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In Defense of Rothbardian Welfare Economics

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Abstract: Murray Rothbard offered a twofold defense of the unhampered market economy. He argued that it upholds natural rights and promotes the life and flourishing of persons more fully than any other social system. His welfare economics was not a defense of the unhampered market economy, but a critique of mainstream economists' use of welfare economics to promote state intervention. He argued that mainstream economists accept the subjectivity of value by adhering to the Pareto rule in welfare economics. In doing so, however, they must embrace all the implications of the subjectivity of value and not just the impossibility of interpersonal utility comparisons. They must accept also the principle of demonstrated preference. Recasting welfare economics along the lines of demonstrated preference reorients it away from artificial models of the economy based on fictitious economic agents toward the real economy of actual human persons. Rothbard's demonstration that *laissez-faire* renders the greatest social welfare in the real economy is shown to be valid.

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I begin by observing that you cannot find out what a man means by simply studying his spoken or written statements ... In order to find out his meaning you must also know what the question was ... to which the thing he has said or written was meant as an answer.¹

1 Rothbard's Defense of the Unhampered Market

Murray Rothbard's defense of the unhampered market economy is based on the philosophy of natural law and the ethics of natural rights. Natural law holds that reason can discover the characteristics, or natures, of the different entities in the world and how these entities behave and interrelate, i.e., natural laws. The natural law ethic is that the good for each entity is what fulfills its nature. Man, too, has a nature and thus, reason can determine what is good for man. "The natural law," Rothbard wrote, "elucidates what is best for man – what ends man should pursue that are most harmonious with, and best tend to fulfill, his nature."²

Salient among the characteristics that constitute man's nature is reason itself. Human action is guided by reason. By it, man learns which ends satisfy him more fully and by it, he identifies the causal connections between things in the world and his ends. In other words, reason discovers means. To act, man must do more than merely recognize the existence of means; he must control the use of, in other words, own, means he deems helpful in attaining his ends. He naturally owns his mind and body, but man cannot fulfill his nature by attempting to act with labor alone. He must produce to sustain himself through consumption. Production requires that he appropriate natural resources and use them with his labor to produce goods. To fulfill his nature, man must have such natural or personal ownership of property. He must own his labor, the natural resources he homesteads, and the goods he produces.

Man exists as individual human persons each possessing the same nature. If each person lived in isolation, then each one would act with his own personal property and there would be no question of one person interfering in the natural development of another. When persons interact, however, one may aggress against the per-

¹ Collingwood (1939, p. 31); quoted in Gordon (1993, pp. 104-105).

² Rothbard (1982, p. 10).

sonal property of another and thereby, disrupt another person's natural process of life. Rights each person has to his personal property protect each person in the fulfillment of his nature. Natural rights declare it immoral for other persons to aggress against a person by using or threatening to use violence to interfere with his acquisition, use, or disposal of his naturally-owned property. The rights of private property include unilateral and bilateral transfer of ownership between willing persons. Bilateral transfers or voluntary exchanges constitute the unhampered market economy. The hampered market economy grants legal privileges of some persons to aggress against the private property of other persons and the command economy denies the natural rights of persons altogether. Rothbard's main argument in favor of the unhampered market economy is that it upholds each person's natural rights of private property and thereby, achieves the ethical use of interpersonal violence more fully than another other social arrangement.

The role economics plays in Rothbard's defense of the unhampered market is subsidiary to that of ethics. Rothbard wrote, "[Superior productivity is a] ... result of the free market, but it is not, to the libertarian, the *prime* reason for his support of the system. That prime reason is moral and is rooted in the natural-rights defense of private property we have developed above."³ While natural law philosophy delineates the natural rights by which man upholds the ethical use of interpersonal violence in society, economics delineates the natural laws by which man produces, exchanges, and consumes in society.

Economics demonstrates that the unhampered market promotes human life and flourishing to a greater extent than any other social arrangement. The diversity of labor skills among persons and the diversity of productivity of natural resources in the world imply the greater productivity of the division of labor. The division of labor furthers the life and flourishing of man by sustaining a vastly larger number of persons at far greater levels of material wellbeing than other social arrangements and by making a place in production suited to each person's talents and personality. For the division of labor to advance beyond a primitive level and continue to progress there must be a market economy. The monetary prices that emerge from the voluntary exchange of private property can be used by entrepreneurs to make economic

³ Rothbard (1978, p. 40). Italics original.

calculations of the net income of producing goods and the net worth of acquiring assets. Within the framework of net income, entrepreneurs can determine which goods people in society value more highly and which combinations of factors of production used to produce the higher-valued goods they value less highly. By comparing the anticipated revenues from selling goods to the anticipated costs of hiring the factors of production, entrepreneurs can economize production in the division of labor. Within the framework of net worth, entrepreneurs can determine which lines of capital investment people in society value more highly and the liabilities they associate with each line. By comparing the anticipated asset value of the investment with its anticipated liability value, entrepreneurs can economize the construction of the capital structure. The command economy eliminates economizing the division of labor for people in society by abolishing economic calculation and the hampered market economy impairs economizing by distorting economic calculation.⁴

Rothbard's achievement was to show that these two arguments, the ethical and economic, are grounded on the same praxeological foundation. Both are constructed from the nature of man and human action. This approach has been called a "science of liberty" because both its parts are objectively established. It was Rothbard's acceptance of an objective ethical system that was the basis of his critique of Ludwig von Mises's defense of the unhampered market economy. He embraced Mises's economic argument, but chided him for his inadequate ethical claims for advocating *laissez-faire*.⁵ As Rothbard wrote:

Thus, while praxeological economic theory is extremely useful for providing data and knowledge for framing economic policy, it cannot be sufficient by itself to enable the economist to make any value pronouncements or to advocate any public policy whatsoever. More specifically, Ludwig von Mises to the contrary notwithstanding, neither praxeological economics *nor* Mises' utilitarian liberalism is sufficient to make the case for *laissez-faire* and the free market economy. To make such a case, one must go beyond economics and utilitarianism to establish an objective ethics which affirms the overriding value of liberty, and morally condemns all forms of statism...⁶

⁴ Mises (1998, pp. 211-232, 258-311, 694-711, and 736-773).

⁵ Rothbard (1982, pp. 205-212).

⁶ Rothbard (1982, p. 212).

Kvasnička incorrectly juxtaposes Rothbard's welfare economics against Mises's approach. He writes, "Both Rothbard's method and its outcome (the welfare theory) differ significantly from Mises' own ones."⁷ But Rothbard accepted and defended Mises's praxeological method and the economic theory Mises built by it as vigorously as anyone. He saw his own role as adding to Mises's theoretical edifice. In the preface to his own economic treatise, Rothbard wrote:

Professor Paul Samuelson has written rhapsodically of the joy of being under thirty at the time of publication of Keynes' *General Theory*. I can say the same for the publication of Ludwig von Mises' *Human Action* in 1949. For here at last was economics *whole* once more, once again an edifice ... Suffice it to say that from now on, little constructive work can be done in economics unless it starts from *Human Action* ... In one sense, the present work attempts to isolate the economic, fill in the interstices, and spell out the detailed implications, as I see them, of the Misesian structure ... it is my hope that this work may succeed in adding a few bricks to the noble structure of economic science that has reached its most modern and developed form in the pages of *Human Action*.⁸

2 Welfare Economics and the Defense of the Market

Rothbard's welfare economics, then, was not an alternative to Mises's economic defense of the unhampered market, which Rothbard accepted. It was, instead, a critique of mainstream welfare economics. It was directed at mainstream economists, a very limited audience that held a narrow set of presuppositions and thought about social welfare within a restrictive framework. Rothbard's welfare economics was not an argument aimed at the general public, which would fail to grasp it. For that audience, he wrote, *For a New Liberty*. Rothbard's welfare economics was not even aimed at academicians in general, who would see its shortcomings all too well. For that audience, he wrote, *The Ethics of Liberty*. Given the limited task Rothbard was trying to accomplish and the narrow audience he was trying to reach with his welfare economics, the import of Kvasnička's criticism of him loses its force. He writes,

⁷ Kvasnička (2008, p. 43, fn. 2).

⁸ Rothbard (1970, p. xi). Italics original.

Thus Rothbard's welfare theory is invalid, and should be rejected. Otherwise it may happen that sound ideas would be ridiculed because they are not defended on the grounds of a sound analysis but on the grounds of the invalid welfare theory, or be even rejected by those who believe in this invalid dogma.⁹

Presumably by "sound ideas" Kvasnička means *laissez-faire* or the unhampered market economy. But, as shown above, Rothbard's arguments for the unhampered market economy were that it upholds natural rights and fosters the life and flourishing of man. Even if his welfare theory were invalid, then, it would matter little to Rothbard's defense of "sound ideas."¹⁰

Rothbard's reconstruction of welfare economics attempted to show mainstream economists that the only sound basis for both utility and welfare economics is the fundamental principles of human action. To the extent that mainstream economists were dissatisfied with the disarray in which both fields found themselves in 1956, Rothbard was offering a corrective. As he wrote:

Both theories have lately been floundering in stormy seas. Utility theory is galloping off in many different directions at once; welfare theory, after reaching the heights of popularity among economic theorists, threatens to sink, sterile and abandoned, into oblivion.

The thesis of this paper is that both related branches of economic theory can be salvaged and reconstructed, using as a guiding principle of both fields the concept of "demonstrated preference."¹¹

⁹ Kvasnička (2008, p. 42).

¹⁰ Rothbard himself lamented just such confusion about the role of welfare economics in his defense of the unhampered market economy. Edward Stringham cites an audio tape of a speech Rothbard made in a lecture series "A Short Course on Free Market Economics," on which Rothbard states:

Unfortunately ... it has been maintained that my whole basis for *laissez-faire* rests on this whole social utility nonsense. Of course it really doesn't. It's all really a gimmick to show that if you really go along with this whole Pareto-optimality-social-utility then you have to confine yourself to *laissez-faire*. It's not my major argument for *laissez-faire*. At any rate, the trouble with those people who think it's my major argument are so inamorate [sic] that that's all they can focus on. (Rothbard, Tape 6, "Cost of the Firm" Side B, 35:57 to 37:44 in Stringham 2007, p. 27)

¹¹ Rothbard (1997a, p. 211).

Rothbard began by attempting to establish the proper meaning of the concept of preference.¹² He argued that the meaning of preference can be found in its role in human action. Action is purposeful behavior. Given the circumstances that make up the situation in which a person finds himself, his action aims at attaining an end. The situation of acting contains both general conditions, elements of the situation a person does not control in his action, and means, elements of the situation he does control. Action is using means in an attempt to attain an end. For something to be a means, the person must own it, i.e., control the use of the thing in action. Because of the scarcity and diversity of means, action requires choice. A person must choose among competing ends to pursue with each set of means and among competing sets of means capable of attaining each end. Preference is the judgment a person makes in ranking the value of alternatives in action.

There are several distinguishing characteristics of preference. Preference is the logical requisite of choice, which is necessary for action. If a person could not establish a preference in his mind, then he could not choose and therefore, could not act. Choosing only requires establishing a rank order of alternatives; one option is better another not as good. Preference does not measure value. It grades it. Preference is established within the circumstances of action, both the psychological conditions internal to the mind and the means and general conditions external to the mind. Preference does not refer to a hypothetical state of affairs in which the actor achieves bliss or happiness or even a state of affairs that he likes. It is not wishful thinking about what one would do if conditions were more favorable. Preference is not a stipulation made by the economist about a person's state of mind. Preference refers to the rank order of more preferred and less preferred alternatives that a person makes in his mind as the basis for choosing in action. It incorporates, therefore, all possible cases of psychological disposition. Preference, being a state of mind, is known experientially only by the person acting and no one else. Only he can know the level of utility he enjoys from attaining his higher-valued alternative and how much more value he gets from it than from his lower-valued alternative. Another person's knowledge of the preferences of a person acting is limited to the evidence empirically available from

¹² On these basic principles, see Rothbard (1970, pp. 1-66).

his action and what can be logically inferred from this evidence and the conceptual meaning of action. That objective knowledge can be acquired from a person's action about his preferences is the basis of the concept of demonstrated preference.

Demonstrated preference, then, is not a special concept of welfare economics, but the basis of all action. Rothbard wrote, "The concept of *demonstrated preference* is simply this: that actual choice reveals, or demonstrates, a man's preference; that is, that his preferences are deducible from what he has chosen in action."¹³

Because a person's preference can be deduced from his action, someone observing his action can have objective knowledge about it. The deduction comes from combining the conceptual meaning of action and the empirical evidence of the action. For example, a farmer plants a corn crop. An economist can deduce from this action that the farmer preferred planting a corn crop to the next best alternative that he considered. This conclusion is not evident from empirical evidence alone, but implied from conceptual understanding of action, specifically the understanding that any action aims at a preferable state of affairs. That to be scientific a treatment of a subject must be objective, i.e., based on facts and reason, is the source of Rothbard's claim that a scientific treatment of utility and welfare economics can include only demonstrated preference.¹⁴

Although there is no welfare economics of the person acting in isolation, Rothbard claimed that the economic theory of the person acting in isolation is the foundation for welfare economics since it underlies any and all action, including social interaction. Thus, voluntary exchange is mutually beneficial because in choosing to exchange ownership of goods both traders aim at a preferable state of affairs. Kvasnička himself, along with most other economists, accepts these basic principles.¹⁵ Rothbard's welfare economics was an appeal to mainstream economists to make these fundamental principles of economics that they accept the foundation of welfare economics. In advancing this line of argument, Rothbard was hoping to bring mainstream economists around to accepting the *laissez-faire* conclusions that stem from

¹³ Rothbard (1997a, p. 212). Italics original.

¹⁴ On his view of science, see Rothbard (1997b, pp. 32-34).

¹⁵ Kvasnička (2008, p. 46) writes, "[Rothbard's first welfare theorem] is derived as a generalization of the old doctrine that both traders benefit from a voluntary exchange, which is in turn a special case of the doctrine which inspired the concept of demonstrated preference that a man acts to benefit."

basic economic theory. In retrospect, Rothbard's quest may seem quixotic, but not, I think, incoherent as Kvasnička claims.¹⁶

Voluntary and involuntary interactions are defined in economics to recognize the distinction between cases in which it is possible to deduce that a person is better off from an interaction with another person and cases in which it is possible to deduce that he is worse off. Each person comes to an exchange with his naturally-owned property. A voluntary exchange occurs when neither trader uses or threatens violence against the property of the other. If the two persons trade the ownership of property without aggressive violence, then the exchange is voluntary. Given their natural ownership of property, each person chooses an alternative he prefers more than the non-interaction alternative. Both traders benefit. If one person violently aggresses against the property of the other person, then the exchange is involuntary. Given their natural ownership of property, the aggressor chooses an alternative that he prefers more than the non-interaction alternative and the victim is forced to choose an alternative that he prefers less than the non-interaction alternative. The aggressor benefits and the victim loses.

These conclusions must be deduced from the conceptual meaning of action and the empirical evidence of the action. They are not evident from the empirical evidence of the action alone. The mutual benefit of voluntary exchange is deduced from the understanding the economist has that each person in any action he takes, given its circumstances, chooses what he prefers. That deduction is necessary to arrive at social welfare conclusions has particular importance in the case of involuntary exchange. What one observes about involuntary exchange appears on the surface to be no different than what one observes about a voluntary exchange. In both cases, a person chooses to transfer the ownership of something to another person. That he is not demonstrating a preference for the transfer in the case of aggressive violence used against him is inferred from his initial property ownership and that aggressive violence is an implicit, non-consensual claim on his property. Without such conceptual understanding, the economist could not deduce the harm to the victim from aggression. It cannot be seen from the empirical evidence of involuntary exchange alone.

¹⁶ Kvasnička (2008, p. 43).

Determining the social welfare consequences of voluntary exchange and involuntary exchange relies upon another basic principle about preference that economists generally assent to, viz., its subjectivity. As discussed above, value is a state of mind. As such, it has no extensive property that can be measured. For this reason, there can be no interpersonal comparisons of utility. To conclude that social welfare has improved from a social interaction, therefore, it must be shown that the interaction makes at least one person better off and no one worse off. Such interactions can be called Pareto superior. If a social interaction makes some persons better off and others worse off, then it cannot be concluded that social welfare has improved. Such interactions can be called Pareto inferior.¹⁷

Even though it can be deduced that both traders benefit from a voluntary exchange, the consequences for social welfare are indeterminate until third-party effects are considered. It is possible that a third person who is not a party to the exchange made by two other persons has an adverse psychological response to the exchange. He is envious, let us say. The economic-theoretical meaning of this case is that the conditions of action external to his mind, and which he does not control, have changed for the envious person. Other persons have used their personal property in a way that he does not like. The relevant question for determining the effect on social welfare is: Does this psychological change affect his preferences? If it does not, then his action does not change. He demonstrates that he is no worse off in preference than before and, to reiterate, preference is the objective standard for social welfare considerations. If the feeling of envy is strong enough to change the person's preferences, then he changes his action toward a more preferred alternative, say complaining to his friend. In this case, too, his action, given the new circumstances, is more-preferred, not less. It can be conceded, though never objectively established, that his level of utility is higher before the voluntary trade of others than after it, but that does not imply that the voluntary trade of others made the envious person worse off in preference. Preference refers to the judgment a person makes in his mind comparing the value of alternatives in action given the circumstances of the action.

¹⁷ Kvasnička seems to think that in using the phrase Pareto inferior to describe cases of state intervention, I meant that a reduction of social welfare had occurred. Pareto inferior, however, refers to cases in which it cannot be concluded that social welfare has improved. No cases could exist for the definition Kvasnička implies for the phrase Pareto inferior, because the only way to have an unambiguous deterioration in social welfare is if both parties to a social interaction are made worse off. Obviously, neither party would act to bring about such a result. See Kvasnička (2008, p. 49, fn. 6).

Deducing the effects on social utility from voluntary and involuntary exchanges requires considering each action in turn given the conditions as they are at that point. Nothing can be deduced about the level of utility a person has at the beginning of a series of actions compared to the level of utility he has at the end of the series of actions. For example, a person having dinner with his friends orders steak from the menu. The economist observing him can objectively conclude that, given his options, he selected what he preferred. He is enjoying the conversation when it turns to a subject he dislikes, but he stays and endures it. The economist observing him, lacking access to what he is experiencing in his mind, can objectively conclude that he prefers to continue dining with his friends. At some point, one of his companions makes a remark so objectionable to him that he says, "Anymore such talk and I shall leave." The economist observing him can objectively conclude that he preferred to make this remark. The economist cannot objectively conclude that this line of conversation has lowered the level of his utility. To conclude that would require the economist to make a judgment about his utility. The economist would have to interpret the meaning of the remark as it relates to his utility. The economist would have to decide whether it was a serious remark or a joke and if it was serious did making the remark push his utility up or down. Bullies, after all, like to intimidate others with such remarks. No such judgments are necessary for the economist to conclude that he preferred making the remark. It follows from the objective evidence of his action and the conceptual meaning of action. And so it goes for the rest of the evening with the level of his utility sometimes rising and sometimes falling, but he continues dining with his friends and leaves only after the party breaks up. Is he enjoying a higher level of utility after the evening is over compared to before it began? Who can objectively say but the person himself? He is the only person with experiential knowledge of his own utility. What another person can objectively deduce is that he preferred what he did each step of the way.

Moreover, recognizing that the given conditions of a social interaction are necessary to determining its social welfare consequences leads to a regression theorem of social interactions. The action taken by the envious person occurred in the conditions that existed because of the prior voluntary exchange of other persons. But that voluntary exchange occurred in the conditions that existed because of the prior actions of other persons and so on. Tracing these interactions backwards step-by-step leads

to the starting point of each person's ownership of his mind and body. Each person's ownership of his labor is the initial endowment of property in which he begins the process of social interaction. Each step of acquisition of property in its natural state by someone demonstrates that he gains in preference and no one is demonstrably worse off in preference. With their naturally-acquired property, persons exchange voluntarily and thereby, demonstrate that they prefer their social interaction while no one is demonstrably worse off in preference.¹⁸

The determination of social welfare is not an end-state of optimality to be achieved. Instead it is a step-by-step comparison of whether or not any particular social interaction improves social welfare. To be consistent with fundamental economic principles, the analysis can use the concepts of Pareto superior and Pareto inferior, but not Pareto optimal. In each voluntary exchange on the unhampered market traders attain what they prefer more without third-parties suffering what they prefer less. Each step taken in the market economy improves social welfare and hence, is Pareto superior. In each involuntary exchange aggressors attain what they prefer more and victims suffer what they prefer less. Each step taken by the state fails to improve social welfare and hence, is Pareto inferior.¹⁹

3 Kvasnička's Critique

Kvasnička claims that his critique differs from the criticism of Rothbard offered by others in that "they analyze a broad context of the theory, or even question Austrian

¹⁸ See, Herbener (1997, pp. 98-101). That naturally-owned property is the initial endowment from which the process of social interaction begins is the Rothbardian rebuttal to justifications for state redistribution of income that mainstream economists make in their welfare economics to achieve equity. See note 43 below.

¹⁹ In writing about welfare economics, a leading historian of economic thought recognizes this distinction between the step-by-step process analysis of Austrian economics and the end-state equilibrium analysis of mainstream economics. He wrote:

[Adam Smith] held what I have elsewhere called "a process conception of competition," nowadays associated with Austrian economics, in contrast to the orthodox "end-state conception of competition," in which all emphasis is directed to the nature of the final equilibrium, regardless of how that equilibrium is attained. (Blaug 2007, p. 189).

economics as such... Our analysis is based on a detailed study of Rothbard's own arguments only. We have only checked the coherency of his arguments."²⁰

The main thrust of Kvasnička's critique, however, is not to point out internal inconsistencies in Rothbard's argument, but to criticize him for holding a distinctly Austrian instead of mainstream view of utility. In the mainstream view, economic theory consists of models constructed by the economist to explain market phenomena. The model contains "agents" whose "actions" are determined by stipulating mathematically tractable utility functions for them. "So there is not a fundamental difference between the indifference curves approach and Rothbard's own utility theory as long as the former one yields a unique solution," Kvasnička writes, "The indifference curves just describe the agent's inner world, in which Rothbard takes no interest, or rather denies its existence altogether."²¹ Concerning welfare economics, Kvasnička writes, "The usual meaning of Pareto's rule is God-like – the analyst pretends to know everything that is happening and how it affects all agents. Obviously, such an approach is scientifically valid..."²² Setting aside the question of the scientific validity of this approach, Rothbard rejects it in favor of praxeology, which builds economic theory as a body of logical implications from the nature of human action as set out above. As a praxeologist, Rothbard is interested in the inner world of real human beings in so far as they establish preferences. He has no interest in the inner world of economic agents, which is nothing more than mathematically tractable utility functions invented by mainstream economists. It is not clear that by being interested in the inner world of agents of their own invention that mainstream economists themselves have any interest in the inner world of real human beings. In any case, with this line of criticism, Kvasnička can, at most, merely show that Rothbard's conclusions are inconsistent with mainstream analysis, but not that they are internally inconsistent.

Because he sees utility as a mathematical function stipulated by the economist, it appears to Kvasnička that Rothbard is merely asserting the concept of demonstrated preference as a constraint on the utility function necessary to permit him to make

²⁰ Kvasnička (2008, p. 43).

²¹ Kvasnička (2008, p. 44).

²² Kvasnička (2008, p. 46).

social welfare claims in the face of the difficulties of interpersonal utility relationships such as third-party envy. He writes,

Rothbard was also able to see that Pareto's rule is very strict, and that almost no change is either Pareto-improving, or Pareto-worsening. He gave the example of envy ... Rothbard believed he could get a determinate solution in more cases with the tool he called *demonstrated preference*.²³

But, Rothbard did not invent demonstrated preference as a means of creating a class of events that satisfy the Pareto criterion as Kvasnička implies. Demonstrated preference was, for Rothbard, a fundamental concept of human action. And it is precisely Rothbard's acceptance of demonstrated preference as a concept logically established before the chain of logic reaches the question of interpersonal utility relations that leads him to deny that envy of a third party constitutes an exception to the Pareto superior status of a voluntary exchange.²⁴

Kvasnička then poses two interpretations of what Rothbard meant by the concept of demonstrated preference. The first is "we can know nothing that was not demonstrated in an action" and the second is "there is nothing more than what was demonstrated in an action." Kvasnička claims that Rothbard held the second view.²⁵ But, he clearly held the first view. Rothbard wrote:

Now since praxeology shows, by the concept of demonstrated preference, that both the newsdealer and I gain in utility from the exchange, and nothing has demonstrably happened to anyone else, we can conclude scientifically, as praxeological economists, that social utility has increased from the sale and purchase of the newspaper – since we have defined social utility in the Paretian manner. It is true, of course, that third parties may well be grinding their teeth in hatred

²³ Kvasnička (2008, p. 43). Italics original.

²⁴ Even the typical mainstream treatment of utility in welfare economics does not include third-party envy in utility functions. As Blaug (2007, p. 185) writes, "The first fundamental theorem states that, subject to certain exceptions – such as externalities, public goods, economies of scale, and imperfect competition – every competitive equilibrium is Pareto-optimal." Third party envy is not on the list of exceptions and, save for such exceptions, every competitive equilibrium is Pareto optimal. If mainstream economists would have taken Kvasnička's view of the pervasiveness of third-party envy, they would never have developed welfare economics at all since under this view the social welfare consequences of every social interaction are indeterminate.

²⁵ Kvasnička (2008, p. 44).

at the exchange. There may be people, for example who through envy suffer psychic loss because the newspaper dealer and/or I have gained. Therefore, if we employ the Paretian definition of “social utility” in the usual psychologizing sense, we can say nothing about social utility one way or the other. But if we confine the concept to its strict scientific compass in demonstrated preference, then we can state that social utility increases from the exchange. Still further, we may know as historians, from interpretive understanding of the hearts and minds of envious neighbors, that they do lose in utility. But we are trying to determine in this paper precisely what scientific economists can say about social utility or can advocate for public policy, and since they must confine themselves to demonstrated preference, they must affirm that social utility has increased.²⁶

Rothbard’s point in insisting on the use of demonstrated preference is precisely that it is consistent with the empirical evidence from an action and the conceptual meaning of action and, therefore, it can be part of a scientific, i.e., praxeological, treatment of human action. Rothbard does not “ignore all changes of a person’s utility except those the person demonstrates through his actions,” as Kvasnička claims; he just recognizes that they play no role in the logical structure of action and hence, are not part of economic theory.²⁷ This distinction between the abstract and concrete aspects of action is the key to solving Kvasnička’s puzzlement that Rothbard can hold at the same time that aspects of action beyond demonstrated preference can be known or understood by the historian while only demonstrated preference can be accepted as objective evidence by the economist.²⁸ The difference is like a scientist who is conducting a controlled experiment to determine the physical effects of smoking. He may know a lot about the lifestyle of his grandfather, who has smoked for forty years with no obvious physical repercussions, but he cannot include this knowledge in his scientific study. As a scientist, he can only include data that has been scientifically generated in his experiment. Another analogy is a mathematician who deduces the Pythagorean Theorem from prior postulates and theorems of geometry. Whatever can be known about actual right triangles drawn on paper or embedded in architecture is not relevant for his proof. He is not ignoring, and does not need, other knowledge about right triangles that he may have acquired from drawings and architecture in making

²⁶ Rothbard (1997c, pp. 88-89).

²⁷ Kvasnička (2008, p. 44).

²⁸ Kvasnička (2008, p. 44, fn. 3).

his proof. In like manner, the economist is not concerned with the particular, concrete aspects of action as the historian is, but with the universal, conceptual structure of action.²⁹

Kvasnička's god-like approach does not avoid this distinction between the conceptual and concrete and its consequent difficulties. This approach does not say that the economist should conduct utility and welfare economics using every aspect of what he can actually come to know about real human persons. Instead, it counsels him to construct mathematically tractable utility functions for mythical economic agents and deduce, by the use of mathematics, utility and welfare theorems from them. Such constructs are held up as a model by which the economist is to understand the action of real human persons. He is still left with the question of how these models relate to the human action of real persons.³⁰

Kvasnička backs up his view that Rothbard held the position that "there is nothing more than what was demonstrated in action," by claiming that Rothbard argued that "there is no way to *demonstrate* indifference, hence there *can be no* indifference at all."³¹ But, Rothbard did not deny that psychological states of indifference can exist. He wrote:

The concept of "indifference" may be important for psychology, but not for economics. In psychology, we are interested in finding out intensities of value,

²⁹ As with economic theory, Rothbard accepted Mises's views of the relationship between theory and history. See his preface to Mises (1985).

³⁰ Blaug claims that mainstream economists have used the difficulty of reconciling the abstract and the concrete as an opportunity to push their own ideologies. He writes,

This sort of intellectual schizophrenia [of mainstream economists over the Coase Theorem] would be excusable provided it were well understood that the irrelevance of the initial distribution of property rights to a final allocation of resources is, like Pareto-optimal properties of competitive equilibrium, a truth about economic models and not a truth about the real world. But I doubt that is sufficiently underlined, because such underlining would destroy the ceremonial value of formal theorems in a subject like economics. Many economists know in their heart that the market is efficient, and know it as an unexamined ideological belief but do not want to admit to themselves that it is ideological. So they revel in mathematical theorems that satisfy their self-respect ... [They] accept the judgment that the theorems are close to reality, while those that distrust markets do not. (Blaug 2007, p. 201)

³¹ Kvasnička (2008, p. 44). Italics original.

possible indifference, and so on. In economics, however, we are only interested in values revealed through choices. It is immaterial to economics whether a man chooses alternative A to B because he strongly prefers A or because he tossed a coin. The *fact of ranking* is what matters for economics, not the reasons for the individual's arriving at that rank.³²

What Rothbard claimed was that indifference has no relevance for the conceptual structure of action. If such states of indifference mean that no preference exists then no action can come from them since preference is the requisite for choice. And if in such states of indifference a person can still establish a preference, then action can take place. In the first case, indifference is not part of the conceptual structure of action and in the second case it is just one of the many psychological, physiological, and other conditions influencing the establishment of a preference. As such, no reason exists to single indifference out of the multiplicity of other such conditions for special treatment. Even in the indifference curve approach of mainstream economists, a person could not choose, and therefore could not act, on the basis of an indifference curve alone. He chooses from among the combinations of goods that give him the same utility, the one that he can obtain for the lowest budgetary expenditure. Or, what amounts to the same thing, for a given budgetary expenditure he selects the combination of goods that places him on the indifference curve which gives him the greatest utility. Either way, he chooses what he prefers, either the same utility with a smaller monetary expenditure or greater utility for the same monetary expenditure. Indifference, as such, has nothing to do with choosing between alternatives even in the mainstream approach. The assumption of indifference is made, instead, to justify the use of a utility function. Indifference in the mainstream approach means, not merely that a person cannot choose between alternatives, but that the utility of the alternatives is equal. If the utility of alternatives is equal, then utility can be presumed to be cardinal. Cardinality is required to establish utility functions and work through the mathematical logic of the utility-function approach.

There is one more point of indictment against Rothbard that Kvasnička infers from his discussion about indifference. Against the claim that indifference might be demonstrated by repeated trials of action in which a person chooses each alternative

³² Rothbard (1997a, p. 226). Italics original.

half the time, Kvasnička says that “Rothbard argues such a comparison is not possible because over time the agent’s preferences might have changed.”³³ Once again, the problem with Kvasnička’s claim is that Rothbard’s praxeological approach develops the conceptual structure of the action of real human beings. It is not a model of economic agents. Of course, it is possible to invent agents with utility functions that give statistical results of whatever type the economist wants. But with a real human person, the economist cannot presume that in repeated trials (even those in which every external circumstance is the same) his preference with respect to the circumstances of action remain the same. On this point, Rothbard is again following Mises who argued that functional analysis of human action is ruled out by the lack of constants. Functional equations have variables and constants, but in human action nothing exists but variables. No constant quantitative relationships exist between a dependent variable (e.g., the quantity of a good a person purchases) and independent variables (e.g., the price of the good) because the quantitative effect on the dependent variable of a change in an independent variable depends on the judgment made in the mind of the person acting which can change over time.³⁴

Although Rothbard claims that the economist cannot compare the results of real actions at different times as a means of determining a person preferences or indifference, he does not hold that “we cannot compare a real situation with another hypothetically the same,” as Kvasnička claims.³⁵ Precisely such comparisons are the basis for many economic laws, e.g., the law of demand. The law is logically deduced from the concept of diminishing marginal utility by posing a hypothetical situation different from the actual buying situation in only one way, viz., that the price is conjectured to be lower. A person would have bought at least as much of the good in the hypothetical case compared to the amount he actually bought. Rothbard accepts such *ceteris paribus* comparisons in cases for which it is acceptable to say that a person’s preferences cannot change, e.g., at the moment a person buys a good.³⁶ He does not, however, accept the presumption that a real human person’s preferences cannot change over time in a series of buying opportunities.

³³ Kvasnička (2008, p. 45).

³⁴ Mises (1998, pp. 347-354).

³⁵ Kvasnička (2008, p. 45).

³⁶ Rothbard (1970, pp. 91-108).

Kvasnička then turns to what he considers the limitations of the concept of demonstrated preference. First, he claims that “an agent can demonstrate only those changes of his utility ... when he is active. There is no way a passive agent may demonstrate a change of his utility caused by an external force he passively suffers.”³⁷ Rothbard, he asserts, uses demonstrated preference to ignore the utility losses of persons who do not actively demonstrate their losses but passively accept them. He writes, “the possibly losing non-involved third party *cannot demonstrate* it loses because it loses *passively* – there is no action that can prove it ...”³⁸ Action, however, can be either “active” or “passive” and hence, can demonstrate a preference in either case. As discussed above, preference is inferred from what we know about action conceptually and the empirical evidence from an action. It cannot be known from empirical observation alone, e.g., that a person is passive. Second, Kvasnička writes, “Moreover, an action only demonstrates that the agent is better off choosing the action in comparison to choosing another possible action in his situation, not that he actually is better off.”³⁹ His examples of being offered a gift and not resisting aggression do not show that demonstrated preference is of no use in social welfare analysis, but that one must take account of the circumstances of action in addition to demonstrated preference in such an analysis.⁴⁰ As discussed above, there must be circumstances of each action and some of them are outside the mind and control of the person. Welfare economics takes these circumstances as given and deduces a person’s preferences from what we know conceptually about action and what the person chooses to do in the given circumstances. This point also applies to Kvasnička’s claim that Rothbard “ignore(s) the impact of a change of the income and wealth distribution on individual’s [sic] utilities under Pareto’s rule” because “distribution is not independent from production and exchange ... and that a change in the distribution is caused by voluntary-made exchanges.”⁴¹ Rothbard’s argument, however, is that changes in income and wealth distribution are conditions of action in which a person chooses what he prefers. Each social interaction is a separate event with its own conditions determined by prior actions. When an interaction takes place it changes the conditions for future actions.

³⁷ Kvasnička (2008, p. 45).

³⁸ Kvasnička (2008, p. 48). Italics original.

³⁹ Kvasnička (2008, p. 45). Italics original.

⁴⁰ Kvasnička (2008, pp. 45-46).

⁴¹ Kvasnička (2008, p. 47).

Social welfare consequences can be deduced for each action, one at a time, as persons face changing circumstances. Kvasnička's claim that "Pareto's rule looks for *all* subjects' utility increases or decreases in comparison to the status quo, despite their cause," may be true in the mainstream approach with the caveat that what counts as a factor changing utility is stipulated by the economist in the agents' utility functions.⁴² The typical treatment of income distribution in mainstream welfare economics, however, is not to include it as a factor in utility functions as Kvasnička implies, but to see it as an initial endowment that conditions the particular Pareto optimal point that is reached by voluntary exchange. Such a treatment permits the state to select what it considers the preferable Pareto optimal outcome and to redistribute income to set the initial conditions so that the process of the market achieves the selected Pareto optimal point. Even if the state cannot intervene in the unhampered market to improve social welfare, it can redistribute income to achieve equity while letting the market achieve efficiency.⁴³

Kvasnička then applies the limitations that he claims for demonstrated preference to the two theorems of Rothbard's welfare economics. The two welfare theorems are "that the free market always increases social utility" and "that no act of government can ever increase social utility."⁴⁴ His argument about the first welfare theorem is that Rothbard uses demonstrated preference to ignore the utility losses suffered by

⁴² Kvasnička (2008, p. 47). Italics original.

⁴³ Blaug writes:

Modern welfare economics is formally summed up in two so-called fundamental theorems. The first fundamental theorem states that, subject to certain exceptions – such as externalities, public goods, economies of scale, and imperfect competition – every competitive equilibrium is Pareto optimal. The second fundamental theorem states that every Pareto-optimal allocation of resources is an equilibrium for a perfectly competitive economy, provided a redistribution of initial endowments and property rights is permitted; alternatively expressed, every Pareto-optimal allocation of resources can be realized as the outcome of competitive equilibrium after a lump-sum transfer of claims on incomes. (Blaug 2007, p. 185)

An example of what Blaug is referring to can be found in a leading Intermediate Microeconomics textbook. About the Pareto criterion, the authors write, "it evades most of the interesting questions about the distribution of income. The criterion has nothing to say about a change that benefits one group of people and harms another." They then provide an example from Hal Varian of how different initial endowments of income permit the satisfaction of both equity and efficiency goals. See, Mansfield and Yohe (2004, pp. 612-613).

⁴⁴ Rothbard (1997a, p. 243).

third parties when others voluntarily exchange. He writes, “Thus under the concept of demonstrated preference the market exchange, and hence the market process itself, increases social utility because at least one party benefits, and no one *can prove* he loses.”⁴⁵ To illustrate his point, Kvasnička applies his analysis to Rothbard’s welfare economics of a voluntary cartel. Kvasnička agrees that members of a voluntary cartel demonstrate their benefit in forming the cartel when selling to consumers at higher prices but that “the consumers have to pay the higher price, but they *cannot demonstrate* they lose by any *action*, and hence Rothbard ignores them, and calls the change Pareto-improving.”⁴⁶ But consumers are demonstrating their preferences. By purchasing the good, consumers demonstrate that they prefer to buy at the current prices. Determining this is done in exactly the same way as it would be before the cartel formed and prices were lower. In that case, too, consumers demonstrated that they preferred to buy at the current prices, even if they were also higher than previous prices. Social welfare consequences can be determined only for each action, one at a time. The conditions of a person’s action determined by other people are given to him for each action. As discussed above, whether or not consumers have higher utility or lower utility from the beginning of a series of actions compared to its end cannot be objectively determined. For this reason, Rothbard does not include such comparisons over time in welfare economics. To do so, the economist would have to account not only for the effect higher prices have on consumers’ states of mind, but any other factor affecting their utility in the interim between buying at lower and buying at higher prices. Of course, in the abstract and *ceteris paribus*, consumers always prefer lower to higher prices but welfare economics is about the consequences of real actions in their actual circumstances and not about *ceteris paribus* conjectures.

Turning to the second welfare theorem, Kvasnička argues that Rothbard switches uses of the Pareto criterion from one based on demonstrated preference, used to eliminate third-party losses of utility from voluntary exchange, to one based on the god-like view of utility, used to show that a person coerced by the state loses. He writes, “[Rothbard] uses Pareto’s rule in its usual meaning now ... because under demonstrated preference the losing party *cannot prove* it loses because it suffers the loss

⁴⁵ Kvasnička (2008, p. 48). Italics original.

⁴⁶ Kvasnička (2008, p. 49). Italics original.

passively ...”⁴⁷ In applying this analysis to Rothbard’s case of the voluntary cartel, Kvasnička concludes that Rothbard has not shown that a state enforced breakup of the cartel fails to improve social welfare. Perhaps this would be correct if Rothbard was claiming that “producers lose [because] they can charge only competitive prices again” as Kvasnička cites as the source of loss.⁴⁸ But Rothbard argued that the loss to members of the cartel can be inferred from the coercion the state uses to prevent them from doing what they prefer to do in the given situation and not from comparing the higher cartel prices before state intervention to the lower non-cartel prices after state intervention.⁴⁹ Kvasnička himself characterizes Rothbard’s argument in this way: “the government’s action coerces someone else to do what he does not want to do, or abstain from an action he would like to do. This person loses.”⁵⁰ Rothbard did not switch meanings of the Pareto rule in his second welfare theorem, but consistently applied the concept of demonstrated preference, that a person’s preference can be deduced from the empirical evidence of his action and the conceptual meaning of action.

Kvasnička makes two criticisms of Rothbard’s welfare economics that do not stem from his claim that Rothbard’s views should be assessed in terms of the mainstream approach.

First, he claims that Rothbard ignores the effect negative externalities have on the welfare improving character of the unhampered market because they are “caused by ill-specified property rights” and hence, “ruled out of the free market by definition.”⁵¹ Rothbard’s argument, however, is that the welfare loss of negative externalities cannot justify government intervention to correct it because the cause of negative externalities is not the working of the market but the failure of government to enforce property rights or government interference in the establishment and defense of property rights. In other words, Rothbard is saying that to correct the inefficiency of negative externalities, the state must remove its own inefficiency-generating activity. State intervention into the activity of the market will not correct negative externalities

⁴⁷ Kvasnička (2008, p. 48). *Italics original.*

⁴⁸ Kvasnička (2008, p. 49). *Parentheses removed.*

⁴⁹ Rothbard (1997a, pp. 242-243).

⁵⁰ Kvasnička (2008, p. 48).

⁵¹ Kvasnička (2008, p. 47).

but impose its own additional inefficiency on the market. Kvasnička's argument that "since the definition and enforcement of property rights is [sic] costly, they cannot be complete in the real world," and therefore, Rothbard's claim that negative externalities are ruled out of the free market by definition "means either that the free market cannot exist, or that Rothbard's theory is of no relevance to the real world" misses the mark.⁵² Even if Rothbard were trying to argue for the superior welfare results of the unhampered market versus the hampered market with respect to negative externalities, all he would have to show is that the former results in smaller welfare losses than the latter, not, as Kvasnička claims, that there are no such welfare losses in the unhampered market. The unhampered market need not achieve Nirvana to be justified.⁵³ It only needs to be better than any other realizable arrangement.

Second, Kvasnička claims that Rothbard's welfare economics contradicts his general economics. Following Barnett and Block, he claims that Rothbard's welfare economics must conclude that an increase in money production by the state cannot improve social welfare while an increase in money production by private enterprise does improve social welfare. Rothbard, however, did not follow his own welfare economics in this case. On the basis of his general economics, he argued instead that any amount of money is socially optimal.⁵⁴ The apparent inconsistency can be cleared up by removing the ambiguity in the phrase "socially optimal." Rothbard meant by this phrase that any amount of money can perform the entire medium of exchange function in society.⁵⁵ The entire set of exchanges people desire to make can be made with any amount of money. No inconsistency exists between the claim that any amount of money is socially optimal in this sense and the existence of social welfare effects from money production described by Barnett and Block. To demonstrate that any amount of money is socially optimal, the economist postulates a given amount of money and underlying preferences and other conditions that give rise to particular demands for goods and factors which result in particular prices of those goods and factors. If each person's money holdings were instead twice as large, with the same underlying con-

⁵² Kvasnička (2008, p. 47).

⁵³ On the Nirvana Fallacy, see Demsetz (1969).

⁵⁴ Kvasnička (2008, p. 50). See Barnett and Block (2004).

⁵⁵ "Any amount" of money means any amount larger than a technologically necessary minimum if such exists. The argument refers to the adjustment of prices to different amounts of money, not to the implications of a technologically minimum amount of money.

ditions, then prices would be twice as high and if they were half as large, prices would be half as high. But no matter the amount of money, people would be able to make all the exchanges they desire to make. There are no social welfare implications of this analysis. It is designed to compare end- states that the market arrives at from given initial conditions that differ in one respect. It shows that in contrast to consumer and producer goods, a larger stock of money in society does not permit people to attain to a greater extent the end to which they put money. To demonstrate the social welfare effects of money production, the economist postulates given market conditions and then that more money is produced by money producers and spent by them on some goods and factors, which in turn is spent by the producers of those goods and factors on other goods and factors and so on. In this case, there are social welfare consequences to be analyzed. The analysis traces the step-by-step process by which the market moves from one end-state to another.⁵⁶

4 Conclusion

Rothbard's main argument for the unhampered market economy was that it achieves the ethical use of interpersonal violence more fully than any other social arrangement. Working within natural law philosophy, he showed that this ethic requires the defense of natural rights against aggression and that the unhampered market economy is integral to the free society in which there is no legitimate aggression against natural rights. Complementary to his main argument concerning ethics was his economic argument that the unhampered market promotes the life and flourishing of man more fully than any other social arrangement. Working within praxeology, he accepted Mises's argument that the life and flourishing of man is promoted by the development of the division of labor and that the unhampered market develops the division of labor more fully than other social arrangements by bringing decisions concerning it under economic calculation as completely as possible. His welfare economics was not written as a defense of the unhampered market but as a critique of mainstream welfare economics. By grounding welfare economics in fundamental economic principles, he showed that every interaction on the unhampered market improves social

⁵⁶ Admittedly, Rothbard's discussion of this matter lacks his usual clarity. See Rothbard (1970, pp. 670-671).

welfare and no interaction of the state can improve social welfare. He offered his argument to convince mainstream economists to follow through the logic of what is implied by the fundamental economic principles they hold to be true to its *laissez-faire* conclusion. Mainstream economists have failed to embrace Rothbard's welfare economics because they reject his praxeological method in favor of a modeling method. As a praxeological exercise, however, his welfare theorems are valid.

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