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Rothbard's Welfare Theory: A Critique

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Abstract: This paper analyzes Rothbard's welfare theory. It differs from other critiques of the theory in that it does not analyze the context of the theory but only its coherency and consistency with the rest of Rothbard's analysis. It shows that the theory is invalid and should be rejected because it is incoherent (its two welfare theorems cannot be defended at the same time), and inconsistent with Rothbard's own claims made elsewhere.

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1 Introduction

There were many attempts to create an economic welfare theory to allow an economist to decide what action is beneficial from the point of view of the society as a whole with no reliance on exogenous ethical norms. Such attempts were in vain because of the fundamental limits of the utility theory on which they were based – it is possible neither to compare the utility interpersonally, nor aggregate it. The only rule to distinguish “good” from “wrong” is then Pareto’s Unanimity Rule: increasing ‘social utility’ (to use Rothbard’s term) is such a change that makes at least one person better off, and no one worse off judged by their own preferences; decreasing social utility is a change that makes at least one person worse off, and no one better off judged by their own preferences; in the remaining cases we can say nothing about the change of social utility. The problem with this analysis is that almost all changes that may happen fall into the indeterminate category.

In his *Reconstruction of Utility and Welfare Economics* Rothbard (1956) first criticized the previous attempts to create the economic welfare theory, and then presented his own version. His critique is sound and decisive, but his attempt must be rejected, however strongly we are sympathetic to the philosophy he wanted to defend. There are four reasons for this: 1) his approach is inconsistent with Pareto’s rule (while claiming the opposite), 2) it is inconsistent with common sense, 3) it is incoherent (its two welfare theorems cannot be defended at the same time), and 4) it is inconsistent with Rothbard’s own claims made elsewhere. 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.¹

¹ Based on Rothbard (1979) some people believe that Rothbard withdrew his welfare theory since he said here that “we cannot decide on public policy, tort law, rights, or liabilities on the basis of efficiencies or minimizing of costs. But if not costs or efficiency, then what? The answer is that only ethical principles can serve as criteria for our decision”, i.e. that no purely economic norm (the welfare theory) can distinguish “right: from “wrong”. However, Rothbard did not withdraw his theory here. He was merely aware of many reasons why an “increase of social utility” is not sufficient criteria for an ethical judgment. He said it plainly even in his older work (1956, pp. 40–41). Only three years before Rothbard (1976) published a paper where he used both arguments together. He claimed that praxeology cannot settle ethical judgments (p. 78), and then used his welfare theory (pp. 87–89).

Our critique differs significantly from other critiques of Rothbard's welfare theory (Caplan, Cordato, Gunning and others). They analyze the broad context of the theory, or even question Austrian economics as such (like Caplan 1999, does). Our analysis is based on a detailed study of Rothbard's own arguments only. We have only checked the coherency of his arguments.

The structure of the paper is: section 2 deals with Rothbard's methodology, especially with the limits and implications of his concept of demonstrated preference. Section 3 shows that Rothbard's welfare theory is incoherent because each of its two theorems is derived under a different and mutually exclusive set of assumptions, i.e. they cannot hold true at the same time. Section 4 analyzes one of potentially many inconsistencies between Rothbard's welfare theory and the rest of his own analysis. Our arguments are summarized in section 5.

2 Rothbard's Methodology: Demonstrated Preference

Rothbard (1956) said explicitly that every welfare theory must be based on Pareto's Unanimity Rule; he then criticized older welfare theories for not satisfying this condition (pp. 23n). However, 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: let us assume that two men make a mutually beneficial exchange that enriches both of them while it makes no one else worse off in terms of goods and services he can consume now or later. Such a trade could be called increasing social utility. However, if there is one envious person that feels worse off because of the success of his neighbors, Pareto's rule rejects the case as "indeterminate" since one (envious) person is worse off (pp. 28–29).

Rothbard believed he could get a determinate solution in more cases with the tool he called *demonstrated preference*.² The idea is simple: human action is purposeful, i.e. a man acts to reach his own goals. He chooses an action because he believes that

² Gunning (2004) shows that Rothbard is wrong when he attributes this concept to Mises. Both Rothbard's method and its outcome (the welfare theory) differ significantly from Mises' own ones. The difference is clear also from Rothbard's own critique of Mises in Rothbard (1976, pp. 90–98).

the action will improve his well-being in comparison to hypothetical situations in which he would have chosen other actions (including no action). Thus we may infer that the action *demonstrates* an increase of the agent's utility. It *demonstrates* he is better off in terms of his own preference in comparison to outcomes of other actions he might have chosen but did not. The concept of *demonstrated preference* is then, according to Rothbard, "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." (p. 2)

The notion that the action demonstrates a utility improvement is not new (Rothbard quotes Fisher, p. 3). What is new is that Rothbard proposes to *ignore* all changes of a person's utility except those the person demonstrates through his actions. Rothbard rejects from analysis everything which is not demonstrated in an *actual* action, i.e. what goes beyond the scope of the demonstrated preference, as a vain psychology (pp. 13–14).³ We can read this in two ways: 1) we can know nothing that was not demonstrated in an action, or 2) there is nothing more than what was demonstrated in an action. While Rothbard might have the first in mind, he spoke as if he believed the second. This can be seen from his assertion that a man cannot be indifferent.

This assertion is a corollary of the concept of demonstrated preference. Rothbard argues thus: since each action is unique, a person can choose only one choice, i.e. there is no way to *demonstrate* indifference; hence there *can be no* indifference at all (p. 15). There must always be *some* preference even if it is established by chance (p. 16). Rothbard then rejects the indifference curves approach on these grounds. However, Rothbard is clearly wrong. The inability to *demonstrate* indifference is no proof there *is* no indifference but only that an outside observer cannot observe it, which is quite a different thing. 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. The indifference curves just describe the agent's inner world, in which Rothbard takes no interest, or rather denies its existence altogether.

³ It is really strange that Rothbard limits knowledge an economist can have to what was demonstrated in an action, but does not limit other social sciences in this way. Rothbard (1976, pp. 88–89) says that "we may know as historians from interpretative understanding of the hearts and minds" more than we can know as "scientific economists". "Scientific economists" should "confine the concept to its strict scientific compass in demonstrated preferences". However, he does not say why a "scientific historian" should know more than a "scientific economist".

However indifferent a man may or may not be, Rothbard's critique of the indifference analysis shows how he means to use the concept of demonstrated preference.

In the same way in which Rothbard denies any relevance (or perhaps existence) of the inner states of man, he denies the possibility of a comparison of the two situations. It is obvious from his defense of the corollary of impossibility of indifference. He argues thus: one might object that the indifference may be demonstrated by a repeated choice. If a person in the same circumstances chooses in half the cases one action, while in the other half another action, we may assume he is truly indifferent, and chooses one of two actions by chance. However, Rothbard argues, such a comparison is not possible because over time the agent's preferences might have changed (p. 16). Therefore, we cannot (according to Rothbard) compare a real situation with another hypothetically the same, but we have to stick to the demonstrated preference which shows the action the agent has really chosen.

To summarize, Rothbard's methodology consists of three elements: Pareto's rule, the demonstrated preference (and its corollary of the impossibility of indifference), and of the impossibility of the comparison of situations at different times (which may truly be seen as another corollary of the concept of demonstrated preference).

The demonstrated preference concept looks simple but it poses severe limits that may be easily overlooked. An agent can demonstrate only those changes of his utility that are caused by his own actions, i.e. 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. 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.⁴

Let us illustrate the point. For instance, I cannot demonstrate that I am better or worse off when I am given a gift. It is a situation that happens to me – I am passive in it. The gift may considerably change my utility; however, there is no action that could demonstrate this. It may seem that my acceptance of the gift is proof that the gift has increased my utility (otherwise I would have rejected it), but it is not so. Rejecting a

⁴ Herbener (1997) in his defense of Rothbard's welfare theory can clearly see these points, and he regards it a positive virtue of the theory. However, he completely fails to notice that this destroys the coherency of the theory. See below.

gift is something quite different from not being given it, as everyone knows who was given an ugly present by someone whose feelings he does not want (or dare) to hurt. In the same way, my non-resistance to a robber does not prove I enjoy being robbed – I simply may not be bold enough to resist, i.e. I prefer no action to resistance. Nor does resistance to the robber prove I do not like being robbed – I may like fighting, and could have come to a dangerous place to challenge it. In other words, every subject chooses the most preferred action in any given situation; but there is no way he could demonstrate how much he prefers the situation that happened as such.

This means that the concept of demonstrated preference is *not compatible* with the usual meaning of Pareto's rule, because it allows us to look at only those utility changes that can be demonstrated with an action, while Pareto's rule looks at *all* of them. 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 (even though it could easily be abused by someone who pretends he *really* is omniscient, as governments sometimes do). Rothbard goes to the opposite extreme. He says we can know (even in principle) nothing that cannot be demonstrated by an action. This is extreme behaviorism, as Caplan (1999, pp. 825–6) rightly says.

To summarize, while Rothbard said that any economic welfare theory must satisfy Pareto's rule, he did not actually follow his own recommendation. The concept of demonstrated preference is a subtle, yet crucial, change of the rules of the game. This change is both conscious and purposeful.

3 Rothbard's Welfare Theory: Analysis of Two Theorems

Rothbard's welfare theory consists of two major theorems. The first theorem says that “the free market always increases social utility” (p. 31). This theorem is derived (pp. 28–30) 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. The traders exchange to benefit, i.e. the utility of each of them is increased by the exchange, at least ex-ante.

To claim that the exchange increases social utility according to Pareto's rule, one has to prove that there is no losing subject. But this does not hold true in general. A voluntary exchange between two or more partners (as any unilateral or multilateral action in general) may have various impacts on a non-involved third party. It may affect it as 1) common physical externalities, 2) a redistribution of wealth or income either through a non-voluntary transfer (say a robbery), or change in prices, 3) envy, etc. If any non-involved third party loses because of an action from which someone else benefits, the action (or the process that generates it) cannot according to Pareto's rule increase social utility.

Rothbard made a couple of subtle claims that (as he believed) allowed him to ignore these effects. First, he said the negative externalities can be ignored, because they cannot occur in the free market because “[t]hese ‘problems’ are due to insufficient defense of private property against invasion. Rather than a defect of the free market, therefore, they are results of invasion, of property, invasions which are ruled out of the free market by definition” (p. 38, footnote 74). The externalities are indeed caused by ill-specified property rights, but this does not allow us to ignore them. Since the definition and enforcement of property rights is costly, they cannot be complete in the real world because complete property rights do not pay off and are often not technically viable at the given state of technology. To say that the 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.

Rothbard also has an (invalid) answer to the problem of redistribution of wealth and income (pp. 29–30). He rightly says that distribution is not independent from production and exchange in a free market economy, and that a change in the distribution is caused by voluntarily-made exchanges. However, this is not a sufficient reason to ignore the impact of a change of the income and wealth distribution on individual's utilities under Pareto's rule. Pareto's rule looks for *all* subjects' utility increases or decreases in comparison to the status quo, despite their cause.

These lines of defense of the theorem are both invalid, and *redundant*; moreover, they do not apply to the case of envy quoted above. There is a very simple reason why Rothbard can ignore all these people's losses on the basis of his concept of demonstrated preference: the trading partners *demonstrate* by their actions that they benefit

by the trade (they must benefit because possible indifference was ruled out). On the other hand, the possibly losing non-involved third party *cannot demonstrate* it loses because it loses *passively* – there is no action that can prove it (see section 2). 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.⁵

Such a conclusion is possible, but it corresponds neither to the usual meaning of Pareto's rule, nor to common sense. Moreover, it proves too much. Under such logic, any action, even a murder, increases social utility since the active agent proves by his action he benefits while the potential suffering party cannot prove it loses. Rothbard himself did not notice this flaw in his theory – perhaps because he did not use the concept to prove obvious nonsenses. Some of his followers were more consistent and went further. They even found “mistakes” in Rothbard's own analysis (see next section).

The second theorem of Rothbard's welfare theory says that “no act of government can ever increase social utility” (p. 31). Rothbard argues (pp. 30–32) that any governmental action makes someone better off – at least the government benefits since otherwise it would not do it (the action demonstrates the preference). On the other hand, the government's action coerces someone else to do what he does not want to do, or to abstain from an action he would like to do. This person loses. Thus such an action does not increase social utility according to Pareto's rule. This holds true for every government action since every action, however beneficial for anyone, is financed by taxes collected on an involuntary basis.

Rothbard's argument seems to be correct, but it is inconsistent with his own methodology because he uses Pareto's rule in its usual meaning now, not the concept of demonstrated preference. This is so because under demonstrated preference the losing party *cannot prove* it loses because it suffers the loss passively (see above).

⁵ This is the purpose for which the concept of demonstrated preference was created. Rothbard (1976) says: “Therefore, if we employ the Paretian definition of ‘social utility’ in the usual ‘psychologizing’ meaning, 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.”

Herbener (1997, pp. 103–104) states it clearly: “It is by this inference [i.e. *deduction*] and not his action under duress ... that the Pareto-Inferior nature of involuntary interaction is seen.” In other words, Rothbard abandoned the concept of demonstrated preference here, and he used Pareto’s rule in its usual “psychologizing” meaning instead. This is the incoherence of the theory.⁶

The result is that the first and second theorem of the welfare theory cannot hold at the same time. Either we use Pareto’s rule in its usual meaning, which yields the second theorem but rules out the first one, or we use the concept of demonstrated preference, and then we can retain the first theorem, but not the second one. Moreover, as we have seen above, this later approach is inconsistent with both Pareto’s rule and common sense. We will see in the next section it is inconsistent with Rothbard’s own claims made elsewhere too.

The incoherency of Rothbard’s welfare theory can be illustrated with the case of a cartel which Rothbard himself used (p. 34). He first argued that a cartel which came to existence on a voluntary basis increases social utility (the first welfare theorem). This is so because the members of the cartel benefit (they can charge a higher price), and they demonstrate it by an action – the formation of the cartel. 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. Then he argued that government prohibition of the cartel does not increase social utility (the second welfare theorem). This is so because someone benefits from the destruction of the cartel. Surprisingly those who benefit are not the customers because they cannot demonstrate they benefit with any action since they are passive, but the government which acts, and its action demonstrates it benefits. But in the same time the producers lose. They can charge only competitive prices again. Rothbard says the prohibition of the cartel “demonstrably injures them”. But this is not so. There is no action by which the producers could *demonstrate* they lose – in precisely the same way as the consumers could not demonstrate they lose from the cartel formation. Thus Roth-

⁶ Herbener is wrong when he calls the involuntary interaction ‘Pareto-Inferior’ since it is only indeterminate. Rothbard (1976, p. 89) says it correctly. This also means that even if Rothbard’s welfare theory was correct (which it is not), it would be a very weak basis for a critique of governmental meddling with the economy, as Caplan (1999) shows.

bard used the concept of demonstrated preference to prove the first statement, and Pareto's rule to prove the later one – but these two concepts are incompatible and inconsistent, see section 2.

4 Contradiction Between Rothbard's Welfare and Economic Theories

Rothbard's Welfare theory is not only incoherent, but it is clearly inconsistent with Rothbard's own economic theory. One example has been found by Barnett and Block (2004): Rothbard in his works held the position that “[a]n increase in the supply of money confers no social benefit whatever” (quoted in Barnett and Block 2004, p. 42). The same position has been defended by many economists from Hume's days on, including Mises and other Austrian economists.

Barnett and Block (2004) try to criticize this theory. Their analysis is more comprehensive (and in my opinion entirely wrong). What matters to us is the fact they use Rothbard's welfare theory to uproot his monetary theory (pp. 44–46). They distinguish between the fiat money produced by the government on a coercive basis, and the gold standard money produced by free entrepreneurs on a voluntary basis. In Rothbard's monetary economics, all types of money (in this context) are treated in the same way: the increase of the stock of money of *whatever* type does not increase social utility. But according to Rothbard's Welfare Theory, Barnett and Block quite rightly argue, the impact of the two types of money must be absolutely different. The extra *fiat* money is produced on a non-voluntary basis, i.e. the second welfare theorem applies, and social utility is not increased. The extra *gold* money is produced on a voluntary basis, i.e. the first welfare theorem applies, and social utility must increase.

We have here three problems: first, there is inconsistency in Rothbard's own claims, i.e. inconsistency between his monetary and his welfare theory. Secondly, the impact of a money injection into the economy depends neither on the quantity of money injected, nor on the way it is injected into the economy, but on its producer. Thirdly, the inconsistency analyzed in the previous section appears again: either we stick to Pareto's rule, and then no injection of money increases social utility since some people lose (they lose a part of their purchasing power, as Rothbard knew very well), or we stick to the concept of demonstrated preference, and then any injection

of money increases social utility, since no one can prove by any action he loses. We can expect that more similar inconsistencies exist.

5 Conclusion

While Rothbard's critique of older welfare theories is sound and persuasive, his own welfare theory failed. It is incoherent because its first and the second welfare theorems cannot hold true at the same time, inconsistent with Pareto's unanimity rule while it claims it is consistent with it, and inconsistent with common sense. Moreover, there is at least one inconsistency between Rothbard's welfare theory and sound economic doctrine – the doctrine he himself held. This means that the maintenance of Rothbard's welfare theory may endanger sound propositions of common economic theory, as the case quoted in section 4 shows. For these reasons we propose to reject it.

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