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# Toward a Libertarian Reconstruction of Neoclassical Welfare Theory

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## Toward a Libertarian Reconstruction of Neoclassical Welfare Theory

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### Abstract

Many libertarians, especially those inclined toward the Austrian school of economics, counter the market-failure justification for government intervention by denying any legitimacy whatsoever to the neoclassical concept of efficiency. But properly interpreted, neoclassical efficiency, rather than providing an open-ended justification for all sorts of government intervention, provides one of the most powerful and comprehensive objections to government coercion in general.

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### I. Introduction

Many libertarians, as well as other free-market advocates, have extreme reservations about the welfare theory of neoclassical economics. They especially object to the derivative notion of market failure and the frequency with which it is employed to justify government intervention. When libertarian economist Bryan Caplan recently defended welfare economics and other aspects of neoclassical analysis from the criticisms of the Austrian school, he elicited an array of dissenting replies from such Austrians as Walter Block, Jörg Guido Hülsmann, and Edward Stringham. These critics utterly reject neoclassical efficiency as a coherent standard for comparing different outcomes in the real world. Indeed, Block has gone so far as to assert that “[t]here are no such things” as market failures.<sup>1</sup>

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\* I have received helpful suggestions from Peter Boettke, Mark Brady, Christopher Coyne, Warren Gibson, David Henderson, Joseph Salerno, and Edward P. Stringham, but none of them bear any responsibility for the final outcome.

<sup>1</sup> Caplan (1999). The first round of critiques came from Block (1999) and Hülsmann (1999). Caplan (2001) replied, which inspired a further response from Block (2003). Although my article focuses on welfare economics, the debate

Caplan, in my opinion, has done a superb job of exposing the weaknesses of various Austrian alternatives to efficiency, but I believe that his defense of neoclassical welfare theory can be taken a step further. Going beyond philosophical debates about the ultimate validity of efficiency, I intend to demonstrate that market-failure justifications for government intervention are usually a misuse of this neoclassical standard. This brief comment strives to combine much of what has become standard fare among economists, some of Caplan's points, and a few original insights into a comprehensive reappraisal of neoclassical welfare theory. Together they demonstrate that efficiency, properly interpreted, offers a far more encompassing rejection of government overall than is generally appreciated.

## II. The Proper Use of Neoclassical Welfare Economics

Those inclined toward the Austrian school of economics often counter the market-failure justification for government intervention by denying any legitimacy whatsoever to the neoclassical concept of efficiency. See, for instance, Murray Rothbard's classic article on welfare economics (1956). The problem with this approach is that it throws out the baby with the bath water. Some standard of efficiency, however crude and whatever its shortcomings, stands implicitly behind Ludwig Mises and Friedrich A. Hayek's socialist calculation critique of socialism. Without such a concept it would likewise be impossible to show that tariffs make economies poorer, and libertarians would be left with purely normative objections, completely divorced from any consideration whatsoever of net economic consequences.<sup>2</sup>

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extends to many additional issues as well. Stringham's (2001) and Stringham and White's (2004) criticisms of Caplan tend to emphasize the inability of judges to apply neoclassical welfare standards in court decisions, a conclusion I actually share but believe can be strongly substantiated within the neoclassical framework. The Block quotation comes from an online review (2007).

<sup>2</sup> Rothbard (1956), which contains his discussion of welfare economics, has been frequently reprinted. Mises (1951) and Hayek (1935) are the standard Austrian critiques of socialism, but see also David Ramsay Steele (1992) for a neoclassical twist on the critique. The Austrian economist Israel M. Kirzner (1973, ch. 6) offers a more subtle yet more equivocal critique of neoclassical welfare economics that rejects the efficiency standard yet essentially reintroduces the same concept under the rubric of "coordination." Roy E. Cordato (1992) critiques Rothbard and basically embraces Kirzner's approach, but changes the name of the standard again, from "coordination" to "catallactic efficiency." An Austrian-based rejection of both

A few neo-Chicago economists go in the opposite direction, with ironically similar results. They imply that if you consider all opportunity costs, including transaction costs, then all actual outcomes in the real world are efficient. We therefore live, according to them, in the best of all possible worlds. This broad definition of efficiency (like the broad definition of self-interest that claims all conscious choices are self-interested) may be an informative tautology for certain questions. But it strips us of a positive standard, grounded in an objective if imperfect assessment of people's preferences, for comparing economic outcomes.<sup>3</sup>

Therefore I accept the usual neoclassical approach to market failure. In the pure-Pareto formulation, it asks the following question: Given factor endowments and people's preferences, can an omniscient and benevolent bureaucrat god imagine any transaction that does not take place on the market even though it would make at least one person better off without making a single person worse off? If so, you have a market failure. Notice that this definition omits from consideration transaction costs: i.e., the opportunity costs of finding a trading partner, negotiating the deal, and monitoring its terms. Without some such cost, the transaction in question would obviously have taken place. Thus, all market failures – whether labeled public goods, externalities, asymmetric information, or something else – stem ultimately from positive transaction costs. The insight follows from the analysis of Ronald Coase.<sup>4</sup>

Efficiency thereby becomes a positive standard against which we can compare market outcomes. Two further questions arise, one

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Rothbard and Cordato's (but not Kirzner's) approach to welfare economics is David L. Prychitko (1993), reprinted in Prychitko (2002). Tyler Cowen (1990) speculates about a historically based alternative to what he calls "Paretian welfare economics."

<sup>3</sup> Notable examples include Donald Wittman (1995), George Stigler (1982), and Gary Becker (1982).

<sup>4</sup> Coase (1988) reprints his major contributions regarding this topic. Demsetz (1968, p.33-34) makes the same point regarding positive transaction costs and market failures. Boettke, Coyne, and Lesson (2007) offer an intriguing but ultimately talmudic challenge to the neo-Chicago position by making a distinction between neoclassical efficiency and what they call "political efficiency." Their political efficiency simply incorporates transaction costs when evaluating government activities (rendering all political outcomes politically efficient) while being unclear about the status of transaction costs in evaluating the efficiency of private activities.

positive and one normative. The positive question is can government alleviate market failure and increase efficiency, and if so, how reliably and systematically. The normative question is should government do so, even if it can. Economics addresses the first question but cannot address the second. Many advocates of government intervention are willing to give up some efficiency for alternative goals, as are many libertarians. In much of what follows, I will concentrate on the practical question of what governments can and cannot do.

On the one hand, inefficiency is pervasive in the real world because transaction costs are pervasive. Even the market's slightest delay in arriving at general equilibrium is a market failure by this measure. Because the very existence of money is a disequilibrium phenomenon, efficiency would require a Walrasian world of instantaneous, computerized, zero-cost barter in which one good might serve as a numeraire for all prices but never serve as a medium of exchange. On the other hand, efficiency is also an abstract optimum, comparing an actual outcome with a superior but non-existent one. There is no guarantee that a market failure, once identified, can be corrected. Any claim that government can alleviate market failure hinges on coercion's ability to reduce transaction costs somehow.

Why does neoclassical efficiency put transaction costs into a separate, privileged category from all other costs? Essentially two reasons. The first relates to the history of economic thought. These are the costs usually assumed to be close to zero in models of perfect competition and in Walrasian general-equilibrium analysis. But a second, more fundamental reason exists to treat transaction costs as special. They are the only costs that an involuntary transaction might potentially lower. All other costs, such as alternative uses of scarce factors or the foregone utility of leisure, cannot be reduced by coercion under any logically conceivable circumstances. But the prisoners' dilemma illustrates a general case in which it is at least theoretically possible that a compulsory transaction makes all parties better off, according to their own subjective preferences. Whether this theoretical possibility can be translated into a practical reality is, of course, another question.

If government coercion were confined to pure Pareto improvements, in which no party was made worse off according to his or her own preferences, it is hard to imagine that it could ever alleviate market failure. Any involuntary net transfer would be ruled

out. Unfortunately, then abolition of patently inefficient government regulations will rarely improve efficiency either. Repealing a tariff normally involves as many transfers imposing one; only a repeal that fully compensated all the losers qualifies as a pure Pareto improvement. I am therefore perfectly willing to admit interpersonal utility comparisons, even though the Austrians are correct that they can never be empirically verified. Comparisons can take either the form of Kaldor-Hicks (ex post) improvements or the more satisfactory but less commonly acknowledged Marshall (ex ante) improvements advocated by David Friedman. In most (but not all) situations, these two, more relaxed standards arrive at identical conclusions.<sup>5</sup>

Even allowing for transfers where (with interpersonal utility comparisons) the gains exceed the losses, we should not view market failure as a blanket justification for all sorts of government coercion. Instead, market failure remains a rigorously narrow criterion. Only if you can demonstrate a market failure is it even theoretically conceivable that government coercion can generate any net benefits. Government coercion can always paternalistically impose one person's preferences on another (as with drug laws and laws against prostitution) or redistribute resources from one person to another (as with welfare). But without some market failure, it is logically impossible for coercive intervention ever to make people better off generally. End of discussion.

Government therefore devotes a lot of resources to finding market failures it might fix, and a large number of economists, unsurprisingly, respond to this incentive. A dubious development along these lines is the theoretical work attempting to show, with such concepts as merit goods and others, that much blatant government redistribution or paternalism in fact corrects some hitherto unnoticed market failure. Government coercion, in these alleged instances, rather than merely making one person better off at the expense of another, as seems apparent, is surreptitiously generating net benefits. I remain skeptical of such claims, which only obscure the precision of the market-failure criterion and back us into

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<sup>5</sup> Kaldor (1939), Hicks (1939), and Scitovsky (1941). See particularly Friedman's neglected micro text (1990, p.434-54). Situations in which the Marshallian and Kaldor-Hicks standards can diverge are discussed in Friedman (1988) and Cowen (1993).

the neo-Chicago world in which all government coercion magically becomes efficient.<sup>6</sup>

Excluding questionable market failures, the concept can still justify much government intervention in theory. But only if we take what Harold Demsetz uncharitably describes as the “nirvana” approach to public policy, which assumes that, once economists have identified a market failure, the government can correct it. In fact, omniscient and benevolent bureaucrat gods do not exist. If instead we compare the real-world market not with our ideal government but with real-world governments, many of the same transaction costs that make solving market failure difficult for market participants also afflict government. Utopia is not an option. Economists face a choice between two inefficient alternatives: the market and government (Demsetz, 1969).

Such an exercise in comparative institutions reveals that government encounters two obstacles in alleviating market failure: the knowledge problem and the incentive problem. The knowledge problem involves more than simply identifying a market failure. In addition, government must often have some way of estimating, however crudely, the efficient optimum. Otherwise it could easily exacerbate the inefficiency. Air pollution is no doubt a negative externality that results in too much production. (Or clean air is a public good that is underproduced.) But how can any economist estimate the optimal level of pollution (or clean air) without some market in which people reveal their preferences? Surely some estimate is necessary in order to set the level of Pigovian taxes.<sup>7</sup>

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<sup>6</sup> Perhaps the first economist to argue that redistribution alleviated a market failure was Lester Thurow (1971, 1973). For a primarily empirical defense of the efficiency of income redistribution, see the popular works of Robert H. Frank (1985, 1999), which build on arguments made more rigorously in Fred Hirsch (1976). On the other hand, Amartya K. Sen (particularly 1973, ch.1; 1992, p.136-43; most formally, 1970, p.74-77, 196-99; but also 1982 and 1987), a strong advocate of coercive redistribution, concludes that such policies cannot be grounded solely in individual utility. Thus, he disparages neoclassical welfare analysis but for the opposite reason as do some libertarian Austrians: i.e., because it can justify too little government intervention rather than too much. Sen, however, appears to accept the widespread illusion that the Hicks-Kaldor criterion actually dispenses with interpersonal utility comparisons.

<sup>7</sup> In personal conversations Caplan has provisionally challenged the distinction between the knowledge and the incentive problems, suggesting that lack of knowledge must result from a lack of incentives to discover it. I remain

The second obstacle, the incentive problem, is of course the subject of public-choice theory. It reminds us that we cannot assume that government will improve efficiency, even should economists know precisely how to do so. Government may not respond to a market failure at all; it may respond at a cost that exceeds benefits; or, in what amounts to the same thing, its response may over-correct so that the result decreases efficiency rather than increasing it. National defense, for instance, benefits the special interests that President Eisenhower identified as the military-industrial complex, and governments therefore tend to provide too much of it. Whether the U.S. government specifically does so is controversial, but we can know with absolute certainty that some governments must be overproviding what is called national defense; otherwise the service would not be needed in the first place. The overprovision is often a significant net loss of efficiency not only in the country “defended” but in other countries its government threatens.<sup>8</sup>

Together the knowledge and incentive problems significantly circumscribe when government intervention can or will reduce transaction costs. Coercion by its nature cannot reliably and systematically address market failure. In other words, only rarely does government generate any net gains, making people better off on average. Most of its activities instead benefit some people at the expense of others (as evaluated subjectively by the individuals affected) through redistribution or paternalism. This distinguishes government from the free market, which routinely generates net gains even when not perfectly efficient. Admittedly, we cannot rule out the possibility that government coercion might enhance efficiency sometimes, just as we cannot rule out the possibility that private coercion wielded by common criminals might reduce transaction costs and enhance efficiency sometimes. Yet, few would consider this a persuasive argument for celebrating or encouraging criminal activity.

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unconvinced, but even if we accept this semantic unification, distinguishing between incentive problems relating to knowledge and other incentive problems would still be analytically useful to economists, for reasons similar to the useful distinction between transaction costs and all other opportunity costs.

<sup>8</sup> Kenneth E. Boulding (1963) first made the point about national defense. The most comprehensive introductory guide to public-choice literature remains Dennis C. Mueller (2003).



But the incentive problem cuts much deeper. Rather than applying only on a case-by-case basis, it raises profound across-the-board questions about the very structure of government. Let us grant for a moment that government has both the knowledge and the incentive to fix some individual market failures. Once it has the power to act in those situations, what conceivable incentive structure can confine its coercion to those cases alone? How do you prevent government from also using that power in ways that are inefficient or otherwise undesirable? The government of Nazi Germany, to take an extreme example, probably alleviated some genuine market failures. But was the overall package worth it? Perhaps this problem should be separated into a third category all its own: the structural or constitutional.

We do not have to rely on such egregious examples as Nazi Germany to illustrate the structural or constitutional aspect of the incentive problem. Consider the U.S. Army Corps of Engineers. Over its long history it no doubt constructed some dams, given their public-goods features, that increased efficiency. But we also know that the inefficient subsidies or environmental damage wrought by other dams it built have recently inspired serious discussions on whether to tear them down. These losses are on top of the enormous transfers that building the dams imposed on displaced populations. Faced with the polar options of no Army Corps dams or all of them, which would have left the American people better off on net? Moreover, the default position would appear to be no dams, if we are not certain beyond a reasonable doubt that all the dams together, both efficient and inefficient, bring net gains.

The structural or constitutional problem underscores the stark reality that government is a major source of additional inefficiency – on top of any market failures or other inefficiencies resulting from private behavior. Because government can just as easily cause as cure inefficiency, limiting government becomes an excellent way to make economic outcomes more efficient. But unfortunately, this goal itself faces significant transaction costs. Improvements in the policies or structure of government are generally non-excludable, giving rise to potential free riders. Therefore, such improvements are public goods, woefully underprovided. Put another way, the level and frequency of tax repeals is suboptimal.

So far, we have considered only changing people's incentives as a way to reduce inefficiency. Another way is changing people's

preferences, not about the ultimate goods they wish to consume but about the means appropriate for the attainment of such consumption. Sometimes people do not free ride, even when they can easily get away with doing so, either out of altruism, civic virtue, or some other internalized morality. This is an obvious empirical observation, now supported by a vast amount of scholarly literature (too numerous and well known to require citing) either confirming or attempting to explain it. Witness the amounts of tipping and voting in the United States, both of which flout the free-rider assumption. Because of such ethical or ideological preferences, people sometimes surmount transaction costs and improve efficiency, either directly on the market or indirectly by limiting government.

Relying upon preferences will no more yield perfect efficiency than will relying on market incentives or on government policy. Yet, this option reveals an inner contradiction in looking to government to correct market failures. If transaction costs such as the free-rider problem are decisive obstacles, a strictly limited government might be necessary to solve some market failures, but is unattainable. If transaction costs are not decisive, a strictly limited government becomes attainable but no longer necessary. The fact that people eschew the free-rider incentive to limit government coercion implies that they can also eschew the free-rider incentive to provide themselves market efficiency voluntarily.<sup>9</sup>

### III. Conclusion

Government cannot correct market failure reliably or systematically. In fact, it is a major source of inefficiency. Thus, the neoclassical concept of efficiency, rather than providing an open-ended justification for all sorts of government intervention, instead provides one of the most powerful and comprehensive objections to government coercion in general.

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<sup>9</sup> I have previously made this argument in Hummel (1987 and 1990).

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