AUSTRIAN THEORIZING: RECALLING THE FOUNDATIONS

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It is a pleasure to reply to Caplan's (1999) critique of Austrian economics. Unlike other such recent reactions[1] this one shows evidence of great familiarity with the Austrian (praxeological) literature, and a deep interest in its analytical foundations. Thus, Caplan correctly identifies the works of Ludwig von Mises and Murray N. Rothbard as the core of what sets Austrian economics apart from the neoclassical mainstream. And he insightfully relegates the writings of F.A. Hayek and Israel M. Kirzner to an intermediate position between the praxeological and neoclassical approaches.[2]

We shall defend this core of Austrian economics against Caplan's criticisms, and show that, just as in the case of these others, his arrows fall wide of their mark. It is nevertheless instructive to highlight his errors. The benefits are a better understanding of the Austrian School, and greater insight into neoclassical shortcomings. This article follows the outline of Caplan (1999) and is divided into the same four sections as his: first an introduction, second, consumer theory, third, welfare economics, and fourth, a conclusion.

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[1]See in this regard Rosen (1997), Tullock (1998), Timberlake (1987), Demsetz (1997), Yeager (1987) and Krugman (1998). For a reply to Rosen (1997) see Yeager (reply to Rosen); for a response to Yeager (1987) see Block (1988), and also Yeager (1988); for a rejoinder to Tullock (1988), see Salerno (1989) and also Tullock (1989); for a reaction to Timberlake (1987) see Rothbard (1988) and also Timberlake (1988); for an answer to Krugman (1998) see Garrison (1999); for the Block–Demsetz debate, see Block (1977), Demsetz (1979), Block (1995), Demsetz (1997) and Block (forthcoming).

[2]More recent studies by Austrian economists confirm this point of view. See in particular Salerno (1990; 1993), Rothbard (1997, chap. 7), Hülsmann (1997).

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CONSUMER THEORY[3]

Indifference

"Indifference," for the Austrian School is a technical word. We deny that indifference is compatible with human action, the attempt to render the world a more preferable place than would have occurred had no such act taken place. Were a man truly indifferent between state of the world A (the one which would ensue without his intervention) and state of the world B, he would not act so as to make the latter more likely.

We do not deny, however, that "indifference" also has a perfectly reasonable usage in common parlance. In ordinary language, a person could be readily understood to be indifferent between wearing a green or a blue sweater. This means that he doesn't care much which one he chooses. Given that he will only wear one of them at a time, and chooses the green, he is still reckoned, speaking loosely, to be indifferent between them, because we can readily imagine him picking the other.[4]

But if we were to "get technical" about the matter, it would be at the very least extremely puzzling for a man to select the green sweater in preference to the blue if he were truly indifferent between them. Indeed, this would be nothing less than a logical contradiction. If indifference were his exact mental state, surely he would select neither article of clothing. As in the case of Buridan's Ass, who avoided both piles of equidistant hay, he would eschew both sweaters.[5] Very much to the contrary, if when presented with both the person selected green instead of blue, we as outside analysts, or economists, would be entitled to infer from this act a preference for green.

But Caplan is having none of this. He states (1999, pp. 825–26):

> The crucial assumption—shared by both Mises and Rothbard—is that all preferences can be revealed in action. But why assume this? . . . I have all sorts of preferences that are not—and cannot be—revealed in action. For example, my preference for ice cream

[3]Caplan (1999, p. 825, n. 3) mentions Nozick (1997) as presenting "different but complementary arguments against Mises's and Rothbard's utility theory and rejection of indifference analysis." This was replied to by Block (1980).

[4]In similar fashion, other academic disciplines also utilize ordinary words and invest them with technical meaning. For example, the physicist means one thing by "work," (e.g., force times distance), while the man in the street means something somewhat different. Were a weightlifter to hold two 50 lb. barbells with extended arms, shoulder height, he would not be doing any "work" in the strict sense. However, sweat would soon be seen to pour off his brow; he would be "working" very hard indeed in the ordinary language definition of that term.

[5]In Rothbard's (1993, pp. 265, 267) view,

> If a man were really indifferent between two alternatives, he could not make any choice between them, and therefore the choice could not be revealed in action. . . . Buridans ass . . . is confronted not with two choices but with three, the third being to starve where he is. Even on the indifferentist's own grounds, this third choice will be ranked lower than the other two on the actor's value scale . . . the ass or the man will allow pure chance, such as a flip of a coin, to decide one either (bale of hay).

> at the current instant cannot be revealed since, but the time I managed to find an ice cream vendor, the current instant would have passed.

Strictly speaking, Caplan's ice cream example cannot be used to reject Rothbard's claim "that all preferences can be revealed in action." Rothbard's argument is that only demonstrated preferences are "genuine" for economic theory, i.e., related to action. Pie in the sky "wishes" that a person has (e.g., to buy ice cream without money, or to purchase it "later") are not preferences at all in the technical sense. Preference is defined, in this technical sense, as the ranking of ends upon which an action is based. This is what makes Caplan's claims about acting on the basis of indifference incorrect.

Using Caplan's exact words, his preference for ice ream *can* (at least sometimes) be demonstrated: at least on those occasions when we catch him in the instantaneous act of making a purchase of this foodstuff. True, it cannot always be so demonstrated. At the precise point of time I am writing these words, Caplan may again be wishing he had some ice cream, and yet, not be in a position to purchase any. *This* preference of his, assuming he now has it, is not revealed by action, but it *could* be, as we have seen, so it is false to claim that it "cannot" be. The point is, however, that this "preference" in the absence of human action is not a *demonstrated* preference. It will do, fully, for ordinary discourse, as in the case of indifference. (This is why we can understand what Caplan is getting at.) But as far as technical economics is concerned, we cannot take cognizance of those of Caplan's wishes which are not objectively revealed or demonstrated in action. How can we, as economists, even know they exist?

Our author's second sally (1999, p. 826) is "One can only observe that I choose a green sweater, but this does not rule out the possibility that I was actually indifferent between a green sweater and a blue sweater." In common parlance, we are certainly prepared to accept Caplan's introspection on the matter. Presumably, he has no strong preference for the one color over the other. But as a matter of technical economics, we are hard put, on the basis of indifference, to account for the fact that he did indeed pick up and put on the green sweater, when he could have had the blue. Perhaps the green one was on top of the blue, and some slight additional effort would have been necessary to wear the latter; perhaps they were side by side, but at the last minute, even thinking he was fully indifferent, he veered toward the green based on a very slight, perhaps even unconscious preference. All we know is that he dug into his sweater draw, and came up with the green one. What else are we to infer but that he preferred his color?

Consider the implications of accepting Caplan's position on indifference. First, it is nothing short of the rejection of the elementary claim that economic action is an attempt to substitute a more desirable state of affairs for a lesser one. But this would render incoherent all purposeful human activity, to say nothing of all of economics. It is an undeniable (e.g., praxeological) fact that people act so as to improve their position, not to move from one state of affairs to another, where both are in all respects identical. Why would anyone bestir himself if there were absolutely no gain in it for him? Caplan is confusing definitions. He is claiming that a man can act when in the *psychological* (or non-technical from an economic point of view) state of indifference. Well and good. But Rothbard, in contrast, is claiming that man cannot act in the *praxeological* state of indifference. This two are not incompatible. *Both* could be true. Thus Caplan never lays a glove on Rothbard in this regard.

Even Caplan, in his attempt to deny this primordial reality, is himself snared in its clutches. For this George Mason economist is not indifferent between the Austrian (anti-indifference) and the neoclassical (pro-indifference) theories. Rather, he prefers the latter to the former, and offers reasons, to the best of his ability, why the still undecided members of the profession should cleave to his own views. From this we can make certain inferences. But what would follow were he truly (e.g., praxeological) indifferent to these two viewpoints? Nothing. Caplan could attempt to reply on his own grounds that he is indifference between the Austrian and neoclassical positions and yet, still wrote his (1999) paper. But this would not be true on technical grounds. This would be a very strange way indeed to demonstrate praxeologically he is indifferent between the two views.

A second implication has to do with public policy. Consider taxation. Under the Austrian interpretation, we are in a position to assert without fear of contradiction that this must worsen the economic position of the taxpayer. For, if he had wanted the government to have his money, he would have rendered it to Caesar. But he did not undertake any such activity on a voluntary basis. Instead, he did so under threat. He was made to accept a state of the world less preferred (one where he paid taxes) to one more preferred (one where he kept his funds for himself). Under Caplan's perspective, we can no longer reach any such conclusion. Now, it is entirely possible that the citizen was indifferent between the two situations. Take another example: trade. Austrians are in a position to deduce from voluntary trade that both parties to it gained utility, at least in the *ex ante* sense. For Caplan, it might be that one of the trading partners, or, even, neither of them, made any gain in utility; that, instead, trade really is a zero-sum game, as our friends the socialists are wont to claim.

The Austrian takes a position midway between that of the behaviorist and Caplan's neoclassicism.[6] For the behaviorist, there is no such thing as motive, introspection; all is human behavior. For Caplan, all is motive and introspection; no behavior whatsoever is necessary to tie these phenomena to the real world. In the praxeological perspective, there is both, and the latter is necessary to demonstrate the former.

Cardinality

The Austrians are clear on the matter of ordinal vs. cardinal utility. The former is a basic building block of economic theory, the latter is a snare and a delusion. There are units for weight (pounds), height (inches), distance (miles) and even

[6] For the view that the Austrian School in general occupies a "middle ground," see Garrison (1982). See also Block (1997, 1998ab).

temperature (Fahrenheit), but this simply does not apply to happiness or utility. Contrary to mainstream economics, there are no utils; there is no way, scientific or even commonsensical, to measure joy. There is only preference and setting aside; that is, ordering different goods, or units thereof.

Caplan sees this full well. Instead of embracing the Austrian perspective on this matter, however, he tries to have his cake and eat it too. That is, he maintains that the neoclassicals, too, eschew cardinality in favor of ordinality. So intent is he upon showing the flaws in praxeology, he insists on vesting the mainstream with the Austrian view when he cannot quite bring himself to a direct rejection of its doctrine. He (1999, p. 827) states:

> While the exposition of utility theory in undergraduate textbooks may sometimes be open to Rothbard's critique of cardinality, neoclassical utility theory is no less ordinal than his own theory [see, e.g., Varian, pp. 95–97]. Let a neoclassical theorist say "bundle one offers utility of 8, while bundle two offers utility of 7," and Rothbard concludes that he believes in cardinal utility. But . . . the meaning of [this claim] . . . is nothing more or less than "bundle one is preferred to bundle two."

This really will not do.[7] First of all, even on his own assumptions, Caplan must explain away the fact that neoclassical "undergraduate textbooks sometimes" employ cardinality. Texts are, presumably, the distillation of the learning and teaching of the subject matter. If they "sometimes" utilize cardinality, this is *prima facie* evidence that so does the profession as a whole. Where there is textbook smoke, there is professional fire. In contrast, the obverse criticism cannot be made. That is, by definition, there is not, there cannot be, any Austrian text which indulges itself in cardinality.

Second, no one disputes that mainstream economics *also* engages in ordinal analysis. Certainly, neither Rothbard nor any other Austrian would reject this claim. The problem, for the praxeologists, is that the traditionalists credulously accept, as well, cardinality. Thus, "neoclassical utility theory is no less ordinal than" Rothbard's "own theory" in the weak sense that it, too, employs ordinality. But mainstream utility theory is certainly "less ordinal" in the sense that it dilutes itself with more than a vestige of cardinality.

Third, this is by no means limited to a few, in effect, renegade neoclassical textbooks. The cardinality error is deeply embedded in neoclassical economics. It pervades virtually all relevant analysis. Every time we see the equation:

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[7]We are unable to find the statement in Varian (1992, pp. 95–97): "bundle one offers utility of 8, while bundle two offers utility of 7," means only that "bundle one is preferred to bundle two." However, in support of Caplan, Varian (p. 95) does state: "The only relevant feature of a utility function is its ordinal character." On the other hand, the two are not precisely equivalent. It is conceivable that in Varian's view, utility can be both ordinal and cardinal, and that the latter is irrelevant. But just because Varian makes this statement, does not mean that we, or he, takes it seriously. Varian (p. 97), for example, differentiates utility. How is this possible if utility is purely an ordinal construct? It is interesting that Caplan cited only one author to the (rough) effect that utility is only ordinal, not cardinal. This is surely idiosyncratic for a neoclassical. There are dozens of other texts which take the opposite perspective.

$$\frac{MU1}{P1} = \frac{MU2}{P2}$$

and we see this *all* the time, there is cardinality at work. For it is impossible to divide ordinal numbers, e.g., 5th, 2nd, 1st, 9th, by anything else.[8] When a utility variable is divided by something else, you can be sure that the numerator is couched in terms of cardinal, not ordinal, utility. Further, all of "cost-benefit" analysis is no more than a futile exercise in cardinal mongering; even worse. For here, in addition to engaging in the unscientific measuring of an individual's utility, these cardinal values are then interpersonally compared. And the same holds true in the analysis of externalities, to say nothing of the "proof" that "imperfect competition" is economically inefficient.[9] Thus, cardinality lies at the very root of neoclassical economics; indeed, this is one way to distinguish the Austrian School from the mainstream.[10]

Fourth, it is rather ingenuous to interpret the statement "bundle one offers utility of 8, while bundle two offers utility of 7," as "nothing more or less than 'bundle one is preferred to bundle two.'" Twist and turn as Caplan will, the plain meaning of the statement is that bundle one is 14 percent more valuable than bundle two, surely a cardinal claim. Were Caplan correct in ascribing ordinality to this claim, the very opposite ranking would ensue.[11] That is, the one ranked 7, or 7th, would be ranked higher than the one ranked 8, or 8th. Surely the runner who crosses the finish line in 7th place has beaten the one in 8th.

Continuity

It is indeed true, as Caplan (1999, p. 828) asserts, that for the Austrians, human action occurs in a discrete manner. Creatures such as ourselves cannot make infinitesimally small distinctions. Since mathematical economics relies on differentiation, and this implies smoothness of curves, this, too, must be discarded if economics is to be based on rational foundations.

Our author has several criticisms of this praxeological principle. First, there is the view that "the unrealism of continuity is only minor"; why throw out the mathematical

[8]If this equation is interpreted merely as a ratio, or an analogy, it might be possible to defend users of it from the charge of cardinality. However, as mathematical operations are commonly conducted with this equation, this is not possible. (I owe this point to David Gordon).

[9]Friedman's (1962, chap. 12) negative income tax is also predicated upon this idea.

[10]It would be an embarrassing and neverending task to document the cases where neoclassicals employ cardinal utility. Let us content ourselves with only two. Musgrave (1959, p. 97; see also Musgrave, Musgrave, and Bird, 1987) is as venerable an example of mainstream thought on this matter as can be desired. In his figure 5-1, he places income on the x axis, and both "marginal utility" and "total utility" on the y axis. Now, what kind of utility could this be: ordinal or cardinal? To ask this is to answer it: only cardinal utility can meaningfully be placed on an axis. Similarly, consult Varian (1992, p. 104, figure 7.3), cited by Caplan as maintaining the premise that utility is ordinal, not cardinal. He, too, places utility on the x axis, and income on the y axis.

[11]I owe this point to David Gordon.

economics baby just because of a slight problem with the continuity assumption bathwater? But the problem here is that differentiability has profound implications for economics, which could not have been deduced in its absence. It is not merely a useful heuristic device, allowing us to translate economics into a more elegant language, and certainly not one which generates insights which are both new and true.

Consider as an example the oft repeated anti-"monopoly" canard that, facing a downward sloping demand curve generated by "imperfect competition," the firm cannot locate its operations at the bottom point of the average cost curve (fig. 1).

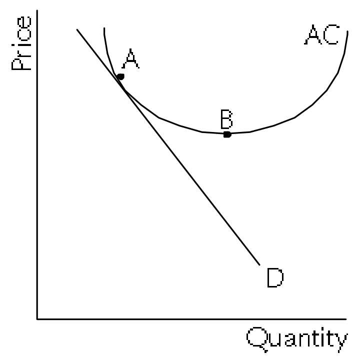

Figure 1

Here, the firm facing a downward sloping demand curve produces at point A, more costly than at point B, which is attained by the "perfectly competitive" firm facing a horizontal demand curve.[12] But this "insight" does not necessarily follow from the downward slope of the demand curve[13]; on the contrary, the continuity assumption of the cost curve is also required. This can be shown by depicting the familiar "u" shaped cost curve[14] in two different non-continuous versions. In each of these cases (fig. 2) a downward sloping demand curve is depicted as compatible with attaining the low point A on the average cost curve.

Second, Caplan (1999, p. 828) attempts a *reductio*. If human beings are not constructed so as to be able to register infinitely small changes,

> then it will also be impossible for humans to see . . . infinitely small steps of a given monetary unit. But with a discrete good and a discrete monetary unit, it is unlikely that supply and demand will ever be equal; no equilibrium price need exist. Excess demand may be -2 units when the price is $1.01 and +1 unit when the price is $1.00.

[12]There are no end to the texts which feature this diagram, or to the journal articles which rely upon such analysis; however, we only cite one: Rothbard (1993, pp. 638, 642).

[13]For a distinctively Austrian approach to this matter, see Rothbard (1993, p. 644)

[14]Such apparatus is not employed by Austrians not because they are not familiar with the "modern tools of economic analysis." This is, rather, due to the fact that praxeologists take seriously the notion that the true meaning of costs is alternatives or opportunities foregone, and that these are subjective phenomena, available only to the human actor himself. On this see Rothbard (1993); Buchanan and Thirlby (1981); Buchanan (1969, 1979); Buchanan (1982); Mises (1966).

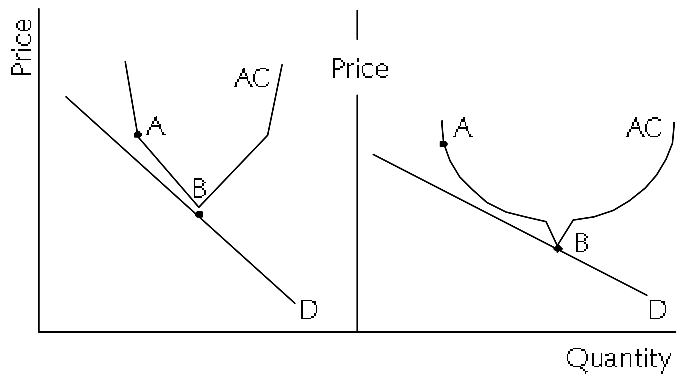

Figure 2

This would indeed be a compelling argument were it launched against neoclassical economics, which focuses on equilibrium, which places this construct at the center of its universe, which lives or dies with it; but not against an economist such as Rothbard. For these two do not contend, and need not since preferences are ordinal, that market clearing equates the utility of the marginal buyer with that of the marginal seller. For them, all the mutual benefit of trade can be exhausted even if the marginal utilities are unequal. As well, equilibrium plays a far lesser role in Austrianism than it does for the mainstream. Here, equilibrium is merely a direction towards which an economy is moving. It is well understood that the end point is never reached in any realistic setting (Mises 1966, p. 244; Rothbard 1993, p. 465), for before it can even be approached, something else changes, with reverberations all throughout the system.[15] Not for Austrians this endless concern with what is or is not true at equilibrium, in nauseating detail. Thus, were we never to arrive at a precise equilibrium point, this would not even be a slight embarrassment for praxeology.

Third, Caplan (1999, p. 828) charges that

> the argument against calculus based upon the rejection of continuity also argues against the use of simple algebraic constructs, like intersecting supply and demand lines, that fill Rothbard's works. . . . If the assumption of continuity is not a harmless fiction, then it is incumbent upon him to remove all of the supply and demand intersections in his works and to state that supply equals demand only under extremely rare conditions.

This is entirely unwarranted. If there is any economist who has been careful, who has been more than careful, to characterize supply and demand as discontinuous functions, it has been Rothbard. Evidently, Caplan has overlooked Rothbard (1993, pp. 67–159), his *magnum opus*, chapter 2. Even a moment's perusal of

[15] For Lachman (1976), Lavoie (1985), Ebeling (1985) and others who have mistakenly been characterized as Austrians (see Vaughn 1994), equilibrium drops out of consideration entirely, and their analysis thus reverts to that of the German Historical School. On this see Rothbard (1989) and Hoppe (1997).

figures 5 and 6 (p. 75), 13 (p. 103), 17 (p. 110), 23 (p. 120) will show any disinterested reader that Rothbard sees demand and supply as essentially discontinuous. Almost in direct anticipation of Caplan's criticism, Rothbard labels figure 21 (p. 115) which characterizes an equilibrium between discontinuous supply and demand curves "unanimously correct forecasts of final price." If this is not just a different way of stipulating Caplan's "extremely rare conditions" then nothing is. Yes, to be sure, Rothbard does indeed, upon many occasions, draw his supply and demand curves as intersecting straight lines. But, give the man a break! He had to communicate in a neoclassical mileau. Surely, after taking great pains to show discontinuities, he may be forgiven for lapsing into the traditional analysis, if only as a heuristic device. Pickiness is one thing, but this critique reaches straight down to the bottom of the barrel.

Income and Substitution Effects

Caplan (1999, p. 828) charges that

> "Though Rothbard rejects neoclassical utility theory, he makes ad hoc concessions to it elsewhere in his writings." Specifically, he "derive(s) the laws of demand and supply as exceptionless theorems" (e.g., demand cannot slope upward, supply cannot slope downward) and yet "concedes the theoretical possibility of backward bending supply curves."

This criticism, too, misses its mark. Of course, downward sloping demand and upward sloping supply are exceptionless propositions, given the *ceteris paribus* assumption of no income changes. And, obviously, when this assumption is relaxed, as in the case of the backward bending supply curve (or the Giffen good), and income changes are allowed into the analysis, then it is theoretically possible for such exceptions to occur. But why should neoclassical economics be granted a monopoly position regarding this rather basic "insight"? Surely, the Austrians, too, without any by your leave tugging at the forelock, may take note of the fact that when price changes, income, too, can be impacted.

In his attack on Rothbard, Caplan (1999, p. 829) makes either an interesting concession, or a denial. He states, "this is a bona fide case where neoclassical economists did not merely tediously formalize the obvious." If he maintains that virtually all of neoclassical economics is indeed the tedious formalization of the obvious, well and good; that is certainly consonant with the Austrian perspective. On the other hand, if he means to deny this, then we need not look too far for a refutation. We need not go beyond the very issue of the *Southern Economic Journal* in which Caplan writes for empirical support[16] for the contention that the mainstream is overwhelmingly concerned with reiterating the trite. For example, Lee (1999) once again shows the Public Choice School as dedicated to supporting socialism and state invervention[17]; Doyle, Ahmed, and Horn (1999) testify that the

[16]As a neoclassical, Caplan should appreciate this.

[17]For support of this contention, see Rothbard (1997, pp. 269–74); Block and DiLorenzo (forthcoming).

doctrine of opportunity costs does indeed apply to crime; Robson and Wren (1999) formally indicate that tax incentives apply to self-employing choices; Goodman, Stano and Tilford (1999) geometrically demonstrate that prices apply not only to the choice between leisure and income, but also to the allocation between health and non-health goods; Granderson (1999) expresses the view that economic regulation lowers technological improvement and raises costs; Herander and Kamp (1999) reiterate that quotas interfere with trade; Arrighetti and Vivarelli (1999) apply the notion that greater skills tend to be correlated with greater economic success; and Hwang Mai (1999) wax eloquent about optimal export taxes.[18]

Uncertainty and Probability[19]

This is the weakest section of Caplan (1999). If there is anything about which one would have thought mainstream economists ought to be modest, it is prediction. Where are now the one time much vaunted econometric models which were to prognosticate the future of economic events? After numerous signal failures, they have pretty much been consigned to the dustbin of history.

Caplan defends neoclassical pretentions to knowledge, at least of the class probability variety. He taxes the Austrians for being unduly pessimistic about the prospects of information availability regarding class probability, without which there cannot be even the possibility of scientific prediction. We may not know everything, but at least we, as an economics profession, can remain secure as regards the behavior of entire classes of economic events, in his view.

In contrast, he maintains, the Austrians, particularly Mises and Rothbard, restrict the scope of class probability to dice, coin flipping, poker, lotteries, and other such games of chance. As for the future pattern of economic considerations such as demand, supply, cost, resource availability, etc., the best that can be said for them by the Austrians is that we know something, but far from all about them, and their class probabilities.[20]

On the basis of these considerations, Caplan (1999, p. 830) attempts a *reductio ad absurdum*:

> every event is unique; if quantitative probability does not apply to unique events, then quantitative probability never applies to actual, specific situations . . . Even in games of chance, all draws and throws are "individual, unique and nonrepeatable." Dice are

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[18]We don't include under this rubric the fact that Long (1999) shows that high marginal tax rates reduce taxable income; and that Shughart (1999) supports Lott's (1998) unexceptionable point that economic incentives apply to gun control legislation. These, too, are but implications of basic economic theory, but they are very distinct from the others in that they tend to support economic freedom, a rarity in mainstream economics.

[19]I am indebted to Guido Hülsmann in the section.

[20]For the Lachmannites (Lachmann 1976; Vaughan 1994; Lavoie 1985) who do not deserve to be counted as Austrians, certainly not of the Mises and Rothbard stripe, matters are far worse. Here, not only is there not class probability, one wonders whether there is even case probability.

always rolled at a particular time and place, in casinos of varying honesty, so we never "know nothing but that they are elements" of the class of dice. Additional information inevitably accompanies every real case. Unless the probability of some unique events can be quantified, Mises seems forced to deny that probability can ever be quantified.

Even were this *reductio* to succeed, at worst it only attacks the minor Austrian point: that class probability does apply in a limited way to human events, pre-eminently to those concerning games of chance. Were the Austrians to concede this point to Caplan, this would create not even a fissure in its foundations. It all depends upon just how "dishonest" are the roulette wheels. If only slightly so, then class probability would still apply; it can be utilized for all types of insurance and industrial processes, e.g., defective bolts (Rothbard 1993, pp. 498–501), and there is no reason to suppose that only slightly dishonest gambling tables would be actuarily less predictable than these events. On the other hand, with seriously dishonest games, all bets would be off; both in terms of the likelihood of people patronizing them, and of our ability to apply class probability to them.

But Caplan's analytic framework fails even to address the major Austrian contention of Mises and Rothbard, to wit, that class probability cannot be made to apply to most economic events. *This* is the crux of the failure of neoclassical economics to make good on its exultant promise to predict the future. As long as there is free will, as long as people are "free to choose," prognostication is a chimera. Even if their past acts could be accurately characterized by a normal distribution, or accorded with some specific elasticity or another, this does not at all warrant the assumption that they will continue to do so in the future.

Let us put this into different words. Caplan does not even try to prove his case. All he does is to insinuate that the neoclassical approach (which denies case probability) makes more common sense than the Austrian (which emphasizes its existence). Clearly, this kind of "discussion" will not satisfy the disinterested observer.

In particular, Caplan fails to address the central question in this field, namely, whether it is at least conceivable that all decisions can be modeled *as* stochastic events, or as *based on* a stochastic model of the world. In short, the crucial question is whether human action can be entirely determined, and on which conditions such a determination depends. Mises (1966, chap. 9; 1985, pp. 74ff., 186ff.) discusses these issues at length, the latter work of which Caplan largely ignores. Mises argues that the emergence of new ideas necessarily overthrows all previous patterns of behavior and, therefore, all economic models based on past data. The only way to get around this problem would be to explain how physical and chemical events determine the emergence of new ideas. But since nothing is known about this process, economists have to plead ignorance, and accept that human beings are confronted with unquantifiable probability (Knight; Mises) or, in other terminology, sheer ignorance (Kirzner).[21]

[21]For more on class vs. case probability, see Hoppe (1997).

RECONSTRUCTING WELFARE ECONOMICS

Demonstrated Preference, Social Utility, and the Coordination Norm

Caplan correctly cites Mises and Rothbard to the effect that economic transactions benefit both parties at least in the *ex ante* sense, and that since the market is just a name for the concatenation of all such events, we may deduce that it benefits all participants.

But then, he gets into trouble when he attempts to paraphrase their views. He states (1999, p. 833): "This claim might be rephrased to say that each voluntary exchange benefits all participants and the free market permits the implementation of all desired voluntary exchanges."

On the basis of this interpretation, Caplan (1999, p. 833) pounces:

> While this conclusion appears to be a simplistic non sequitur, it follows immediately from his unusual utility theory. For Mises and Rothbard, it is simply confused to posit latent preferences; if two individuals fail to make an exchange, then this *ipso facto* demonstrates that at that moment at least one of them would not have benefited from the exchange.

Simplistic non sequitur? On the contrary, this is one of the basic building blocks of all of economics. If voluntary trade is not mutually beneficial, economics as a science (at least the Austrian variety) is doomed. Of course the free enterprise system only *permits* the implementation of all desired voluntary exchanges, this is a far cry from *guaranteeing* any such outcome. Caplan appears to assume the latter, however. It is perfectly possible for there to be a failure to communicate. Just because all trade is mutually beneficial does not mean that "if two individuals fail to make an exchange, then this *ipso facto* demonstrates that at that moment at least one of them would not have benefited from the exchange." Both *could* have benefited, if only they had but known of each other.

But what of third party effects, much beloved by mainstream economists? Rothbard gives the back of his hand to those who claim their envy vitiates the benefits-from-trade claim. For these busibodies have no way to definitively *demonstrate* that the gains to the trading partners are more than offset by their own losses. Indeed, they have no way to prove they lose out at all.

But this does not satisfy our author. Instead, he (1999, p. 833) launches another *reductio ad absurdum* at Rothbard. If envy cannot demonstrate loss of welfare, well, then, neither can the signing of a contract by two people

> actually demonstrate their preference for the terms of the contract. Perhaps they merely demonstrate their preference for writing their name on the piece of paper in front of them. There is no ironclad proof that putting one's name on a piece of paper is not a joke or an effort to improve one's penmanship.

Caplan is making an error here similar to the one he made about indifference. Austrians do not deny that both indifference and envy have a role to play in ordinary parlance. Both concepts can be used correctly, or misused. There *is* such a thing as envy, and only a pure behaviorist (or philosophical skeptic) would be inclined to doubt it. But Rothbard was speaking praxeologically, not as an ordinary language philosopher. Rothbard (1993, p. 18), specifically cited by Caplan (1999, p. 833), states: “A person’s ‘envy’ unembodied in action, becomes pure moonshine from a *praxeological* point of view” (emphasis added).

Compare and contrast the “skepticism” evinced by Rothbard and Caplan. The former doubts that C, the envious person, can demonstrate that he loses utility when A and B trade, certainly that this loss more than offsets their gains.[22] The latter doubts, in effect, that people can agree to trade at all, since their efforts to demonstrate this may be a mere exercise in penmanship. If we took cognizance of the former doubt, the world would be much the way it is, except that a good bit of economic regulation and government interference with market choices would disappear. If we incorporated the latter into public policy, the economy would grind to a halt and most of the world would quickly die. Without property rights and the ability to transfer them (contracts) few would survive. Is the choice, as Caplan would have it in his *reductio*, between almost complete skepticism, and slavish devotion to the claims of the envious person? No. Again, Austrianism occupies a midground of sanity between these two extremes.

Further, in his retort about “penmanship,” Caplan fails to come to grips with the Austrian notion of understanding, or *vershtehen*. The economist must *interpret* human action; he must “get into the mind” of the economic actor. For example, what, exactly, is going on in Grand Central Station during rush hours? Is it a magnificent ballet, with a cast of thousands, similar to the mass dance scene in the movie “All That Jazz”? Or is it the more pedestrian attempt of thousands of people to go to work, or return home? Even biologists must attempt to understand the phenomenon of stotting deer; do these creatures jump up and down to altruistically warn their colleagues of the presence of wolves, or is this behavior a message to the predators: “See how fit I am? You’ll never catch me. Better focus on these other deer.” The point is, praxeology works hand in glove with *vershtehen*. Unless there are extenuating or contrived circumstances (e.g., they are filming a movie in Grand Central Station, and all of those “commuters” are really actors; or, what appears to be a contract signing is really a penmanship class), we *know* what a contract signing means. But in the case of supposed envy, we really do not. Yes, sometimes it is real envy. But other times it can well be a joke or a lie, or, perhaps even more likely, a “rent seeking” attempt to divert resources to oneself. Praxeology, combined with *vershtehen*, cannot, as a matter of economic science, take cognizance of envy. But it certainly can interpret contract signings for what they are.

Putting one’s signature on a contract is not merely penmanship or writing one’s name; it obligates the person to act according to the terms of the contract. Signing one’s name on a napkin, i.e., that act of signing, may indicate only what

[22] Given that interpersonal comparisons of utility are invalid.

Caplan claims; but signing a contract binds one to other actions besides merely signing. Also the envy of a third party cannot be used to overrule the demonstrated preference of traders making a voluntary exchange. The action that demonstrates his envy increases his welfare since he preferred it. But, scientifically, we can no know nothing about states of mind not demonstrated in action.

Taking a stance as the defender of laissez-faire capitalism vis-à-vis Rothbard, Caplan (1999, pp. 833, 834) taxes the latter for his "agnosticism" on the issue.[23] This charge goes as follows:

> It is important to note, however, that Rothbard does not claim that government intervention reduces social utility. Since the victim loses and the intervener gains from the application of coercion, it would be impossible to assert this without making a *verboten* interpersonal welfare comparison. Rothbard could only claim the welfare effect of government intervention upon social utility is indeterminate. . . . His welfare criterion justifies agnosticism about—not denial of—the benefits of state action.

In sharp contrast, Caplan (1999, p. 835) and his ilk *are* in a position to take a truly critical view of the state. Relying on Coasian (1960)–Posnerian (1998) neoclassical wealth maximization,[24] "allows one to make efficiency judgments about the real world to judge, for example, that Communism was inefficient, or rent control is inefficient, or piracy was inefficient."

There are problems here.

First of all, it was Mises and his followers, *not* neoclassical empiricists such as Friedman, nor for that matter market socialists of the Lange–Taylor stripe, who could point to the inefficiency of Communism. For the logical positivists, the claim that communism is inefficient must always and ever be a tentative one, dependent upon further evidence. Only the Mises (1966; 1981) critique, in sharp contrast, would get to the essence of the matter and show the underlying fallacy of this system.[25]

Second, there are serious and grave problems with the Coase–Posner approach.[26] For one thing, it commits the same "*verboten* interpersonal welfare comparison" Rothbard has successfully evaded. Rothbard, we have seen, was unable to consider state action necessarily harmful in that it benefited some, and harmed others, and without interpersonal comparisons of utility, he could not conclude that the former outweighed the latter.[27] One gets the impression from

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[23]In Rothbard's long career, he has been criticized for most things under the sun, but not usually for insufficient advocacy of economic freedom. This argument was first made by Prychitko (1993).

[24]The Coasean philosophy has been widely adumbrated; this literature includes Coase (1960), Demsetz (1966; 1967), Posner (1992) and Medema (1997; 1998; 1999).

[25]On this see Mises (1966, chap. 26; 1981, chaps. 5 and 6), Rothbard (1976), Salerno (1993), Hoppe (1996), Hülsmann (1997).

[26]Critics of Coase, Demsetz and Posner include Block (1977, 1995, 1996, 1999), Cordato (1989; 1992; 1998), Krecke (1992), North (1992), and Rothbard (1990).

[27]This is why Rothbard (1973; 1982) based his defense of market not mainly on utility, but rather on rights and justice.

Caplan that the neoclassicals were somehow able to overcome this minor obstruction. Nothing could be further from the truth. Instead of overcoming it, they ignore it. For another, Coase and Posner is an attack on the very institution of private-property rights which underlies economic growth and development, in that it asks judges to play essentially the role undertaken by Soviet planners.[28]

Third, it is by no means clear that economists, at least of the Public Choice School variety, are in any position to maintain that Communism, rent control, or piracy are inefficient. Worse, in a *reductio ad absurdum*, Lee (1999) has explicitly taken the very opposite tack: that these things and more, far more,[29] are actually *efficient*, given the overriding importance of subsidizing those responsible for the provision of public goods. Rothbard is known far and wide, and justifiably so, as perhaps the single greatest critic of statism. Neoclassical economists such as Friedman, Coase, Posner, Buchanan, Tullock, Demsetz, etc. are, at least compared to him, veritable socialists.[30] For Caplan to conclude that their criticism of governmental intervention is more profound than Rothbard's cannot be justified.

Fourth, far from an attack on Rothbard, Caplan's is actually a high compliment. Rothbard, and to a degree all free-market economists, are continually accused of orienting their technical economics toward political and ideological ends; that is, approaching science with a free-market ax to grind. There is no one who would have more wanted to be able to definitively conclude that government action could be shown to be harmful than Rothbard. The temptation to engage in economically illicit interpersonal comparisons of utility toward this end must have been especially powerful for him. Yet, unlike the neoclassicals, he resisted them. He adopted his "agnostic"[31] position because the logic of economics compelled this conclusion, and forbade what for him would have been a far more welcome one. But, better a valid claim that state action cannot be proven beneficial than an invalid one that it can be proven harmful, especially emanating from a quarter known for its *support* of government intervention, not opposition.[32]

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[28]When property rights are under dispute, and they always are, at least potentially, they are to be awarded in the positive transactions costs world not to those who have homesteaded or purchased them in the past, but rather to those who in the opinion of the judges can make the best (wealth maximization) use of them in the future. If this is not central planning, one is at a loss to specify precisely what is.

[29]For example, the military industrial complex, the environmental industrial complex. etc.

[30]See on this Block (1995a, pp. 61–125; 1995b, pp. 15–26, 151–55; 1977, pp. 111–15; 1999, pp. 15–33; 1996, pp. 265–86; 1994, pp. 31–64; 1998c, pp. 315–26); Block and Gordon 1985, pp. 37–54).

[31]Caplan (1999, p. 835) discusses Mises (1966, p. 659) and states: "Thus, while Mises's analysis initially sounds neoclassical, his discussion of positive externalities appears to make the strong claim that the free market *ipso facto* serves the most urgent needs of the consumer." Question: how is it possible to reconcile this claim with the charge of "agnosticism"?

[32]Caplan (1999, p. 833, n. 20) cites the very important work by Salerno (1993, p. 131) who is able to conclude that intervention is unambiguously welfare reducing only by "completely discount[ing] any gains, in terms of direct utility or exchangeable goods, that accrue to the interveners and their beneficiaries."

Public Goods

The Austrian position on public goods is stark and clear.[33] There are no positive externalities of which the police and courts should take cognizance, since they cannot be demonstrated, or revealed through human action. (The market, in contrast, can internalize externalities of this sort, if they exist, in common parlance, through privatization and private property, through condominiums, restrictive covenants, discrimination, segregation, etc.) As for external diseconomies, they fall into two categories. First, smoke, noise pollution, crime, trespass and other physical invasions. It is precisely to counteract acts of this sort that we have police and courts in the first place (Rothbard 1990; Block 1998; Whitehead and Block 1998; Yeatts and Block forthcoming; Whitehead and Block forthcoming; and McGee and Block 1994). Second, are the external pecuniary diseconomies, including all other supposedly negative effects which cannot be demonstrated through human action. For example, I open a grocery right across the street from yours, and "steal" some customers, much to your (not demonstrated, but likely real) consternation. These, too, since they do not constitute uninvited border crossings, are to be ignored by the forces of law and order.

Public goods for the neoclassicals are entirely a different matter. This concept is used, to be accurate about it, as an entering ideological wedge for government intervention into the economy. If there are alleged to be external benefits of schooling, for example, this justifies taxes and subsidies for this industry. Even though the universities typically teach Marxism, feminism, black studies, sociology, multiculturalism, political correctness and other "disciplines" hardly conducive to the good ordering of society (Kors and Silverglate 1998), and even though ~~there~~ exists no unambiguous way to measure the costs and benefits, still, the theory is widely used for this end.

Caplan (1999, p. 836) concedes that:

> Economists, applying public goods theory have all too often failed to consider the possibility that consumers' valuation of the alleged public good is less than its cost of production. But just because some people misuse an economic theory does not invalidate it.

The problem is, how does Caplan or anyone else *know* when the theory is well or ill used? Without any independent criterion of success, there would appear to be a daunting task. Caplan (1999, pp. 835, 836) allows that Rothbard's utility theory would not countenance any such conclusion, but insists that "contra Rothbard, preferences can exist without being acted upon." Sure they can, in the ordinary commonsensical notion. The problem is, however, to *measure* these things in the absence of human action. How does Caplan solve the problem, for example, of whether education, or defense, are or are not appropriate applications of the theory or not? He, as is the wont of the neoclassicals, gives us no answer whatsoever.

[33] See on this Rothbard (1990; 1993, pp. 883ff.), Hummel (1990), Block (1983), Hoppe (1989, chap. 10; 1993, chap. 1).

CONCLUSION

We have tried to take Caplan to task for his many errors of omission and commission. Nevertheless, we think his was a very worthwhile article. Why? First, its quality. As a critique of Austrianism it far surpasses many of the others cited above, and is easily in the class of Nozick (1977), which we certainly mean as high praise. Second, it is important for the profession as a whole to at least be aware of the praxeological tradition, and the publication of an article critical of it in as prestigious a periodical as the *Southern Economic Journal* cannot but help in this regard.[34] It is no exaggeration to state that the typical member of the economics profession is far more aware of another heterodox view, Marxism, than he is of Austrianism. And yet, surely even Caplan would agree, the latter has far more to offer the practitioner of economics than the former.

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[34]There are now three periodicals in regular publication dedicated to the study of Austrian economics. They are *The Quarterly Journal of Austrian Economics*, *The Review of Austrian Economics*, and *Advances in Austrian Economics*. It is fair to say that even altogether, these three have far less influence within the economics community than does the *Southern Economic Journal*.

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Errata

“Austrian Theorizing: Recalling the Foundations”
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The omission occurs on p. 28, nine lines below figure 2. Line nine now reads:

direction towards [BEGIN HERE] which an economy is moving. It is well understood that the end point is never reached in any realistic setting, for before it can even be approached, something else changes, with reverberations all throughout the system. Not for Austrians is there this endless concern with what is or it not true at equilibrium, in nauseating detail. Thus, were we never to arrive at a precise equilibrium point, this would not even be a slight embarrassment for praxeology.

Third, Caplan (1999, p. 828) charges that

> the argument against calculus based upon the rejection of continuity also argues against the use of simple algebraic constructs, like intersecting supply and demand lines, that fill Rothbard’s works. . . . If the assumption of continuity is not a harmless fiction, then it is incumbent upon him to remove all of the supply and demand intersections in his works and to state that supply equals demand only under extremely rare conditions.

This is entirely unwarranted. If there is any economist who has been careful, who has been more than careful, to characterize supply and demand as discontinuous functions, it has been Rothbard. Evidently, Caplan has overlooked chapter two in Rothbard’s (1993, pp. 67-159) his magnum opus. Even a moment’s perusal of figures 5 and 6 (p. 75), 13 (p. 103), 17 (p. 110), and 23 (p. 120) will show any disinterested reader that Rothbard sees demand and supply as essentially discontinuous. Almost in direct anticipation of Caplan’s criticism, Rothbard labels figure 21 (p. 115) which characterizes an equilibrium between discontinuous supply and demand curves “unanimously correct forecasts of final price.” If this is not just a different way of stipulating Caplan’s “extremely rare conditions” then nothing is. Yes, to be sure, Rothbard does indeed, upon many occasions, draw his supply and demand curves as intersecting straight lines. But, give the man a break! He had to communicate in a neoclassical mileau. Surely, after taking great pains to show discontinuities, he may be forgiven for lapsing into the traditional analysis, if only as a heuristic device.

Income and Substitution Effects

Caplan (1999, p. 828) charges that

> Though Rothbard rejects neoclassical utility theory, he makes ad hoc concessions to it elsewhere in his writings.” Specifically, he “derive(s) the laws

> of demand and supply as exceptionless theorems" (e.g., demand cannot slope upward, supply cannot slope downward) and yet "concedes the theoretical possibility of backward bending supply curves.

This criticism, too, misses its mark. Of course, downward sloping demand and upward sloping supply are exceptionless propositions, given the *ceteris paribus* assumption of no income changes. And, obviously, when this assumption is relaxed, as in the case of the backward bending supply curve (or the Giffen good), and income changes are allowed into the analysis, then it is theoretically possible for such exceptions to occur. But why should neoclassical economics be granted a monopoly position regarding this rather basic "insight"? Surely, the Austrians, too, without any by your leave tugging at the forelock, may take note of the fact that when price changes, income, too, can be impacted.

In his attack on Rothbard, Caplan (1999, p. 829) makes either an interesting concession, or a denial. He states, "this is a bona fide case where neoclassical economists did not merely tediously formalize the obvious." If he maintains the virtually all of neoclassical economics is indeed the tedious formalization of the obvious, well and good; that is certainly consonant with the Austrian perspective. On the other hand, if he means to deny this, then we need not look too far for a refutation. We need not go beyond the very issue of the *Southern Economic Journal* in which [CONTINUE]