Episode 488: Welfare Economics: Rothbard Was Right

Guest: Jeff Herbener

WOODS: I just got done explaining to people that when we talk about welfare economics, we're not talking about the economics of welfare payments, although I can understand why an average person would think that, that they don't know about this particular sub-field of economics. And as a matter of fact, you gave a talk at the Mises University Program on welfare economics. I'm sure you've done it more than once, but there was one year where you gave it, and when it went up, somebody who obviously didn't bother to listen — can you believe people comment on videos without bothering to listen to them?

HERBENER: (laughing) No, it's shocking.

WOODS: It went on to say in the comments section that of course you're a white man, so naturally we would expect you to have these views on welfare. And I thought, I don't think your views on Pareto have anything to do with whether you're a white man or not. The guy obviously thought we were talking about aid to families with dependent children or food stamps or something.

HERBENER: (laughing)

WOODS: So anyway, that is not what we're talking about. But we are talking about something that involves trying to assess whether people's well being has been improved, and so in that sense of the word "welfare" the term is appropriate. I'd like to start off by having you explain two things: first, I want you to talk about the test of Pareto optimality or Pareto superior movements, and then secondly, talk about Murray Rothbard's approach to welfare economics and how that was a challenge to the way other economists had been thinking about the subject.

HERBENER: Okay, sure. So to start with Pareto, it was developed — Pareto, again, was part of the neoclassical economics movement in the early part of the 20th century, and so this became a mainstream approach to the question of what you might call social welfare. That is to say, can we logically conceive of all of the different social interactions that people might engage in that would demonstrably make people better off in society? And so Pareto said, sure, we can think of different types of social interaction that would do that.

For example, voluntary exchange. So Pareto said in a voluntary exchange, both the trading partners benefits according to their own subjective judgment of the value of what they obtain compared to the value of what they give up. So each person in a voluntary exchange gives up what they value less and acquires what they value more. And so Pareto said in that instance we can say when two people make a voluntary exchange, that both of them benefits, and it doesn't appear that anybody else through that action is made worse off, that their welfare has diminished. So you can imagine exchanges with three people involved or four or whatever, so everybody else in society is not engaged in that action, so their welfare is staying the same, and the welfare of everyone participating in the voluntary exchange is improving.

And so Pareto said that sort of activity of voluntary exchange would be what came to be called Pareto superior. So this move increases the welfare of people in society overall, and the condition under which Pareto insisted that this would be so would be that in the — all the participants in this interaction, no one can be harmed.

So if somebody's welfare goes down in a social interaction, which wouldn't be the case with a voluntary exchange, but let's say it would be the case with maybe the government is taxing one group and then transferring the funds to another group, that the well being or the value that accrues to the goods that the taxed group has is diminished. Pareto then said, in cases like that, he called this Pareto inferior. Some persons are harmed; their welfare goes down, and other persons who are benefited, their welfare improves. And Pareto said in that case, we can't say that social welfare has improved, because we can't make interpersonal welfare comparisons. So that's the basic idea.

WOODS: So in other words, you have no basis for comparing the — there's no number that can say this group's welfare went up by X, but the other group's welfare went down by X+7, so therefore it's a net minus. There's no way to make — I just want people to understand what you mean when you say you can't make interpersonal welfare comparisons.

HERBENER: Yeah, that's correct. And this was a big innovation of modern economics from the Marginalist Revolution. This was a conclusion that was accepted by economists and being debated in this time of Pareto, and Pareto accepted the conclusion the neoclassical economists came to, which was that the subjectivity of value, the fact that we have the value of our actions in our mind does not permit us to have meaningful numeric analysis of utility. But if we don't have a unit of utility, then we can't do comparisons between people. So we could measure the difference in height between people, because we have an external unit of height, the foot or whatever, to measure their height, but we can't measure people's subjective values, because we can't come up with a common unit of value. And so in all cases where one person or group of people, their utility goes down, and another group, their utility goes up from some kind of participation in a social interaction, then Pareto said that's Pareto inferior. A situation like that could never move us towards the situation where we've exhausted all possible Pareto superior interactions. If we could imagine a state of affairs like that, which is purely hypothetical, Pareto said we'd call that Pareto

optimality. Pareto optimality is a situation where all of the Pareto superior social interactions are taken in society, and none of the Pareto inferior social interactions are taken.

WOODS: All right, how does Rothbard differ from this? Because some of this does sound a little bit like what Rothbard says in — he had a book chapter that became very influential in Austrian circles in 1956, "Toward a Reconstruction of Utility and Welfare Economics." I'll link to that at TomWoods.com/488. That really is the definitive statement of Rothbardian welfare economics.

HERBENER: Right. So what happened after Pareto — we have to pick up the story sort of in the development of welfare economics. What happened after Pareto was some other economists came along and tried to circumvent this restriction that Pareto had put upon social interactions, because it seemed quite apparent that if we adopt this Pareto rule, that no action of the government whatsoever could be considered Pareto superior, because there are always persons who are harmed and —

WOODS: Right, exactly. There's always — right. And so therefore, instead of saying I better modify my policy preferences, we have to change the rule. (laughing) The kids aren't doing well on the SAT? Let's change the scoring. Like, we never make any fundamental changes.

HERBENER: (laughing) Yeah, so economists succumb to the same problem as people in general. But anyway, so people tried to get around the Pareto — other economists tried to get around this restriction, but they can't bear to give up this principle that no interpersonal comparisons of utility can be made. So they come up with this notion of the social welfare function, where they say that, okay, one thing that the government could do is redistribute income of everyone, and then with the redistributed income, we just let the market play out and we'll get the Pareto optimal solution. But we could imagine getting different Pareto optimal solutions depending on the income distribution in society, so governments are justified, they argued, in redistributing income; that would not interfere with the achievement of the Pareto optimal state.

And so where Murray comes in in this debate, he says, now wait a minute. Actually, that reasoning seems to beg the question, because there's a — the distribution of income, so to speak, is an outcome of the market process, and so if the government redistributes income, they are engaged in Pareto inferior moves, because they're taxing one group and giving the funds to another, so that doesn't seem to work. And it was really recognized by the neoclassical economists working in welfare theory that they were reaching a dead end.

And Murray stepped in, and he said if the neoclassical economist is serious about welfare economics, we could reconstitute it, but we would have to reconstitute it along the lines of a genuine starting point in private property. And so we would have to say that each person own his own labor as a starting point of property ownership, and then homesteads goods out of nature and that would be a Pareto superior move, and then produces things maybe in voluntary cooperation with other people, which

would also be a Pareto superior move, and then they exchange those things, and so on. And so you can work through a kind of Pareto dynamic that would result in the justification, once again as the original Pareto analysis did, of all market activity, of all voluntary activity in the market, and yet not justify any state activity whatsoever. I should say just for clarity that this analysis was drawn out of Murray's work by Hans Hoppe.

WOODS: Yeah, you know what? I should link to Hans also on welfare economics. Yeah, okay; I'm going to do that too. So the concept of demonstrated preference is really central to what Rothbard is talking about. We're not talking about what's hidden in people's minds. It's nothing like that. It's just if I in the market engage in a transaction, that is my way of telling you — in a way it's like "actions speak louder than words."

HERBENER: Right.

WOODS: That, in taking the action, you can tell that I've improved my condition as compared to what it would have been if I hadn't taken the action, or otherwise, why would I do it? Now, just so that we can anticipate, he talks into account the possibility that you could later regret your action or that you could act in error, but he's talking about at that particular moment, you're doing what you believe to be something that improves your welfare, and this demonstrates to a neutral observer that you're improving your welfare.

HERBENER: Right. So here I think there is an important addendum to make to Murray's work here. Some people, and we'll get to this when we talk about Kaplan, but some people seem to think that the Pareto analysis as developed by Pareto himself took now account of this distinction between welfare or utility or value that people acquire who are participating in an action and the states of minds of bystanders with respect to that action. But actually the whole Pareto analysis depends upon this distinction.

What Murray's doing is simply making this explicit. He's simply drawing out this sort of hidden assumption in the Pareto analysis that existed already. So what he's saying again is that there is no way that we as economists as objective analysts of society can say anything objectively about people's welfare, unless it's a logical implication of the way in which they're choosing and acting. And so third party bystanders, we simply, whatever their state of mind is with respect to the activity of other people, we can't know anything scientifically or objectively about those states of mind, and therefore we can't include their states of mind in objective scientific analysis. So that's —

WOODS: Okay, so that handles an objection that I have heard, which would be, suppose I sell my company to you for $100 million. You pay me the money; I give you the company; we're both better off. Rothbard would say that clearly both of our utility has been increased, even though there's no unit for it. But one of the objections has been what if there are people in our society who are envious, and even though they are not directly harmed by my sale of my company, they just can't believe I earned $100 million for selling a company, and they are just so fuming with envy that Rothbard would have to say that the effect on social welfare is indeterminate,

because there's no way that I can have a unit to measure how much worse off they are because their envy has been stoked at my good fortune, as compared to the realization of my good fortune and the increase in welfare that I get from that.

HERBENER: Right, and again just to reiterate, no economists in welfare economics have taken the position that somehow we can scientifically include envious people or third party bystanders in welfare analysis. To do scientific analysis, we can only include in the analysis what we can objectively ascertain about people's states of mind, and since they're objective, we can only ascertain something about their states of mind objectively from inference that we make from the actions that they take.

You might think of this as an analogy. Let's suppose we had a medical scientist who wanted to do a scientific study of the effect of smoking on the body. And so he would set up a control and a test group of people and observe them over the decades and their behavior where one group's similar in behavior to another, but one group smokes and the other doesn't, and he would get all this data. And he would use that data in his analysis, but he might know of all sorts of anecdotal instances of people who smoke without any effect or people who just smoke a little bit and get terrible cancer, you know, his brother-in-law maybe smoked all his life until he was 90 and never got cancer. But he can't include that in his scientific study. It's not scientifically ascertained data, and so it just doesn't count, right? And in a similar fashion, envy just — we can't count it. We don't know how to incorporate it into an objective, scientific analysis.

WOODS: Let's turn now to the Bryan Kaplan analysis of this, and it's not that long. There are only five paragraphs in his essay on why he's not an Austrian economist. I'm just going to read the first two paragraphs verbatim, and then we can — because the first two paragraphs have one self-contained argument.

So he says — he's continuing from a previous section: “While Rothbard and Mises had similar objections to mainstream utility theory, Rothbard went one step further by 'reconstructing' welfare economics along Austrian lines. His main conclusions are simple and austere: every market transaction benefits all participants, while every act of government intervention benefits some people *at the expense* of others. Rothbard goes on to make a seemingly stronger claim: ‘If we allow ourselves to use the term ‘society’ to depict the pattern of *all* individual exchanges, then we may say that the free market 'maximizes' social utility, since everyone gains in utility.’” So that sentence was a quotation from Rothbard. He says, “This claim might be re-phrased to say simply that each voluntary exchange benefits all participants, and the free market permits the implementation of *all* desired voluntary exchanges.” That's the first paragraph.

Then he says, “Hans-Hermann Hoppe, arguing for Rothbard's approach, makes a subtly stronger claim.” And here he quotes Hans: “‘Pareto-optimality is not only compatible with methodological individualism; together with the notion of demonstrated preference, it also provides the key to (Austrian) welfare economics and its proof that

the free market, operating according to the rules just described, always, and invariably so, increases social utility, *while each deviation from it decreases it*.'"

Now back to Kaplan: "Strictly speaking, however, Rothbard could only claim the welfare effects of government intervention upon 'social utility' are *indeterminate*; i.e., since the victim loses and the intervener gains, it is impossible to say anything about social utility without making a *verboten* interpersonal welfare comparison. This is an important point, because it shows that Rothbard's welfare economics provides a much weaker defense of the free market than usually assumed. In particular, Rothbard's own theory strips him of the ability to call *any* act of government 'inefficient.' By denying the ability to endorse state action in the name of efficiency, Rothbard also implicitly denies the ability to reject state action in the name of efficiency. This is no logical flaw in Rothbard's theory (although it does reveal a logical flaw in Hoppe's presentation of Rothbard's theory), but it's political implications are rather different than commonly assumed: Rothbard's welfare criterion justifies agnosticism about — not denial of — the benefits of statism."

So let me state this succinctly: what he's saying is we take Rothbard to be giving a ringing defense of the free market, because he says that because of demonstrated preference, we can clearly see that a voluntary un-coerced interaction improves people's utility and, by extension, social utility, if we want to use that term. But in fact, when we're dealing with a government interaction where the government takes my money and gives it somebody else, all right, well we've got clearly I'm made worse off by the government taking my money, so we can say that things have been made worse.

But Kaplan would say we can't say that, because maybe the person who got the money is made so much better off than you are made worse off, maybe it's an improvement. There's no way to know. So instead of saying it's a definite decrease in social utility, we have to say it's indeterminate. We can't tell one way or the other, because we can't measure how much worse off you are as versus how much better off the other person is. What's the problem with that objection?

HERBENER: Okay, well let me say something, kind of a general point first before we deal with the specifics of that claim. I think what is generally wrong about Kaplan's assessment here is that he's misinterpreting the point of Rothbard's article on welfare economics. The point of his article was not to provide a defense of the free market. It's well known that Rothbard's defense of the free market is not utilitarian. It's not based on maximizing social welfare. Rothbard was not a utilitarian. His defense of the market was based on natural law and natural rights, as laid out in *The Ethics of Liberty*.

And so what Rothbard is doing in this article is not saying here is my number one defense of the free market, and argument in favor of the free market. He's saying if neoclassical economists are serious about doing welfare economics, then they must accept the free market as providing the greatest social welfare. Their own theory leads them to this conclusion if they reconstruct this theory on proper grounds. He's

just taking Pareto's original analysis, and he's bolstering the logical underpinnings of it, saying look, this is what you guys must conclude from your own analytical apparatus.

So I think this whole discussion of Kaplan is misdirected. Rothbard isn't using this as an argument in favor of the free market, but simply trying to get neoclassical economists to recognize the implications of their own analysis, and if they wish to continue to accept this notion of Pareto optimality and general equilibrium, then they should be in favor of the free market like Rothbard is too. Even their analysis would demonstrate the efficacy of the free market.

Now, on this narrow point, what Rothbard says again as a conclusion to this state of affairs about what can be said about social utility is again exactly the same thing that Pareto and the other neoclassical economists say about social utility. This conclusion really is no different. They both say that all voluntary interactions unambiguously improve social utility and therefore are movements toward Pareto optimality, and all state interactions that lower the utility of some and raise the utility of others are Pareto inferior and do not move us toward Pareto optimality, and that's the end of that. You know, it is true that one could maybe go too far, one could draw conclusions out of this case of the state action harming some and benefitting others that aren't warranted, but I don't think Rothbard does this. I think that he's just reiterating the same conclusions that neoclassical economists come to.

WOODS: All right, well then let me read to you the other primary objection that Kaplan has. He says, “There is however a more serious flaw in Rothbard's welfare economics — a flaw which again flows from his behaviorist insistence that only preferences demonstrated in action are real. Thus, Rothbard rejects the argument that the envy of a third party vitiates the principle that voluntary exchange increases social utility.” All right, that's the objection that I raised a little while ago.

And now he quotes Rothbard: “‘We cannot, however, deal with hypothetical utilities divorced from concrete action. We may, *as praxeologists*, deal only with utilities that we can deduce from the concrete behavior of human beings. A person's “envy,” unembodied in action, becomes pure moonshine from a praxeological point of view... How he feels about the exchanges made by *others* cannot be demonstrated unless he commits an invasive act. Even if he publishes a pamphlet denouncing these exchanges, we have no ironclad proof that this is not a joke or a deliberate lie.’”

Now again, Kaplan: “Indeed, Rothbard could have taken this principle further. When two people sign a contract, do they actually demonstrate their preference for the terms of the contract? Perhaps they merely demonstrate their preference for signing their name on the piece of paper in front of them. There is no ‘ironclad proof’ that the signing of one's name on a piece of paper is not a joke, or an effort to improve one's penmanship.”

And then second paragraph of this part of the critique: “Rothbard's refusal to acknowledge unobserved preferences would have to impress even B.F. Skinner. What possible reason could we have to believe that utility is ‘moonshine’ unless expressed in

concrete actions? At every moment, by introspection we are aware of preferences unrevealed by our behavior. Figuring out the mental states of *other* people is obviously more difficult, but that hardly shows that their mental states do not exist. The statist could easily reverse Rothbard's objection, and claim that since there is no 'ironclad proof' that third parties *do not* object to other people's voluntary exchanges, it is impossible to say whether that they *increase* social utility. Thus, Rothbard's welfare economics terminates in agnosticism about not only the benefits of intervention but the benefits of voluntary exchange."

All right, there's a lot packed into there. How do you want to attack it?

HERBENER: Yeah right. Let's start with the easiest part and the signing of the contract as an extension of this attempted *reductio ad absurdum* on Rothbard. But I don't think Rothbard would say anything about the states of utility in the minds of people signing a contract. That's not the action that he's referring to. The social interaction he's referring to is not the signing of the contract, but the actual exchange of the property, so it doesn't really matter what their states of mind are in the signing of the contract —

WOODS: Oh, that's good. Okay.

HERBENER: — what's important in the voluntary exchange is the actual trade of the property ownership, so that it's analogous to somebody writing a pamphlet and saying I'm envious. So I think Kaplan misfires here.

The main other point about all of this is that if one is to accept third party envy as relevant for doing welfare economics, then it's not Rothbard's system of welfare economics, at least not alone, that crashes to the ground. It's all welfare economics. Of course, you can't do any welfare economics if you include unobservable — if you just make guesses about what people's unobservable, hypothetical states of mind are as they react to other people engaged in real behavior. If Pareto had that notion in his mind when he first formulated his rule, then of course he would have nothing to say whatsoever. Who would? All we could say is that every social action is indeterminate in that sense.

What we need is some way of discerning or a distinction between objectively demonstrable welfare states that, as researchers and scientists, we can infer something objectively as true about welfare in the minds of people and distinguishes those states of affairs from instances where we can't say anything objectively about people's states of mind.

WOODS: Jeff, let's just look at one line here in the Kaplan critique that I read. He says, "There's a more serious flaw in Rothbard's welfare economics and it flows from his behaviorist insistence that only preferences demonstrated in action are real." Well, I don't think he's saying that they're not *real*. I think the question is are they the potential subject of scientific investigation.

HERBENER: Yeah, exactly right. So Rothbard never denied that subjective states of mind are real. Of course they're real. He even has cases — he goes through this analysis in some of his writing about how there are envious people — we can admit this — but the point to reiterate is to, as you said, to make a distinction between scientifically observable or data that we can infer through observation about people's states of minds and then states of mind that we can't as scientists have any objective knowledge about.

WOODS: Jeff, you have written on this, but have you written on Rothbard's welfare economics because other people were criticizing it, or have you written something just spontaneously of your own accord?

HERBENER: No, what I've written has been in response to critical work.

WOODS: Do you think you'd be able to — I know I've read your stuff. I know there was an article I think written by two people that you responded to, if I recall that right, and it was some years ago. Is that something that's immediately at hand that you can send me? I could put it on TomWoods.com/488.

HERBENER: Ooh, I —

WOODS: That's right; I'm making you do the work.

HERBENER: Yeah —

WOODS: I bet if we dug through — it's in the *QJ*, wouldn't it be?

HERBENER: No, it's not in the *QJ*; it's in a European journal.

WOODS: Ah. All right.

HERBENER: So I don't know if I could get online access to it. I could send you a file.

WOODS: Oh okay, one way or another, we'll get it up. You tell me once we get off the line here; I'll get the title of the piece from you, and I'll Google around for it first. All right, well look, this was great. This is actually a really technical topic, but I bet at least half the listeners don't even realize that because of how well you expressed it, and I think that's a combination 80% of you're a very good explainer and 20% of I put the fear of God into at the beginning of this episode that no one's going to understand what we're saying.

HERBENER: (laughing)

WOODS: (laughing) We have to be really careful to explain this, because it's a really important field of economics.

HERBENER: Right.

WOODS: Now by the way, since I'm not a professional economist and I don't deal with textbooks and so on, what is the state of welfare economics today? Do economists have this field that they refer to as welfare economics? Is it just part of the warp and woof of economics so that it's not really studied distinctly?

HERBENER: Yeah, I would say the latter. It's still a part of what economists study, at least as the historical development of economic thought. It's sort of in the toolkit of economists, but I wouldn't say it's an active area of research really.

WOODS: Okay. Yeah, I was just wondering about that, because I don't hear it talked about anymore. And by the way, this is great. I'm going to put this on the calendar. Let's see, this is running on September 11th, 2015. First time in my life I've ever gotten to use the expression “warp and woof.” (laughing) That's awesome.

HERBENER: (laughing)

WOODS: All right, Jeff, thanks for your time. We'll try to get that article up by hook or by crook — first time I've ever used *that* expression.

HERBENER: (laughing)

WOODS: We've got to end this conversation. Who knows what I'll say next? Thanks so much. It was great talking to you.

HERBENER: You too, Tom. Thanks.