foreign market prices, (2) comparing home market prices with a third market prices, (3) creating a constructed value, (4) comparing home market prices with non-market economies prices and (5) depending on the "facts available". Of course, a critical observation could be addressed, concerning the nature of predatory prices: why is there something problematic in the nature of cutting prices, even below production costs? Since the authorities developed ways to discover and counteract these prices, it follows that it views the nature of this activity as problematic and dangerous. (Irwin, 2009, p. 164) If there is no theoretical consensus between economists among predatory price theory, it should be clearly seen as a more dangerous situation if legal standards share only one vision on competition in general. For it is not yet clear that neoclassical interpretation of markets and competition is the best standard. However, the first four methods used for detecting dumping or price cutting are another example of arbitrary legal standards. Irwin (2009) and Lindsey (1999) have shown that theoretical problems still affect in a great proportion how authorities use these five methods for detecting dumping and establish dumping margins. The core of their critical argument is that, in these five methods, as they are constructed, lies a visible desire to find dumping by all means, even where it is not.

On the other hand, the practical implications of Austrian cost theory is a would-be discussion, since present legal standards consequently follow the neoclassical cost theory. In any case, an

obvious implication would be a sort of laissez-faire, laissez-passer policy. Free competition based on private property rights, which is also a theory developed by the Austrian economists means that any individual or firm can enter in the production of goods and services for the consumers. The only requirements refer to the fact of being able to resist competition. For a free market, predatory price is not an appropriate term. Selling below costs is a very risky commercial attitude and can lead to permanent losses, or even bankruptcy. Neither do these problems affect in any measure the market. Entrepreneurial losses and so bankruptcy are a penalty for not *keeping the eye on the consumer*, as Rothbard (1986) would have stated it. Losses in fact mean a relocation of some idle resources in the hands of more efficient firms. The possibility of going bankrupt is the sign that entrepreneurs operate in a world of scarcity and uncertainty, where not every action is *per se* is a profitable one.

CONCLUSIONS AND FINAL REMARKS

The aim of the present paper was to shed some light on a dispute between two different cost theories, which have economic and legal implications. The cost problem is probably the essence of the general problem of predatory pricing or dumping.

The conclusions of the study can be exposed on three main lines of argumentation. First, we depicted that there are different methodological approaches on the cost problem which also affects the economic approach on costs; the present paper critically addressed them and made a comparison between the objective and subjective cost theory, claiming that the latter is more appropriate for economic theory. Using objective cost theory can lead to working with non-operational concepts (e.g.: social utility,

aggregate welfare, social costs etc.). But economic science needs operational concepts not only realistic concepts.

In the second place, from an economic point of view, subjective cost theory does not help us determine and distinguish legitimate low prices from illegitimate low prices (unfair competition). If this is correct, then there are legal implications. If legality must follow theory and the theory of subjective costs is correct, predatory pricing or dumping should be only a feature of a dynamic and complex market, not unfair competition.

Thirdly, even if we don't follow the specific analytical observations of subjective cost theory, there are still some fundamental issues which prove the inconsistency of neoclassical predatory price theory: it fails in describing the economic consequences in the case of the predator, derived from the attitude of its competitors, outside would-be competitors and consumers.

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