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Rothbard on Ethics and Welfare Economics

Outline

In my essay "Rothbard's Rejection of Economics: The Ethics of the Non-invasive Society," especially in Part Three, I documented the mass of confusion that Rothbard promulgated due to his conflation of his ethics with traditional economic theory, including Austrian economics and the economics of Mises. Contrary to his claims, the theorems about government and voluntary action that he derived in his *Man, Economy and State* (1962 – MES) by assuming the absence of invasive actions are not economic theorems. They are also not theorems that pertain to the "free market," as that term has traditionally been used. Rothbard's conclusion to the contrary was the culmination of a tangle of convoluted reasoning and Rothbard's special meanings of words.

Rothbard had high hopes for his MES manuscript. At about the same time that he completed it, he wrote an article that he conceived as a revolutionary contribution to the professional economics of his day. He entitled it "Toward a Reconstruction of Utility and Welfare Economics" (1956 –

UWE). Along with other essays on various subjects, it was published in a collection of papers in honor of Mises.

Welfare criteria: criteria used by modern professional economists to judge how a particular policy affects "social utility" or "economic welfare."

At the time, "welfare economics" was emerging as a popular subject in the literature. Articles on it were being published in the top professional journals. The professional welfare economists sought a criterion that they could use to decide whether a particular economic policy should be adopted – a "welfare criterion." With such a criterion, an economist, in theory at least, could determine whether a particular policy would raise or lower "social utility" or "economic welfare." The reader will recall that his analysis of voluntary and coercive actions in MES led him to conclude that a study of economics shows that since "all State actions rest on...taxation, it follows that no State action can increase social utility, i.e., can increase the utility of all affected individuals" (MES: 881-2). He reaches the same conclusion in UWE. The difference is that in the essay, he emphasizes that the conclusion is based on what he calls the guiding principle of demonstrated preference.[1] On the basis of this principle, he maintains, we can evaluate all policy proposals according to whether they entail coercion. Since all government action requires taxation, one can judge that no government action can increase social utility. While he referred to exchanges on the "free market," he refrained from associating it with the noninvasive society. Indeed, he seems to have concealed any connection between the assumptions required to build the image of the noninvasive society and what he called the "free market" or "free society."[2]

By proposing a "reconstruction" Rothbard apparently wanted to challenge the profession with a new criterion, which he proposed as a revolutionary rival. He labeled his criterion "demonstrated preference" and suggested that it could be associated with Mises.

In UWE, he claims that the *real* choices that people make demonstrate that no state action can increase social utility. That individuals do not, in reality, choose to be coerced, he says, demonstrates that coerced action, such as taxation, harms them. That they do choose to make voluntary exchanges demonstrates that voluntary actions benefit them. These demonstrated preferences provide a basis for the economist to evaluate all actions involving government coercion.

Rothbard introduced his article by writing the following about welfare economics.

> The problem of "welfare economics" has always been to...make ethical, and particularly *political*, statements directly. Since economics discusses individuals' aiming to maximize their utility or happiness or welfare, the problem may be translated into the following terms: When can economics say that "society is better off" as a result of a certain change? Or alternatively, when can we say that "social utility" has been increased or "maximized"? (UWE: 22)

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[1]See UWE: 224; MES 879, 1239. Still he did write in MES that in "praxeology we are interested only in preferences that result in, and are therefore demonstrated by, *real choices*, not in the preferences themselves" (MES: 701).

[2]Rothbard provides the link between MES and UWE in a footnote in MES, were he cites his UWE article and writes that we "have seen above that praxeology may deal with utilities only as deduced from the concrete actions of human beings" (MES: 882n).

Rothbard believed that the welfare economists had been unsuccessful. Both "utility theory...[and] welfare theory have lately been foundering in stormy seas," he wrote. Nevertheless, these sub-fields of welfare economics can be salvaged by "the concept of 'demonstrated preference'" (UWE: 1). He believed that by means of the "tool of Demonstrated Preference," he could "effect a thoroughgoing reconstruction of utility and welfare economics" (UWE: 40-1).

According to this reconstruction, voluntary action, including voluntary exchange, can be judged beneficial. He writes that an exchange on the "free market"

> is voluntarily undertaken by both parties. Therefore, the very fact that an exchange takes place demonstrates that both parties benefit (or more strictly, expect to benefit) from the exchange. The fact that both parties chose the exchange demonstrates that they both benefit. The free market is the name for the array of all the voluntary exchanges that take place in the world. Since every exchange demonstrates a unanimity of benefit for both parties concerned, we must conclude that the free market benefits all its participants. In other words, welfare economics can make the statement that the free market increases social utility...UWE: 28-9)[3]

Government action, on the other hand, cannot be beneficial.

> The State is distinguished from all other institutions in society in two ways: (1) it and it alone can interfere by the use of violence with actual or potential market exchanges of other people; and (2) it and it alone obtains its revenues by a compulsory levy, backed by violence (UWE: 30).

As a result,

> *no government interference with exchanges can ever increase social utility*. But we can say more than that...Given the fact that coercion is used for taxes...and since all government actions rest on its taxing power, we deduce that: no act of government whatever can increase social utility (*ibid*.: 31).[4]

He concludes that his reconstructed welfare economics enables "the framer of ethical judgments to use these results as part of the data for his ethical system" (UWE: 41).

Note that these judgments are the same as those that he derived from his image of the noninvasive society in MES. What is different is the basis for the conclusion. In MES, Rothbard erroneously wrote that his conclusions are deductions based on an analysis of the free market that economists had always studied. In fact, as

Rothbard's conclusions based on his "demonstrated preference" welfare criterion:
1. The free market increases social utility.
2. No act of government whatever can increase social utility.

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[3]Strangely, he follows this with the statement that

> We are led inexorably, then, to the conclusion that the processes of the free market always lead to a gain in social utility. And we can say this with absolute validity as economists, without engaging in ethical judgments (*ibid*.: 29).

Although this statement is consistent with the convoluted conclusion he reaches in MES by defining the free market as his noninvasive society, it is certainly out of place in this article. After all, his aim is to show that the demonstrated preference criterion enables one to reach such a conclusion.

[4]Note that in the last statement, he removed the quotation marks from "social utility," thereby indicating that his concept of demonstrated preference enabled him to complete the salvage operation.

shown in my essay "Rothbard's Ethics of the Non-invasive Society," his image of the free market was that of the noninvasive society. Accordingly, his belief that his conclusions about voluntary exchange and government action applied to the real world were unwarranted. In UWE, he readily admits that his conclusions are based on an ethical judgment, or welfare criterion.

This essay shows that the term "demonstrated preference" is a misnomer. What Rothbard really means is "assumed preference." His deductions are based on what he assumes about preferences. Since a person can assume anything he wants about preferences, the proper starting point for Rothbard is to state his assumptions. Sadly, he conceals these. This point is made in Part One.

Part One also shows that Rothbard's implicit claim that his welfare criterion is based on Mises is bogus. Indeed, if Rothbard had followed Mises, he would have rejected welfare economics outright. Parts Two and Three analyze two of Rothbard's more specific conclusions. The first is that the decision to finance government projects through taxation is always demonstrably harmful (Part Two). It presents an example of a project that cannot be deduced to be harmful, according to the method of deduction used by Rothbard. The second conclusion that is analyzed is that the harm due to pecuniary external effects cannot be demonstrated. It shows that harmful pecuniary external effects can be deduced to occur in the same way that Rothbard deduces other beneficial and harmful effects (Part Three). Part Four tells Mises's view of professional welfare economics in order to draw a sharp contrast between Rothbard and Mises. Mises asserted that this field of study is either propaganda or the manifestation of bad economics, thereby implying that Rothbard attempt to contribute to it was misguided.

1. THE *ASSUMED CHOICE* CRITERION

In this part, I show that Rothbard's decision to label his criterion "demonstrated preference" is misleading. A close examination of his reasoning shows that a proper label is "assumed choice." A proper reformulation is this. If one assumes that he knows the choices that individuals will make, she can judge whether the individuals will benefit or be harmed by market interaction and by a government action. This leads me to conclude that the criterion that he actually applies is what I call the "assumed choice criterion."

Demonstrated Preference is Really Assumed Choice

Rothbard defines demonstrated preference as follows. The "concept of *demonstrated preference* is simply this: that actual choice reveals, or demonstrates, a man's preferences; that is, that his preferences are deducible from what he has chosen in action" (UWE: 2).

The term "demonstrated preference" suggests that an observer can deduce preferences from an individual's observed, or demonstrated, *behavior*. However, Rothbard's meaning is different from this suggestion. To understand the true meaning of his words and how his choice of terms led him astray, it is best to start with his examples.

Rothbard's Examples

The first example is of a man who chooses to spend time at a concert. "[I]f a man chooses to spend an hour at a concert rather than a movie," Rothbard writes, "we deduce that the former was preferred, or ranked higher on his value scale" (*ibid*.). In this example, he specifies that the time

spent at the concert is the result of a choice, thereby expressing the assumption that the concert goer has made a choice. That is, she exercised an act of will. He also specifies the alternatives. With this assumption and specification, the interpreter can deduce that she preferred the concert over the movie.

Rothbard's second example is of a man who spends five dollars on clothing. "[I]f a man spends five dollars on a shirt we deduce that he preferred purchasing the shirt to any other use he could have found for the money" (*ibid*.). In this example, Rothbard does not specify that the spending is a choice. As a result, a reader may assume that the spending may be behavior. The interpreter could not infer the spender's preferences from the behavior even though she assumes that she knows the spender's perceived alternatives. It is possible that the behavior would have resulted from a spontaneous impulse or from operant conditioning. To infer preferences, she would have to also assume that the spending behavior is the result of a "free" choice. It is possible, for example, that the spender was ordered by another person, under threat of physical punishment, to buy the shirt. Alternatively, the spender may be subject to intense social pressure. The conclusions reached by Rothbard only apply to a free choice.[5]

Rothbard removes this ambiguity later in his article. He writes: "This concept of preference, rooted in real choices, forms the keystone of the logical structure of economic analysis, and particularly of utility and welfare analysis" (*ibid*.). The phrase "rooted in real choices" implies that in the clothing case, he was also *assuming* that the spending was chosen. He was not writing about behavior that is not chosen. Also, his use of the terms "coercion" and "coerced" later in the article shows that he is assuming that the choice is "free."

True Meaning of Demonstrated Preference

A careful reader recognizes that Rothbard states the following proposition. He states that if the interpreter assumes that a person makes a voluntary choice and if she assumes that she knows the chooser's perceived alternatives, she can deduce something about the chooser's preferences. A more correct label for his concept is "assumed choice." If the interpreter assumes that she knows the choices that individuals have made, and if she assumes that she knows the individuals' perceived alternatives, she can deduce their preferences. In fact, observed behavior is irrelevant. It is superfluous to refer to the observed behavior.

True meaning of demonstrated preference: an interpreter of action can infer the preferences of an individual from the assumption that she chooses and assumptions about her perceived alternatives.

[5]One might argue that a choice to yield to social pressure is not coerced since no physical violence is involved. That possibility is of no concern here.

Assumed Choice Welfare Criterion

A more accurate formulation of his demonstrated preference criterion is that *an interpreter can logically deduce a person's preferences from what he assumes about her choices*. The applied welfare economist can infer a person's preference from her assumption that the person has made a non-coerced choice and her assumption that she knows the perceived alternatives faced by the chooser. In light of this, I call his criterion "the assumed choice criterion." Rothbard asserts that such a criterion would enable the applied welfare economist to determine whether market interaction and a particular market intervention is beneficial or harmful.

Demonstrated Preference Welfare Criterion as stated by Rothbard: "actual choice reveals, or demonstrates, a man's preferences; that is, that his preferences are deducible from what he has chosen in action."

Assumed Choice Welfare Criterion: the idea that an interpreter of a person's action can logically deduce her preferences from assumptions about her choices.

Misinterpretation of Mises

When he introduces the concept of demonstrated preference, Rothbard refers to Mises. He writes that the "clearest and most thorough formulation of the concept has been the works of Professor Mises." He does not quote Mises but cites pages in HA. The curious reader who consults those pages discovers that Mises was not writing about what Rothbard calls demonstrated preference. Instead, he was writing about rationality and the consistency of preferences, which had been challenged in professional economics. Some professionals had questioned the idea that all action is rational by referring to the following scenario. Instead, he was writing about rationality and the consistency of preferences. Some professional economists had challenged the idea that all action is rational by referring to the following scenario. Suppose that a person chooses *a* over *b*. Then, later she chooses *b* over *c.* Still later, she chooses *c* over *a.* This scenario, said the challengers, demonstrates that her preferences are inconsistent and therefore that she did not act rationally. In his section entitled "The Temporal Relations Between Actions," Mises pointed out that such a scenario does not prove that preferences were inconsistent. The reason is that "two acts of an individual can never be synchronous" (HA: 103). The scenario can be explained by assuming that preferences had changed from one period to the next. Rothbard's reference to Mises was a misinterpretation or misrepresentation.

2. GOVERNMENT ACTION IS DEMONSTRABLY HARMFUL: THE CASE OF "EXTERNAL ECONOMIES"

As pointed out, Rothbard uses his demonstrated preference criterion to deduce that no action by government can ever increase social utility. What he means is that no action by a government can ever satisfy the condition that every individual would prefer the government action over some alternative. He begins with a case in which government intervention prohibits an exchange:

> [W]hat happens when the State, or a criminal, uses violence to interfere with exchanges on the market? Suppose that the government prohibits A and B from making an exchange they are willing to make. It is clear that the utilities of both A and B have been lowered, for they are prevented by threat of violence from making an exchange that they

> otherwise would have made. On the other hand, there has been a gain in utility (or at least an anticipated gain) for the government officials imposing this restriction, otherwise they would not have done so. As economists, we can therefore say nothing about social utility in this case, since some individuals have demonstrably gained and some demonstrably lost in utility from the governmental action (UWE: 251-2).

His next example is of a "coerced exchange" such as a command to redistribute wealth:

> The same conclusion follows in those cases where the government forces C and D to make an exchange which they otherwise would not have made. Once again, the utilities of the government officials gain. And *at least one* of the two participants (C or D) lose in utility, because at least one would not have wanted to make the exchange in the absence of governmental coercion. Again, economics can say nothing about social utility in this case.
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> We conclude therefore that *no government interference with exchanges can ever increase social utility* (UWE: 252).

He goes on to consider the fact that every government action requires taxation. Because people must be coerced to pay the tax, they are demonstrably harmed. He concludes that the application of the demonstrated preference criterion shows that government action cannot be justified.

> [W]e can say more than that. It is the essence of government that it alone obtains its revenue by the compulsory levy of taxation. All of its subsequent acts and expenditures, whatever their nature, rest on this taxing power. We have just seen that whenever government forces anyone to make an exchange which he would not have made, this person loses in utility as a result of the coercion. But taxation is just such a coerced exchange. If everyone would have paid just as much to the government under a system of voluntary payment, then there would be no need for the compulsion of taxes. Given the fact that coercion is used for taxes, therefore, and since all government actions rest on its taxing power, we deduce that: *no act of government whatever can increase social utility* (*ibid*.).

Since demonstrated preference is really assumed preference, what he really means is this. Because he *assumes* that a person prefers not to be coerced, the collection of taxes can never be said to increase "social utility" regardless of what the tax revenue is used for. The following example shows that his analysis is shortsighted and consequently flawed.

An Agreement to Use the Government as a Means of Collecting Taxes to Finance a Project

This critique of Rothbard's view considers the possibility that everyone may agree to pay periodic taxes in the future in order to finance a project that they are not willing to finance in any other way. Because the critique assumes voluntary agreement, it challenges the statement in the last quotation that a system of voluntary payment is a substitute for the "compulsion of taxes." It shows that individuals may cooperate by agreeing to submit themselves to the periodic payment of taxes under threat of punishment. Rothbard gives three examples of such projects: military protection, dams, and highways (UWE: 257). Consider the case of a dam. Assume that there is no government and that somehow members of the community live peacefully together. The dam is expected to require, say, ten years to build. A proposal is made to create a government in order to impose and enforce an annual tax of a given sum over ten years on each member of the community. Each member believes that if the dam were built, the expected value of her benefits would be greater than the expected value of the money she would be coerced to pay under the proposed plan.

To distinguish this case from that of Rothbard, it is assumed that if every member was required to pay the entire bill today, she would choose not to finance it. On the one hand, she does not want to sacrifice so much consumption in the near future. She realizes that she could borrow the money

to pay the tax. However, to borrow entails additional costs of transactions. Lenders must evaluate the loan applications and collect the money. Nor, in the absence of a government, can they achieve full enforcement of loan contracts. In addition, the taxpayers cannot be certain that the dam will be built as promised. Considering these factors, each may want to retain the option of ending her support after one or a few years if the construction is not completed as promised or as expected. Accordingly, they may collectively specify in their agreement that the government be created to collect taxes and that the project will be abandoned and government dissolved if a supra-majority decides later to do so.

In this scenario, every member is willing today to pay an initial sum to start the project. And each is willing to be taxed every year, subject to the proviso that the dam production proceeds according to the plan. However, each also realizes that a verbal commitment to pay the annual tax is insufficient to assure that the taxes will be paid as promised. She wants a government to enforce these promises by threatening punishment to a member who refuses to pay or who conceals her ability to pay. Each member recognizes that, unless coercion is used to threaten each with greater harm than she expects from being taxed, she might choose not to pay. This would jeopardize the completion of the dam.

In short, each believes that if she is not coerced to pay the tax, she may not pay it. Under these circumstances, there may be unanimous agreement to a plan to create a government to collect the taxes. In Rothbard's terms, by choosing to agree to create a government, each member would demonstrate that she preferred the government coercion. Thus, Rothbard's reasoning is faulty. His conclusion about government is incorrect, even according to his own welfare criterion.

A Rebuttal?

Rothbard actually considers this argument, at least roughly, in his article. He refers to writings by William Baumol (UWE: 256n).[6] An analysis of his reasoning will help to illustrate the source of his error. Here is what he says:

> Baumol's external economy" thesis may be put succinctly as follows: certain wants are by their nature "collective" rather than "individual." In these cases, every individual will rank the following alternatives on his value scale: In (A) he would most prefer that *everyone but himself* be coerced to pay for the satisfaction of the group want (for example, military protection, public parks, dams, and so on). But since this is not practicable, he must choose between alternatives B and C. In (B) no one is forced to pay for the service, in which case the service will probably not be provided since each man will tend to shirk his share; in (C) everyone, including the particular individual himself, is forced to pay for the service. Baumol concludes that people will pick C; hence the State's activities in providing these services are "really voluntary." Everyone cheerfully chooses that he be coerced (*ibid.*).

Rothbard writes that Baumol "cannot establish voluntary coercion" (UWE: 258)

> it is absurd to hold that "voluntary coercion" can be a demonstrated preference. If the decision were truly voluntary, no tax coercion would be necessary – people would voluntarily and publicly agree to pay their share of contributions to the common project. Since they are all supposed to prefer getting the project to not paying for it and not getting it, they are then really *willing* to pay the tax-price to obtain the project. Therefore, the tax coercion apparatus is not

[6]Rothbard also discusses this case in his Appendix B of his chapter 12 in MES. His discussion illustrates a variety of confusions between economics and ethics. It is not as targeted as his analysis of Baumol's argument.

> necessary, and all people would bravely, if a bit reluctantly, pay what they are "supposed to" without any coercive tax system (UWE: 257).

Rothbard does not account for the possibility that everyone would agree that the "tax coercion apparatus" *is* necessary in order to enforce the voluntary agreement to finance the project over time. In short, contrary to Rothbard, the prospective benefits of "voluntary coercion" are demonstrated in the same way that he establishes that they are demonstrated in voluntary exchange. This is achieved by making the necessary assumptions about choosers' alternatives and their preferences toward them.

3. PECUNIARY EXTERNAL EFFECTS

Professional economists have identified two types of harmful external effects: pecuniary and real.[7] A pecuniary external effect refers to harm or benefit due to a market participant's choice to change a price. For example, the desire by a shoe producer to gain customers may lead her to reduce price. This would harm a competitor who cannot afford to match the price reduction. The competitor is said to have incurred negative pecuniary external effects. Specialized factor suppliers may also incur such effects. If the competitor lays off specialized workers as a result, they would be harmed. Consumers of shoes enjoy pecuniary benefit. One might say that some are harmed and some benefit from the external effects of the price reduction. However, in light of the law of consumer sovereignty, it is more accurate to say that some individuals acting in the role of competing entrepreneurs and factor suppliers would lose while individuals acting in the role of shoe consumers would gain.

The second type of external effects are called *real*, or non-pecuniary. Examples are air and water pollution, lost productivity due to overgrazing on shared grazing land, and the like. Air and water pollution and the lost labor productivity on land are due to direct non-pricing actions taken by others. They can only occur under impure capitalism, where private property rights are either not completely defined or not completely blocked through enforcement.

In UWE, Rothbard does not deal directly with either type of external effects. In the case of real external harmful effects, he defers to Mises.[8] The reader who is interested in comparing Mises with

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[7]See Prest and Turvey (1965).

[8] He writes that the

> famous "external diseconomy" problems (noise, smoke nuisance, fishing, and so on) are due to insufficient defense of private property against invasion. Rather than a defect of the free market, therefore, they are the results of invasions, of property, invasions which are ruled out of the free market by definition. See Mises, *Human Action*, pp. 650-56 (UWE 259: n).

This is a gross misrepresentation of Mises. Mises's "free market" is not the same as Rothbard's free market. Mises does not refer to invasive actions. Nor is it correct to say that Mises regarded real external effects as being "due to an insufficient defense of private property." Rothbard is spinning.

Mises writes that real external effects are due to loopholes in the law and that they could be removed by a change in the law. Since Mises associates law with government, what he means is that a government could eliminate these real negative external effects. But he does not go beyond making this observation. In

Rothbard on real external effects should consult Gunning 2000b. The interest in this section is in pecuniary external effects.

Rothbard writes that the "free market is the name for the array of all the voluntary exchanges that take place in the world." He reasons that because each participant in a voluntary exchange expects to gain, "the free market benefits all its participants" (UWE: 250, as quoted above). This is a fallacy. The economist cannot legitimately make a deduction about the benefits of a single exchange throughout all of market interaction on the basis of assumptions about the choices of the two parties. He must consider the prospect for pecuniary external effects.

Negative Pecuniary External Effects in MES

Under the conditions of capitalism, voluntary exchange between two parties is typically followed by harmful pecuniary external effects. In his MES discussion, Rothbard refers the reader to UWE. It is reasonable, therefore, to use the MES discussion as a proxy for the argument that such effects are not relevant in judging whether the system of voluntary exchange always maximizes "social utility." Rothbard's example is of price change caused by a technological advance:

> A common objection to the conclusion that the free market, in unique contrast to intervention, increases the utility of every individual in society, points to the fate of the entrepreneur whose product suddenly becomes obsolete. Take, for example, the buggy manufacturer who faces a shift in public demand from buggies to automobiles. Does *he* not lose utility from the operation of the free market? (MES: 882)

The modern professional economics textbooks focus mainly on two elements in the example. The first is that the money-evaluated utility benefits to consumers from the technological advance exceed the money-evaluated utility losses to the competitors and owners of the factors of production. The second is that competition is a characteristic of capitalism. To continue capitalism while avoiding pecuniary external effects would require some sort of compensation program for those who are harmed. To finance such a program would impose harm on others and it may not be successful anyway. But even if it was successful, it would reduce the incentives of businesses to avoid losses and the incentives of workers to prepare for potential layoffs by out-competed employers.

In general, writers of textbooks reach the conclusion that although some people are typically harmed by technological advance, no policy is available that would mitigate these effects without causing greater harm.

Rothbard's analysis is similar except that he asserts that the harm cannot be demonstrated. His aim is to deny that the harm to competitors (the pecuniary external effect) is relevant to judging whether voluntary exchange is always beneficial. His support for this assertion is novel. He writes: "We must realize...that we are concerned only with the utilities that are demonstrated by the manufacturer's action" (*ibid*.). He explains what he means with the following reasoning, which divides preferences into those that exist prior to the technological advance and those that exist after the pecuniary effects have been experienced. He writes:

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particular, he does not write about the cost of enforcement or of how the decision to enforce or not enforce entails a weighing of the anticipated gain against the anticipated loss. Rothbard's reference is bogus and misleading.

> In both period one, when consumers demanded buggies, and in period two, when they shifted to autos, [the buggy manufacturer] acts so as to maximize his utility on the free market. The fact that, in retrospect, he prefers the results of period one may be interesting data for the historian, but is irrelevant for the economic theorist. For the manufacturer is *not* living in period one any more. He lives always under *present* conditions and in relation to the present value scales of his fellow men...The buggy manufacturer could not restore the conditions or results of period one unless he used force against others to coerce their exchanges, but, in that case, social utility could no longer be maximized, because of his invasive act (MES: 882-3).

Specious Reasoning

Rothbard is playing word games. To see the speciousness of this reasoning consider his first example of the concert goer. Rothbard claims that the choice to attend a concert "demonstrates" the concert goer's preference. But by the reasoning he employs to analyze the buggy manufacturer, this must be wrong. The choice was made before the experience of the concert occurred. Once the concert begins, the concert goer is not living in the period during which he made his choice. That he benefitted from the concert cannot be known unless we know his present preferences, which may have changed. For the choice to attend the concert to "demonstrate" that a person gains from the concert, the economist would have to know that the concert-goer's preferences did not change.

Envy

Rothbard is virtually dismissive of pecuniary external effects. He does, however, write an interesting paragraph on envy. An envious person feels harmed by an exchange and prefers that it not occur. Rothbard comments on this case by saying that the person's "preferences are not demonstrated through action and are therefore irrelevant." He writes:

> To the extent that [the envious individual] has participated in the market, to that extent he reveals that he likes and benefits from the market. And we are not interested in his *opinions* about the exchanges made by *others*, since his preferences are not demonstrated through action and are therefore irrelevant. How do we *know* that this hypothetical envious one loses in utility because of the exchanges of others? Consulting his verbal opinions does not suffice, for his proclaimed envy might be a joke or a literary game or a deliberate lie (UWE: 250, some italics added).

In the first sentence, he writes that the past behavior of exchanging demonstrates a preference for benefits of the market. This is a mistake. There is no way to know whether the observed behavior of participating in the market is a freely chosen exchange. A person cannot observe another person's *choice* to participate in the market. He can only observe behavior. This is as true of his earlier examples as it is of this one. An observer cannot know whether a concert goer was compelled to attend or whether a shirt buyer was compelled to buy a shirt. The only way to "demonstrate" the greater value is to make *assumptions* about preferences and perceived alternatives. It is true that if "the market" is defined as the array of two-person voluntary exchange, every market participant must benefit by definition, or assumption. But this does not rule out her being harmed by a particular voluntary exchange on the part of other market participants.

The first sentence is surprising when one considers the rest of the quoted paragraph. Rothbard is correct to say that an observer cannot *know* about the envious person's preferences from his statements about them. Yet, if Rothbard can assume that a market participant, a concert goer and a shirt buyer gain from their actions, he can surely also assume that a person can be harmed due to her envy.

The answer to Rothbard's rhetorical question is clear. We can *know* that the "envious one loses in utility" because we *assume* that she is envious.[9] Rothbard either confused himself with his terminology or he was playing a rhetorical trick.

4. MISES VS. ROTHBARD ON WELFARE ECONOMICS

Rothbard's treatment of welfare economics was very different from that of Mises. In the 1950s, he fancied himself as a "revolutionary" who could overturn the positivism that had come to permeate professional economics. Mises, having studied the rise of positivism along with other anti-liberalism ideologies over two centuries, saw professional economics as propaganda, either intentionally promoted by leaders or unwittingly transmitted by dull and unquestioning followers. This part of the essay begins by describing the emergence of welfare economics in the late 19th and 20th centuries. Next it makes an hypothesis about Rothbard's thinking when he wrote his DEA article. Then it describes Mises's treatment.

The Emergence of Welfare Economics Prior to the 1950s

The field of study called "welfare economics" is based on the practice in professional economics of dividing its studies into two classes: positive and normative. Professional economists who do positive economics are often represented by saying that they study "what is;" those who do normative economics are then represented by saying that they study "what ought to be." The distinction developed in the late 19th century, as professional associations were becoming popular in the Western nations. The members of these associations perceived benefits from using their "expertise" to contribute to economic policy decisions made by governments. In some cases, government agents solicited their opinions; in others the economists regarded stating such opinions as a professional responsibility, much like the classical economists had done a century before. Broadly speaking, the writers supported capitalism but most believed that individuals in the consumer role could benefit from various laws that sought to change actions in cases where real external effects were present. They also tended to sympathize with government programs aimed at giving special help to individuals who were poorly suited to earning income under capitalism.

In the 1930s, as economic positivism and the use of mathematics gained more influence among professional economists, mathematicians and "mathematical economists" turned their attention to the positive and normative distinction. They developed a mathematical model that optimizes what they called "social utility." The model is an image of what they called factors of production that are employed to most efficiently produce a wide range of bundles that they called material consumer goods. They assumed that each bundle could be distributed among individuals in a given number of ways. Each distribution of each bundle could then be ranked in relation to the other distributions of bundles according to its social utility. Positive economics, they said, is not concerned with how these different bundles are ranked. Ranking them is a subject in normative economics.

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[9]Note that Rothbard's treatment of taxes is just the opposite of the case of envy. Rothbard could argue that the existence of taxation in a democracy demonstrates that citizens prefer to have a government collect the taxes and provide services. Instead, he *assumes* that individuals expect to be harmed by taxes.

They coined the term "social welfare function" to refer to a normative judgment that enables one to rank such bundles. If a normative economist ranks bundle *A* higher than bundle *B*, *A* is said to have the higher social utility. The normative economist is using a social welfare function that ranks *A* higher than *B*.

Rothbard's Use of Welfare Economics to Advance His Anti-statist Principle

A name is needed for what Rothbard variously called a conclusion from his value-free economics in MES and his welfare criterion in UWE. A good descriptive name, it seems, is *anti-statist principle*. It refers to the judgment that all government action is harmful, while all individual action that is non-coercive is beneficial. In UWE, he sought to teach the principle by referring to the positive-normative dichotomy in professional economics.[10]

Anti-statist principle: the judgment that all government action is harmful, while all individual action that is non-coercive is beneficial.

This is regrettable. His acceptance can be traced directly to his rejection of Mises's reasoning that the evaluation of intervention arguments offers a means of building a value-free economic science. The proper way to deal with the positive-normative dichotomy is to show that, regardless of the judgments one might make about the bundles of goods that should be produced or who should receive them, there are no policies available to achieve the outcomes represented by the mathematical model. The same is true in the natural sciences. Natural scientists can build mathematical models of an earth in which the global weather contains bundles of seasonal variations in temperature and bundles of geographical distributions of weather. Then they can rank these according to desirability. But the critical question is whether a policy is available to achieve bundles that a person may regard as more desirable. If not, the models are irrelevant.

In the case of mathematical and conceptual models of production and distribution, there is the additional fact that the economist already has special knowledge that whatever current production and distribution occurs is a consequence of distinctly human action in the presence of the division of labor law. It is the result of uncountable individuals acting in the role of the entrepreneur, as defined by the image of integrated functions. To determine the effects of any proposed change in policy requires tracing its effects on these entrepreneur actions and the results of those actions on the other passive roles. Then, if one is concerned with the effects on particular individuals, the image of functions and roles must be transformed into one in which the functions performed by such individuals are specified. To think that one can devise a policy that would change the result without changing the complex of separate actions that produced that result is to make what Hayek called an error of constructionism (Hayek 1978). It is to disregard the fact that the entrepreneur role in the theory of market interaction under the conditions of capitalism encompasses all discovery of

[10]Note that he had already sought to teach this principle in MEW. See my essay "Rothbard's Ethics of the Non-invasive Society."

consumer wants and the means of satisfying them.[11] In light of these considerations it is easy to understand why Mises regarded the positive-normative distinction as propaganda. The classical economists had already shown that knowledge of the division of labor law was needed in order to make sound economic policy judgments. But now, more than a century later, the professional economists were advocating an approach toward policy that disregarded that knowledge. By so doing, they failed to account for the division of intellectual labor (HA: 709) and economic calculation.

Mises on Welfare Economics as Propaganda

Mises criticized the welfare economists of his day in his chapter 35 of HA entitled "The Welfare Principle Versus the Market Principle." He begins with a history lesson about the "propagandists" who have opposed capitalism. Already in HA, he had evaluated the principal arguments favoring market intervention and showed that they could not achieve the aims of their proponents. His concern was only secondarily with welfare economics. His primary concern was with why leaders had adopted policies that weakened the conditions of capitalism even though the policies could not achieve the aims that the leaders claimed they wanted to achieve. One who adopts a policy of intervention in light of this fact, he suggests, must be acting in accord with the wishes of the propagandists.

The ultimate determinate of the decisions of leaders, is the ideology of the common man, which is strongly influenced by the molders and shapers of public opinion. If one wants to explain why proposals that cannot achieve their aims have been adopted, he should focus on the propaganda that is produced by such molders and shapers.

Mises introduces the discussion by referring to the propaganda that caused a reaction against the policies adopted after the discoveries of the classical liberal economists. The leaders in a handful of nations in the late 18th and early 19th centuries were persuaded by the classical economists to adopt classical liberal policies. They strengthened private property rights, reduced government-sponsored monopolies, reduced barriers to international trade, and helped enforce private contracts. The result was increasing standards of living for increasing populations.

A large proportion of people whose sustenance had previously depended on the charity of the feudal lords and other elites were liberated by the wage system. They became consumers. Thus, when the leaders took actions that strengthened the conditions of capitalism, they incentivized those individuals who were brighter, more venturesome, and more knowledgeable of the conditions of demand and supply than their counterparts to identify ways to profit by producing and selling to the ordinary consumer. Individuals who previously had no opportunity to gain riches and political power

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[11]Kirzner has described this function in several articles without directly referring to the division of labor law. He locates the entrepreneur role within an orbit of exchange as among owners of *assumed* factors of production and consumer goods. This seems to be a narrower orbit than the one associated with functions and roles. The argument might be made, however, that a wider orbit is implied in his definition of the entrepreneur. See Kirzner 1982.

– the entrepreneurs – took advantage of the numerous new and previously uncharted paths to riches and political power that the conditions of capitalism motivated them to discover. In doing so, they fractured the traditional barriers of class and privilege.

The aristocrats, landowners, and military – along with the artists, intellectuals and clowns in the monarch's court whose livelihood depended on these elites – suffered a decline in status. The political and social filters that had operated under the feudalistic and dictatorial states that dominated the pre-capitalist era began to break down.

This environment was ideal for the rise of anti-capitalist propaganda. The new consumers under capitalism were not only interested in tangible consumer goods. They also were willing to pay for speeches and books. They were particularly interested in stories that championed the positions of themselves as "good people" in relation to others. Profit opportunities emerged for story tellers who could best appeal to such desires. These story tellers and the promoters of market intervention perceived opportunities to profit by serving both the threatened classes and the new classes simultaneously. They created markets in which story tellers could earn both pay from sponsors and royalties from publishers for writing fiction and interpreting historical events in ways that persuaded the common man that the desired restrictions on free enterprise were in his interest. In the burgeoning democracies of the West, the result was a public opinion that the standard of living of most people could be raised by means of political action (government coercion) against entrepreneurs who determine their wages and wealth owners who lived off their dividends and interest.[12]

The common man did not and could not comprehend the long chains of reasoning required to recognize that the heights of wages are the outcome of a competitive process. Nor could he recognize that, under the conditions of capitalism, he himself could create his own opportunities, as an entrepreneur, to earn higher incomes. He was swayed by the propagandists' claims that his immediate employer determines his wages. Since the employer was typically richer than he, he was easily persuaded that he deserved to receive a higher wage and that market intervention would enable him to get what he deserved. Thus, in the rivalry for the common man's support, the classical economists were out-competed by the socialists and Marxists. The result was a variety of political movements based on ideologies that attacked the classical liberal policies. One class of such attacks promoted market intervention. Proposals were made that various interventions would benefit the deserving workers or ordinary citizens.

Having discussed this first class of reactionary propagandists, Mises narrows his focus to a group that emerged later in history. Members of this group, he assumes, recognized the superiority of the more capitalist systems of cooperation to satisfy material consumer wants. But the new propagandists claim that capitalism

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[12]Mises discusses this persuasion process in several of his works. See my essay "The Determinants of Public Policy: The Ideology of the Common Man"

> is deficient from what he calls the social point of view. It has not wiped out poverty and destitution. It is a system that grants privileges to a minority, an upper class of rich people, at the expense of the immense majority. It is an unfair system. The *principle of welfare* must be substituted for that of profits (HA: 833, italics added).

He is describing a somewhat unique and special group of individuals, who he later calls "welfare economists." These individuals agree that establishing the conditions of capitalism lead to larger amounts of material consumer goods. Nevertheless, the members of this group still want to reduce the scope of capitalism or to eliminate altogether the incentives that the conditions of capitalism help people create for each other. To do this, they invoke what they call the "principle of welfare."

Social Utility

Mises goes on to say that the welfare principle that they propose is non-operational. It is at this stage that he introduces the concept of "social utility." The welfare economists, he says, try to add content to their principle by introducing this term. As soon as they do this, however, they begin to contradict themselves. His point is that the concept of social utility has meaning only as a rough characterization of the consequence of market interaction under the conditions of capitalism. Economists can use this concept to represent the outcome of an adjustment process, under capitalism, in which each person must

> adjust his conduct to the requirements of social cooperation and look upon his fellow men's success as an indispensable condition of his own. From this point of view one may describe the objective of social cooperation as the realization of the greatest happiness of the greatest number (*ibid.*).

As a substitute for the phrase "greatest happiness for the greatest number," the student of capitalism may use "highest social utility." Beyond that, however, the concept loses its meaning. When the classical economists referred to the benefits of capitalism, they did not mean that

> the good, whatever it may be, should be imparted to the greatest number...If we interpret the welfare [to refer to the greatest good, the concept of social utility or welfare] is void of any specific significance. It can be invoked for the justification of every variety of social organization. (HA: 834).

In other words, the concept of "social utility" becomes a tool for a new class of propagandists who claim that social utility, or welfare, can be increased by all sorts of interventions. The new propagandists refer to the welfare principle when they recommend policies that they claim will increase social utility or welfare by reducing poverty, inequality, and insecurity and or by achieving greater social justice. Thus he writes that the "passionate talk [coming from] the welfare school [propagandists] ultimately boils down to three points. Capitalism is bad, they say, because there is poverty, inequality of incomes and wealth, and insecurity" (HA: 835).

Mises does not discuss external effects in his chapter on the welfare principle. His concern is with proposed laws to reduce poverty, inequality and insecurity and to achieve "social justice." The point here is that the same critique of the concept of "social utility" that he attributes to proponents of intervention to deal with these other "problems" applies to all uses of the term.

The Unaware Welfare Economist

Mises writes that some "welfare economists," cannot be placed in the category of propagandists. Their fault is not that they propose policies that cannot achieve their aims, it is that they make logical errors in their analysis. They are simply "not aware of the logical inadmissibility of their reasoning" (HA: 834). One presumes that Mises would place Rothbard in this class.

Remarks

By implicitly endorsing the positive-normative dichotomy of professional economics, Rothbard severed his ties to Mises. He showed that he was either unfamiliar with or that he rejected the argument made by Mises in his analysis of welfare economics. Specifically, he disregarded the fact that "social utility" has no meaning aside from the general notion that individuals tend to gain from the division of labor that accompanies the emergence of the conditions of capitalism.[13]

The reason for this error is his apparent failure to learn Mises's economic science, as described in my essay "The New Science of Economics in Mises's Treatise." He did not regard the evaluation of particular intervention arguments as important and he did not learn how to build the economic theorems required to do this.

The question arises, in light of this critique, how Rothbard was able to convince other Austrian economists of his era that he was doing economics in the Misesian tradition. Why did the intellectuals who regarded themselves as followers of Mises and knowledgeable about Mises's writings fail to explode his claims? The answer, so far as I have been able to determine, is that there were no aspiring Austrian economists who understood Mises's scientific economics. No one to my knowledge recognized the supreme importance of the ultimate goal that Mises set for those who study economics and, therefore, the reason why he separated economics from history as branches of the study of distinctly human action. The ideas of most of them on this matter were already formed from their familiarity with positivism either in the natural sciences or in professional economics. They could not distinguish between science based on the evaluation of intervention arguments and the positive-normative myth promulgated by the professional economists, the positivists of natural science and economics, and the ethical philosophers.[14] The best manifestation of this is the accession of these intellectuals to the definition of economics as the study of "reality," a code word for historical events. Since Rothbard promoted this view, his interpretation of Mises was tolerated, even by the aspiring Austrians who disagreed with his natural rights ethical philosophy.

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[13]Indeed, a search of MES shows that Rothbard readily adopted the term "social utility" in its professional economics usage. A critique of his claim to have properly interpreted Mises in MES could be based on that fact alone.

[14]A number of students in Austrian economics noticed Mises's argument. But none to my knowledge saw that it was essential if one wanted to attain scientific status and value-neutrality for economics.

5. CONCLUSION

As an aspiring young scholar in the mid-1950s, Rothbard sought to impress the professional economists of his day with a profound contribution to the field of welfare economics, namely the welfare criterion of demonstrated preference. He failed in that. His article was ignored by the profession. Nevertheless, the article has been touted by his followers as a major contribution to economics. I have shown in this essay that the term "demonstrated preference" really means "assumed preference." It follows that when he wrote that according to the demonstrated preference criterion, government action is always harmful; he really meant that such action is always harmful, *by assumption*. Accordingly, what he touts as a welfare function is an assumption, or set of assumptions, about individual preferences towards the situations he specifies. In short, it amounts to mere assertion.

In addition to pointing out the mislabeling, I discussed the examples he used to deal with counter-arguments concerning the benefits of market interaction. I showed that the examples were irrelevant to the policy issues with which the professional economists were concerned. In particular, he did not account for a prospective unanimous decision to create a government and he did not deal adequately with the external effects of market interaction. The only reasonable conclusion is that, insofar as Rothbard's goal was to make a contribution to the evaluation of economic policy, his article was simple-minded. Finally, I presented Mises's ideas on the subject of welfare economics, which Rothbard disregarded.

Other Austrian Economics Commentary

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*In chronological order according to the time at which the the original version was written.