Rothbard's Welfare Theory: A Critique

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Major Claim

Rothbard's welfare theory (*Reconstruction of Utility and Welfare Economics*, 1956) should be rejected because it is

- inconsistent with Pareto's rule (pretending the opposite),
- inconsistent with the common sense,
- incoherent (its two welfare theorems can't stand together),
- inconsistent with Rothbard's own economics.

Different from Caplan

Caplan (1999): "The Austrian Search for Realistic Foundation" in *Southern Economic Journal*, 65, 4, April, p. 823–828.

Caplan criticizes the whole "Austrian Credo".

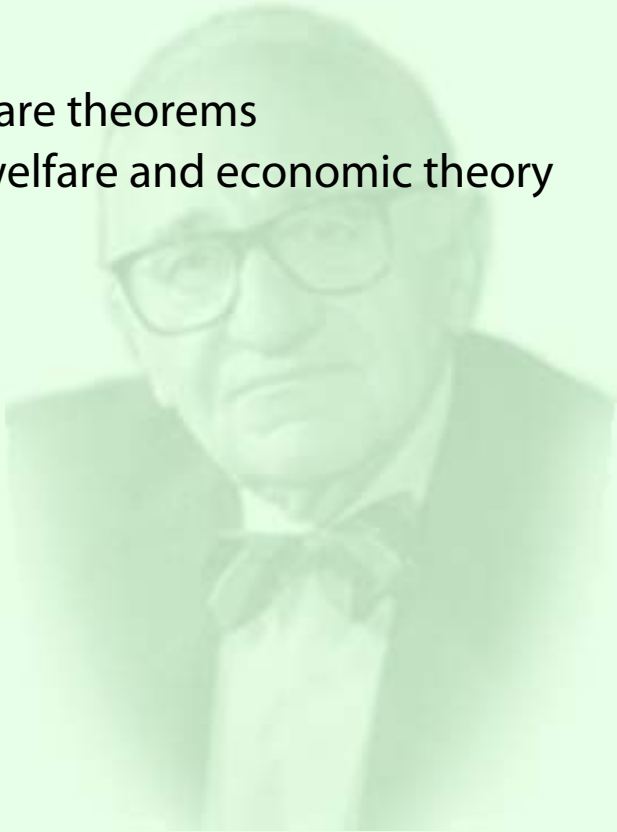
We just analyze coherency of this welfare theory.

Our findings are more severe.

They should be accepted by the Austrians.

Structure of Presentation

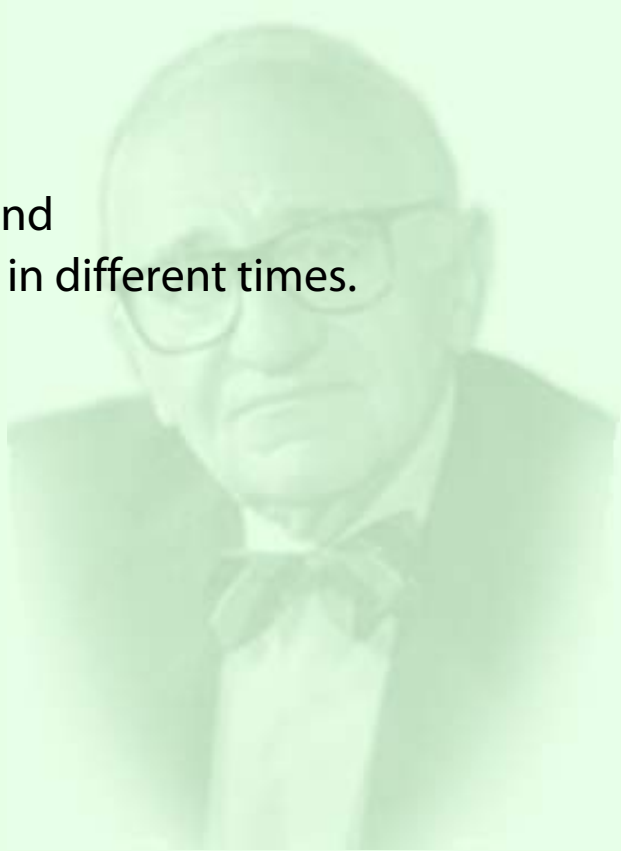
- Rothbard's methodology
- Consistency of the two welfare theorems
- Consistency of Rothbard's welfare and economic theory
- Conclusion



Rothbard's Methodology

Three elements:

- Pareto's unanimity rule,
- demonstrated preference, and
- impossibility of comparison in different times.



Pareto's Rule

Rothbard: Every welfare theory must satisfy Pareto's rule.

Pareto's rule = "Social utility" is

- increased by a change that makes at least one person better off, and no one worse off,
- decreased by a change that makes at least one person worse off, and no one better off, or
- "indeterminate" in the rest cases.

Everything judged by the persons' own preference.

Problem: Almost all changes are "indeterminate".

Concept of Demonstrated Preference

Rothbard uses it to get more “determinate” solutions.

Demonstrated preference = **“[A]ctual choice reveals, or demonstrates, a man’s preferences; that is, that his preferences are deducible from what he has chosen in action.”**

What was not demonstrated by an action, should be ignored:

- we cannot know it, or
- it does not exist.

Corollary of Impossibility of Indifference

Rothbard: A man cannot be indifferent.

It is not possible to demonstrate indifference by any action.

$$\Downarrow$$

Rothbard: Indifference cannot exist.

(But: It proves only our inability to observe indifference, not that it cannot exist.)

Impossibility of Comparison at Different Times

We cannot compare an agent's choice in two hypothetically identical situations since his preferences might have changed.

$\Downarrow$

Rothbard: We have to stick to demonstrated preference.

(Other corollary of the concept of demonstrated preference.)

Limits of Demonstrated Preference

An agent can demonstrate only those changes of his utility that **are caused by his own actions**—when he is active.

An action only demonstrates that the agent is better off choosing the action **in comparison to choosing other possible actions**, not that he actually is better off.

A passive agent **cannot demonstrate** a change of his utility **caused by an external force** he passively suffers.

Example: A gift.

Demonstrated Preference vs. Pareto's Rule

Demonstrated preference focuses only on the preference actually revealed in an action.

Pareto's rule focuses on all utility changes.

$\Downarrow$

Rothbard's methodology is not compatible with Pareto's rule.

It is a subtle, yet crucial change of the rules of the game.

Rothbard's First Welfare Theorem

Rothbard: **"[T]he free market always increases social utility."**

Both trading partners expect to benefit from the trade.

Trade increases "social utility" if it makes someone better off, and no one worse off. The traders are better off.

But someone can loose because of

- physical externalities,
- redistribution of wealth / income (transfer / price change),
- envy, . . .

Can we ignore them?

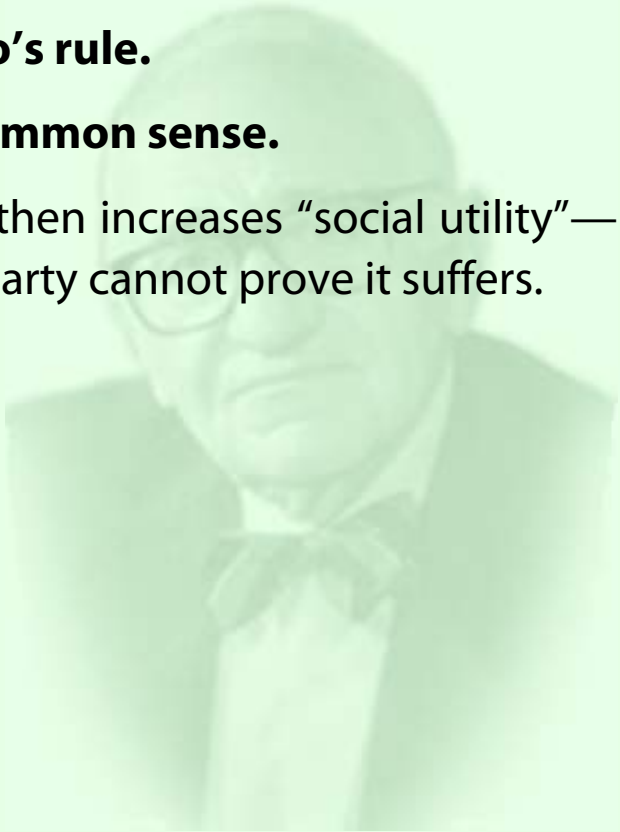
Yes! **It is impossible to demonstrate the loss by any action.**

Problems

It does not correspond to Pareto's rule.

It does not correspond to the common sense.

It proves too much: Any action then increases "social utility"—the agent benefits, the suffering party cannot prove it suffers.



Second Welfare Theorem

Rothbard: **"[N]o act of government can ever increase social utility."**

Someone benefits (the government—it proves it by the action).

Someone else looses—he is forced to do something / abstain from something.

It is always so—government is financed from taxes.

$\Downarrow$

Government's actions are never Pareto-improving.

Problems

The loosing party cannot demonstrate it looses.

Now Rothbard **uses Pareto's rule, not demonstrated preference**.

$$\Downarrow$$

The two welfare theorems cannot hold together:

- Pareto's rule: the 2nd theorem holds, the 1st one does not.
- Demonstrated preference: the 1st theorem holds, the 2nd one does not.

Example: A cartel formation, and destruction.

His Welfare and Economic Theory

One inconsistency found by Barnet—Block (2004): "On the Optimum Quantity of Money" in *The Quarterly Journal of Austrian Economics*, 7, 1, p. 39–52.

Rothbard: "An increase in the supply of money confers no social benefit whatever."

According to Rothbard's Welfare Theory:

- Fiat money is produced by the government $\Rightarrow$ the second welfare theorem applies $\Rightarrow$ "social utility" **is not increased**.
- Gold money is produced by the "market" $\Rightarrow$ the first welfare theorem applies $\Rightarrow$ "social utility" **is increased**.

Problems

Inconsistency of Rothbard's welfare and economic theory.

Impact of money injection depends on its producer rather then quantity, . . .

Inconsistency of Pareto's rule and demonstrated preferences:

- Pareto's rule: someone benefits, someone looses $\Rightarrow$ "social utility" increases for no type of money.
- Demonstrated preference: no one can demonstrate he looses $\Rightarrow$ "social utility" increases for all types of money.

Conclusion

Rothbard's welfare theory should be rejected because it is

- inconsistent with Pareto's rule (pretending the opposite),
- inconsistent with the common sense,
- incoherent (its two welfare theorems can't stand together),
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May endanger sound economic theories.

Very weak critique of governmental interventions (Caplan, 1999).

$\Downarrow$

It should be rejected even by those who want to retain the "Austrian Credo".

Thank you for your kind attention.
Any questions, comments, or hints?

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