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Productive and Non-Productive Entrepreneurship and the Interaction Between Founders and Funders

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Abstract: By focusing on the economics of productive and unproductive entrepreneurship this paper explains venture capitalism in different institutional contexts, defined in terms of property rights and regulation. It is shown that venture capitalism is just one among the various possibilities of transforming good ideas into success stories; and that tends to be discarded when transaction costs are high. Although venture capitalism is likely to be positively correlated with growth, it is not a necessary condition. Still, it can provide indications as for the nature of the prevailing institutional framework and possibly signal unexploited opportunities.

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1 A Tale of Two Entrepreneurs

This paper puts forward an explanation of the features and dynamics of venture capitalism based on what is known as the Austrian approach to entrepreneurship. In particular, sections 1 and 2 recall the concept of entrepreneurship and show its implications for the traditional economics of venture capital. Section 3 introduces the notion of simultaneous entrepreneurship and leads to the central part of the paper (section 4), where the funder-founder relationship is reconsidered and a new and broader vision of the economics of venture capital (VC) is suggested. It turns out that VC is mutually rewarding for the investor and for the receiving firm only when certain conditions apply. These findings are further clarified in section 5, where the interaction between venture capital and the institutional context is examined; and in section 6, where some implications for growth are investigated.

1.1 On the Austrian Approach to Entrepreneurship

Following the Austrians, we define entrepreneurship as the propensity of each individual to improve his wellbeing by exploiting his knowledge, resources, talents or sheer luck so as to produce goods, services and ideas and transform them into profitable opportunities.[1] Of course, individuals are not all equally endowed with entrepreneurial talents. Moreover, such talents show up in different ways as people display different propensities – say – to accept risk, to engage in one industry rather than in another, to work alone or in teams. However, it is fair to assume that the distribution of talents does not depend on race, geographic location or political regime. The same also applies to entrepreneurship, which does not follow the institutional framework, either – since the desire to improve one's own wellbeing is always there. Nonetheless, institutions and political regimes do affect the rules of the game according to which such efforts take place and the chances to obtain success. That is, individuals do react to the institutional environment where they operate. And ap-

[1] See for instance Boettke and Coyne (2003). According to this definition, consumers are not entrepreneurs. They do use their knowledge and skills in order to enhance their well-being. But do not seek to profit from the sale of products or services. Honest politicians are not entrepreneurs either, since they are supposed to make rules in the public interest, not in their own.

ply their entrepreneurial talents in different ways and to different degrees, following their own inclinations, emotions, ideologies, expectations.

In many cases entrepreneurial commitments benefit both the economic actor and his counterparts. Obvious examples are product and process innovations, but also insights in the realms of marketing and organization.[2] If so, overall economic growth takes place. In other cases all the benefits are internalized and thus restricted to the actor. It might also happen that property rights are violated, e.g. by means of rent-seeking or criminal behavior. Then, entrepreneurship actually produces unjustified welfare losses for at least some economic actors. In fact, the dynamic effects of competition always lead to welfare gains for some (the successful producers and the buyers) and to welfare losses for others (the losing producers). From an Austrian standpoint, this process is 'just' when it complies with the freedom-to-choose principle and does not violate freedom from coercion. As such, it can obviously generate undesired negative indirect effects (i.e. undesired by some). It is 'unjustified' otherwise. Of course, fear of unjustified confiscation reduces the incentive to create wealth and thus inhibits growth.

1.2 Baumol's Productive and Unproductive Entrepreneurs

Consistent with this broad framework, some years ago Baumol (1990) relied on the institutional tradition and identified two types of societies. One generates incentives that induce entrepreneurs to be productive and use their abilities in order to ultimately satisfy consumers' wants. In this context innovative action enhances overall economic growth. Instead, the alternative institutional framework encourages unproductive behaviours, whereby entrepreneurs find it rewarding to engage in rent-seeking or even in outright destructive operations (violence). When so, their skills are directed to making a profit (or avoiding a loss) without creating new wealth. In fact, they often absorb resources and/or provoke inefficiencies.

[2] The pure imitation of a product or of a process is not enough to qualify a producer as an entrepreneur. But if this producer manufactures a well known product in a way that others had not figured out or made use of before, or finds new methods to reach demand, then he is indeed a productive entrepreneur. However, to the extent he does so by preventing others from reaching potential buyers – e.g. thanks to his efforts to obtain regulation or tariff barriers – he becomes an unproductive entrepreneur (see sections 2 and 3 on the various categories of entrepreneurship).

Of course, the distinction between productive entrepreneurs and rent-seekers was already prominent in the literature on the economics of privileged interest groups, which has indeed grown enormously since Gordon Tullock's seminal work in the late 1960s. However, Baumol's contribution is important in that it posits that entrepreneurs change the nature of their activity – productive or unproductive – from one period to another, as a consequence of the reward structure in the economy. In Baumol's view this provides useful guidelines to analyze growth episodes in history. For instance, low growth during the classical period was explained by its institutional incentive structure, which encouraged entrepreneurs to concentrate on rent-seeking, protect their privileges and disregard productive ventures. The opposite was true during the Industrial Revolutions.

2 Baumol's Founders and Traditional Venture Capitalists

By developing the concepts mentioned in the previous section, we take advantage of Baumol's distinction between productive and unproductive entrepreneurship, we introduce the idea of simultaneous interaction between these forms of entrepreneurship and then use it to shed light on the relations between two categories of entrepreneurs: founders and funders. Founders engage in the production of goods and services in order to make a profit; while funders intervene by supplying financial resources.

In this paper the term 'funders' actually refers to a specific category of investors – venture capitalists (VCs).[3] If one accepts Baumol's original framework with no further qualifications the role of venture capitalists is straightforward. Within a productive-entrepreneurial context, VCs acquire control in relatively small firms with a potential for growth, and eventually end their participation by going public (IPOs), direct selling or liquidating, depending on the success and features of the company. When doing well, VCs' profits consist of the remuneration of their ability to spot a potential winner and to take steps to transform it into a real victor.[4] Instead, when the

[3] VCs will be defined in greater detail in section 4.

[4] Tykvová (2007) provides an exhaustive survey of the existing literature on the theoretical questions relating founders and funders, which are understandably concentrated on designing optimal contracts within a dynamic principal-agent context.

rent-seeking scenario applies the name of the game is creating or protecting rents, not financing new ideas and economic activities; and traditional VC funders are often out of the picture.[5] Indeed, when young companies present a potential for high profits because of their promising rent-seeking prospects, their founders devote most of their energies to maintaining and expanding their connections, rather than to hitting upon new equity and thereby losing control. That explains why unproductive entrepreneurs are more likely to raise funds by asking friendly bankers to supply credit or by going public, than by opening to venture capitalists; indeed, in Western Europe there are many examples of companies that enjoy state protection (e.g. trade barriers or exclusive licenses, if not outright monopoly power), make fat profits and succeed in attracting both bankers and shareholders looking for limited exposure to competitive pressure and prospects of safe dividends.[6] In fact, when founders are ready to accept new equity from dynamic and watchful investors the potential has often been exhausted, and traditional VCs are no longer interested.

3 From Sequential to Simultaneous Entrepreneurship

In this paper we extend the actions of the entrepreneur from Baumol's sequential rotation of efforts to a simultaneous one. A producer can do his best to generate output (through acts of productive entrepreneurship), but can also seek rents and privileges at the unjustified expense of other people's welfare (through destructive entrepreneurship); or strive to protect his wealth from aggression (through defensive entrepreneurship). All at the same time.[7] Put differently, simultaneous entrepreneurship means that founders often find it rewarding to engage in unproductive ac-

[5] A non traditional VC would be one who engages in the political market. That is unlikely to happen, though: Rent-seeking is frequently labour intensive, it often requires a long-term vision (developing personal contacts with bureaucrats and policy-makers), is not transparent. That explains why VC funders are interested neither in direct rent-seeking (if anything, their job would be funding rent-seekers, not carrying out rent-seeking themselves), nor in supporting rent-seekers (too many intangibles, exceedingly high monitoring costs, lack of transparency).

[6] See Berger and Udell (2002) on small firms and 'relationship lending'.

[7] Following the definition proposed in section 1, the notion of productive entrepreneurship also includes the activities of those who try to destroy rent-seeking situations, such as tariff barriers or normative constraints to the freedom of contract. On the other hand, lobbying to introduce tariff barriers is an act of destructive entrepreneurship, whereas lobbying to avoid legislation to that effect is here considered an act of defensive entrepreneurship.

tivities as long as they succeed in acquiring or maintaining some privileges (e.g. as a consequence of special personal relations with the authorities) so as to monitor and possibly affect the design of future regulation, reduce the bureaucratic entry costs they are facing in some industries or geographical areas, increase barriers to entry for potential competitors.

By means of these two notions – destructive and defensive entrepreneurship – we also believe we clarify an intrinsic ambiguity that characterizes Baumol's original definition, in that his term 'unproductive' is limited to what we here call 'destructive' and omits to consider defensive activities, which are in fact far from negligible (Tullock 1993). In particular, defensive activities cannot be captured by Baumol's productive/unproductive distinction for they absorb resources which could otherwise be devoted to productive purposes (hence they are unproductive), but at the same time happen to avoid greater destructions of wealth (hence they are also productive).

The reward structure of the economy – institutions – determines how profit-seeking efforts are allocated and which company features are conducive to better results. For instance, one may expect that productive entrepreneurship be intense when institutions encourage and protect economic freedom – private property and freedom of contract.[8] Instead, entrepreneurship will reveal significant wealth-destructive features if rent-seeking opportunities are promising. And will bring to light defensive elements whenever economic freedom is jeopardized, either by other individuals or by state organizations. Uncertainty and fears about policy-makers' discretionary power usually discourage (productive) entrepreneurs from taking action, but may create a favorable environment for those who believe they can successfully influence political mechanisms, or stand better chances to protect their property from outside interference. Under these circumstances one observes a mix characterized by acts of destructive and acts of defensive entrepreneurship.

In a simple extension of this principle entrepreneurs may also conceive strategies that recognize the role of unproductive activities in order to enhance the profitability of their productive efforts. As an example, this explains why small-size software developers are inclined to sell their business to larger companies, which are indeed

[8] See for instance La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997), Laffont (2000), Glaeser and Shleifer (2003), Weede (2006).

able to reach a wider market (economies of scale in distribution); but are also more effective in making sure that the government does not force them to reveal the codes of their newest products, thereby transforming a private profit into a free ride.

As hinted above, company size is also likely to be affected. For instance, in countries where labour-market regulations increase in severity with the size of the firm, defensive entrepreneurs would restrict the size of their company well below what would allow full exploitation of the economies of scale. On the other hand, in countries where rent-seeking is more pervasive, large firms are going to be more effective in lobbying national governments, and size might increase beyond what would be optimal from a strictly manufacturing standpoint.

3.1 Simultaneous Entrepreneurship and Transaction Costs

Simultaneous entrepreneurship also helps to shed new light on the role of transaction costs, an issue of particular importance in the economics of venture capitalism. When analyzing efficiency, economists usually focus on how to reduce transformation and (standard) transaction costs (Williamson 1981). The former are just a matter of good engineering, as taught in introductory economics. Standard transaction costs are the expenses that producers incur in order to reach their business counterparts, specify the nature of the contract, deliver the goods that form the object of the transaction. Contract enforcement also belongs to the category of standard transaction costs. As a result, according to the traditional approach producers are efficient when they equalize relative factor prices to the marginal rate of technical substitution (optimality condition); and minimize standard transaction costs.

Although this paper does not deny the importance of standard transaction costs, the introduction of simultaneous entrepreneurship lays considerable emphasis on another category of costs, which we call 'total institutional transaction costs'. In the present context they describe the difference between the costs incurred by a profit-maximizing firm operating in the real world, where the rules of the game generate incentives to engage in unproductive and defensive activities; and the costs incurred by an efficient company in an ideal Lockean institutional context where private property, freedom of contract and freedom from coercion are guaranteed.[9] For instance, other things being equal, companies that make use of labour-intensive techniques usually enjoy more bargaining power when engaging in rent-seeking *vis-à-vis* politicians, who tend to be particularly sensitive to the dynamics of employment, even on a local scale; as a result, they might be encouraged to use labour-intensive techniques even when inefficient from a purely engineering/transformation standpoint. In fact they do so, because such inefficient techniques turn out to be more profitable, once the rent-seeking opportunities are taken into account. Similarly, small-company size might be an advantage when it comes to evading taxation or dodging regulation, even when larger size would allow lower average costs. In order to exploit at least some of the economies of scale, this may thus lead to the existence of networks of more or less cooperating small companies, or even sets of small companies that are de facto run by the same management – among other things, with problematic consequences on the statistics.[10]

As will be explained shortly (see section 4), total institutional transaction costs are likely to play a crucial role in the VC context, for they explain both the features of the firm and its relationship with outside actors, among whom funders. In the presence of significant interdependence between institutional transaction costs and the other costs of production – transformation and standard transaction – the producer might appear to be inefficient according to the traditional approach, but not necessarily under the simultaneous view proposed here. The consequence on the funders can be mixed. Although these actors might understand the importance of optimizing total institutional transaction costs, they may be unwilling to accept their implications: re-

[9] The terms 'total' is explained by the fact that these expenses do not refer to the mere cost of dealing with the institutions (e.g. lobbying). Rather, they concern the cost suffered as a result of the decision to take advantage of the institutional context in order to reap a rent or to avoid a loss. Thus, they often imply less than ideal engineering; and might also affect the choice of the standard transaction costs, say when it comes to selecting the appropriate contract.
Surely, the mainstream literature is well aware of the presence of institutional costs. Nevertheless, it generally considers them as a set of variables that affect localization strategies, i.e. the decision about where to start a new business and which the relevant time horizon should be. Contrary to our approach, the traditional view on institutional costs overlooks the analysis of their implications regarding the operational features and requirements of a firm, and largely ignores the consequences for the funding of newly-born companies.

[10] Both examples are typical of the Italian economic context, which is certainly not unique in this respect.

liance on informal rules, personal and often implicit contracts, exorbitant monitoring expenses.

Finally, total institutional transaction costs can also play a role in a dynamic perspective. Contrary to the original view held by Baumol, where the switch from productive to unproductive activities would take place only in the very long run (historical periods), we posit that today an entrepreneur must be ready to reshape the mix of his efforts relatively quickly. Then, total institutional transaction costs are the appropriate concept to use to account for those entrepreneurial decisions that must be taken in order to adapt the company characteristics to the new normative conditions. Once again, a funder who is not involved in daily management and is unwilling to depart from the business strategies set up at the beginning of the investment period – which is not unusual in the VC world – might not be quick and flexible enough to go along with what the institutional dynamics requires. Or might simply be afraid to blindly trust the founder-manager and take the responsibility for giving up on strict monitoring.

To sum up, we maintain that the ability of entrepreneurs to combine their productive and unproductive efforts following the reward structure has a bearing on the relations between them and the venture capitalists (funders). In the remaining part of this paper we make use of simultaneous productive/unproductive entrepreneurship in order to explore the interaction between such two partners in this new light.

4 The different Roles of a Venture Capitalist

Venture capitalists are a special category of entrepreneurs, loosely defined as “limited partnerships in which the managing partners invest on behalf of the limited partners” (Denis 2004, p. 304). VCs typically acquire a substantial share of equity in relatively small companies with difficult-to-assess prospects, most of the time because of the presence of intangibles and strong information asymmetries, thereby requiring close monitoring.[11] In particular, VCs pick young companies with a potential to expand

[11] VCs may be minority shareholders, but by introducing preferred equity, convertible securities and suitable contract clauses they usually make sure they retain control on strategic decisions, create

and improve,[12] possibly in growing industries; and where they sense that they could make the difference by contributing as active funders. They share ownership with the incumbent stockholders (the founders), provide expertise in various domains, often appoint new managers and revise human-resource policies in the early stages. However, although their efforts are crucial to obtain success, VCs do not usually engage in daily management. Furthermore, since they raise their capital from investors that do not abstain from taking risks and expect high returns within a relatively short time period, VCs operate on a relatively short-term basis. The life of a venture-capital fund averages 10 years, while the funding of a projects usually extends over a 3-7 year period (Tykvová 2007, p.80). That contributes to explaining why their investments tend to concentrate in high-tech sectors.[13] And also why VCs tend to disregard large firms, where structural change occurs more slowly and/or with greater difficulties, where assessing the personal qualities of the entrepreneurs and the potential of their ideas in terms of profits is more complex; and where monitoring could be considerably more expensive.[14] Not to mention that if VCs concentrated on large firms and wished to acquire control, each VC would be obliged to concentrate resources on a very small number of enterprises, thereby reducing the benefits of diversification. Surely, large firms might offer the opportunity to exploit some economies of scale in contracting and monitoring. But these are more likely to be reaped by other actors in the financial markets, such as investment funds and merchant banks, which could do the same without suffering neither from the lack of diversification, nor from the time constraints imposed by those who finance VCs.

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incentives to cooperate with the founders and do not reduce the founders' motivation. See also Gompers and Lerner (2001), who provide information about the operational features and history of venture capitalists in the US; as well as Carpenter and Petersen (2002), who document the role of new equity for small, high-tech companies.

[12] Not necessarily brand-new firms, though. As reported in Denis (2004, pp. 307-310), start-ups are financed by "angel investors", while VCs are more likely to intervene at a later stage. Each venture capitalist follows some eight, nine companies at the same time, which allows him to attend periodical, non-technical meetings with the management, study the reports and occasionally sit on the board of directors.

[13] This also matches the founders' needs of course. For risky, high tech projects presented by young firms with little tangible collateral are unlikely to be financed by debt (see for instance Carpenter and Petersen 2002).

[14] The cost and the effectiveness of monitoring are indeed crucial (Gompers 1995): VCs know that most companies they are involved in will not produce the expected results. In fact, the difference between a good and a bad VC ensues both from his ability to select potential winners and from his talent to drop losers before too much money has been disbursed.

On the other hand, founders appreciate the contribution of venture capitalists, since they provide capital and often contribute also by reducing the cost of risk. Unlike banks, they do not require collateral, and unlike public providers of equity funds they do not force the founders to disclose their plans to a wide public (including potential competitors). In addition, VCs usually offer an extensive network of contacts, which in many cases represents a welcome contribution to the marketing opportunities of the founders. Perhaps even more important, venture capitalists fulfill an important signaling function. For instance, most recently-born companies, especially if started with limited financial resources, find it difficult to persuade potential customers about the quality of their products and suppliers about their creditworthiness.[15] Similarly, VC support makes it easier to approach additional funders (e.g. banks) or qualified workforce, for under such circumstances the presence of VCs certifies the producer.

Of course, from the VC standpoint the ideal partnership with a founder is a situation where competitive pressures reduce the cost of monitoring – the size of the profits (or of the losses) will signal whether the company is badly managed – and the personal role of the founders is limited, so as to make sure that the value can be transferred with the company, rather than with the founders. For although VCs risk their resources along with the founders, founders and funders do not always share the same preferences and behavioral patterns: the potential for conflict on strategic decisions looms high (Kaplan and Schoar 2005).

In fact, the founders-funders relationship presents a number of problems, most of them typical of the principal-agent literature. The agent/founder may fail to disclose relevant information about the company and the industry (or the market niche) where it operates; by managing daily business he has opportunities to siphon off company profits into his own personal accounts; by having a smaller and time-constrained stake in the company the founder might reduce his entrepreneurial efforts and possibly deploy them somewhere else. On the other hand, the founder might be persuaded that the short-run strategies enacted by VCs ultimately damage the company, and that his increased accountability reduces his degrees of freedom, his willingness

[15] See Gompers (1995, p.1403), Cable and Shane (1997, p.171), Hellmann and Puri (2000, p. 960).

to experiment, his ability to create a suitable environment within the firm. Not to mention the risk of being replaced by outside CEOs (Hellmann and Puri 2002).

According to this (widely accepted) version of the principal-agent problem, there are three ways to mitigate the conflict. First, the investor (principal) can collect information about the entrepreneur before funding the project with the intention to screen out bad undertakings. Second, the investor can write an elaborate contract with the entrepreneur. This contract will allocate the benefits of the real investment – cash flow, control and termination rights – between the two parties so as to provide incentives to the entrepreneur, while defending the interests of the VC. Third, during the contract the VC can monitor the entrepreneur in order to ascertain that the project is run properly. All three, of course, require additional costs, which can further increase if VCs choose to intervene under syndicated forms.

In general, however, tensions between the two groups remain frequent. Sophisticated contracts and effective enforcement might reduce the cost of opportunism when entrepreneurship is entirely productive. Still, if the incentives to engage in defensive entrepreneurship are significant, the role of personal relations and informal routines can become very important, especially when the original founders and managers are few, often times close relatives to each other or at least long-time friends (Faccio and Lang 2002). Under such circumstances company loyalty and personal loyalty are one. Transparency and accountability need to be replaced by trust, formal procedures by informal dealings. As a whole, entrepreneurial specificity increases, in that the success of a firm engaged in defensive activities depends more and more on the characteristics and personal contacts of the founding entrepreneurs, on whom most informal contracts are built. Obvious examples in this direction are tax evasion and tax avoidance (both require several people turning a blind eye, or both), underreported work performances (they involve side payments to the worker), dodging regulation, coordinated access to government procurement (whereby different companies take turns and decide ex ante each time who the winner is going to be).[16]

Within this (defensive) framework venture capitalists are still an attractive possi-

[16] Entering a cartel that distributes rents (government procurement) can be necessary – and thus qualify as a defensive move – when staying out and trying to outcompete the cartel may lead to violent retaliation by cartel members. Of course, in this case the border line between defense and destruction can become very thin, for a defensive decision might easily degenerate into a destructive activity.

bility for the founders (and vice versa) if they are friends or relatives. But they tend to become a questionable choice otherwise. In the end, outsiders feel uneasy, as they remain unwilling to invest in enterprises that might be profitable, but require substantial investments in the enforcement of informal contacts.[17] Eventually either funding partners become founders themselves, or VCs prefer to move out and founders increase their dependence on personal or family funds, bank loans guaranteed by personal asset.

5 Venture Capitalisms and Institutions

The previous sections have outlined the elements of the relation between funders and founders. This section develops those insights by focusing on two institutional categories: property rights and regulation. For each category different situations will then be evaluated in order to assess how the role of VCs is affected, to what extent the presence of VCs is necessary, how companies are likely to evolve.

5.1 Property rights: Weak Enforcement and Discretionary Assignment

Today much of the academic debate about property rights regards the principles underlying their assignment and the incentive structure that those principles imply. However, it is often overlooked that the main problem with private property rights is not their theoretical regime as defined – say – in the constitution. Stability and credibility are far more important. Property rights may be clearly defined, but they are of little relevance if they can frequently be altered by ordinary politics, or 'interpreted', bypassed, watered down by the judiciary.[18] That explains why, when enforcement is

[17] See Hart (2001), Cable and Shane (1997) and Kaplan and Strömberg (2004) on the design of optimal contracts that would reduce conflicts of interests between VCs and entrepreneurs. Contrary to this (prevailing) literature, we claim that VC contracts do not break down when badly specified. Instead, they break down because they are no longer suitable when informal agreements become more important. Informal agreements are reliable when they are the result of repeated interaction over a long period of time among individuals that share the same time horizons and the same structure of accountability. This is not what happens in the VC framework.

[18] For instance, Opper (2008) notes that the success of transition in the former Soviet-bloc countries does not depend on the quality of institutions (assignment), but rather on the degree to which they can be put into effect (enforcement).

weak or inconsistent, efforts are generally devoted to protecting existing assets from outside aggression, or to joining the aggressors. As a result, entrepreneurship is likely to present a high degree of defensive or even destructive elements. Instead, productive activities are limited to short-term initiatives and VC funders are likely to shy away: profits tend to be hidden, personal relations and possibly some forms of corruption become critical, accountability to outsiders turns out to be a heavy liability. In a word, tackling institutional transaction costs raises the cost of monitoring in the founders-funders interactions and easily becomes intolerable for the latter.

On the other hand, when property-right enforcement is credible, but assignment is unstable (discretionary), rent-seeking activities at a national or super-national level are encouraged. Thus, in large countries destructive entrepreneurship pays off for large-size companies that stand a chance of internalizing a significant share of their rent-seeking efforts. Once again, these are not an ideal target for VCs, though. In addition, smaller companies can be successful only by engaging in defensive activities, which also cuts down VC presence. To conclude, VCs are unlikely to be numerous in this institutional environment.

5.2 Regulation

Venture capitalists' attitudes are also influenced by regulation, which generates two sets of consequences. By interfering with individual decision making, regulation reduces efficiency and productivity overall. As a result, profit opportunities are also less attractive. Furthermore, the weight of regulation is not uniform across industries, size, production techniques and classes of actors. Hence, in regulated environments some categories of firms can do better than others; and some defensive strategies are more profitable than others. For instance, if compared with a large-company manager, the owner-manager of a small company appropriates a larger portion of the residual created by successful defensive entrepreneurship. Thus, when it comes to defensive entrepreneurship, competitive selection is likely to reward small companies with respect to large firms. On the other hand, large companies might be favoured when engaging in destructive activities, since a large company enjoying political connections and affection may be able to drive the regulatory bodies to their own advantage and be more profitable than smaller companies open to competition, but without appropriate contacts.

True enough, VCs are not necessarily deterred by regulated environments, as long as transparency is satisfactory and the rules are enforced consistently, so that monitoring costs do not become prohibitive. It is however important to observe that the demand for VC funders is going to remain modest. As emphasized in section 2, within a regulated environment part of the profits are in fact either established rents guaranteed by normative barriers to entry, or the reward to defensive entrepreneurship, hard to monitor, heavily characterized by intangibles (trust) and by asset specificity (high dependence on the founder). Thus, VCs' hopes to make profits are realistic only for incumbents who might have dissipated the rent through bad management, rather than for newcomers competing for market shares and possibly displacing obsolete or inefficient producers.

In regulated environments venture capitalists will therefore be eager to provide financing to companies that had been poorly-managed and where the incumbent management can be easily replaced. Under such circumstances the VC profit would amount to the previously dissipated normative rent. Still, why should founders need venture capitalists to get rid of the (bad) incumbent management and replace it with new staff? In fact, they often don't, to the advantage of headhunters as well as of prestigious consultants that take the responsibility of the changes that the owners alone wouldn't have been able to enforce.

6 Growth and Structural Change

Surely, growth with modest venture capitalism is possible, as the European experience has shown. Still, the absence of VCs is important in two respects. VCs are a tell-tale sign about the prevailing institutional conditions (low institutional transaction costs) and the incentives to concentrate entrepreneurial talents on productive ventures. Hence, they act as some kind of 'entrepreneurial multiplier' by motivating other categories of funders with an interest in productive projects. In addition, growth without VC often implies the presence of undesirable path-dependence processes. As noted previously, when companies grow by carrying out substantial destructive and defensive activities, financial sources tend to be provided by banks or personal funds. In particular, banks are relied upon when founders exhibit long-time horizons,[19] or wish to supplement or replace personal funds (personal collateral is however required to cover risk). Put differently, the banking sector plays an important role either in order to manage the rent-seeking economy, thereby signalling some forms of crony-capitalism; or to provide support to small, flexible companies, possibly in the presence of substantial personal assets (family capitalism). Such companies solve the private property right problems – poor enforcement and/or instability – by shortening their time horizon, whereas flexibility allows them to reduce the cost of regulation.

As a result, the absence of VCs reveals property-right and/or regulatory features that drive the economy towards a structure characterized by a few large companies engaging in destructive entrepreneurship and a substantial number of small firms engaging in defensive entrepreneurship. The former are unlikely to expand and display a propensity to collude with the banking sector. Lack of transparency scares stock-exchange investors to a larger extent than (domestic) bankers familiar with relationship lending.[20] The latter are family funded. They are seldom based on high-tech breakthroughs, for this area is too risky and usually requires considerable investment in R&D. In addition, they are unable to increase in size. They would be beyond reach for family financing and too vulnerable to regulatory authorities to be profitable.

In the end, one might speculate that an economy that does without venture capitalism is characterized by relatively high barriers to entry (otherwise rent-seeking would be eroded or deeply resented) and a somewhat inadequate framework for impersonal trade to take place satisfactorily. Product innovation does remain attractive, especially if conceived by small-size companies that subsequently sell their rights to larger firms interested in further development for commercial purposes. Nonetheless, in a regulated economy where personal networks play a significant role a large

[19] Family loans are usually short term. Otherwise they tend to become semi-gifts: they are paid back if and when possible, but if the debtor is in trouble it is unlikely that the credit is terminated, or that the creditor is taken to court.

[20] This may be typical of areas where capital market globalization is not welcome. If so, by restricting competition established rents are protected and producer's profits are high enough not to require external financing. Following this insight, Johnson et al. (2002) have observed that local companies in the former communist bloc were not suffering from significant financial constraints during transition.

part of technological growth is likely to be imported from outside. New technologies are bought, imitated and/or adapted, for the domestic rewards to the search for potential technological breakthroughs would be rather modest, as VCs know all too well. Surely, despite disregard for significant and systematic product or process innovation (supplanted by imitation), productive entrepreneurship is not necessarily absent. For instance, one can devise new or more effective organizational structures, discern new sources of latent demand or conceive new ways to reach that demand. Still, once the potential for catching-up has been exploited, growth prospects are going to be constrained by the unwillingness to take risks on a large scale or – more precisely – to share risk and thus allow productive entrepreneurs to pursue their intuitions. Sometimes the constraint is severe, e.g. in Italy and France; sometimes its bite is minimal, as in China or India.

7 Summary and Conclusions

The previous paragraphs have suggested that venture capitalism is just one among the various possibilities of transforming founders into successful producers of goods and services. The appeal of this form of financing depends on many variables that can be summarized by referring to the institutional features within which entrepreneurs operate. In particular, venture capital tends to be a poor choice when informal rules are at odds with the formal institutional framework; or when productive entrepreneurship is stifled by violations in property rights, regulation, privileges. In the end, either the time horizon becomes very short – intangibles and asset specificity are dominant – and the outcome depends on the founders' action; or uncertainty prevails and decision-making becomes some sort of systematic groping. Both scenarios imply high institutional transaction costs and thus high monitoring costs. Often times too high for VCs' tastes.

Indeed, the need to allocate efforts across productive and unproductive activities creates an extra dimension of asymmetry between the two parties. Because of the asymmetric information between founders and funders, the founders fid it cheaper to raise capital from family and friends, whereby the cost of trusting is lower than the cost of monitoring.

Bottazzi and Da Rin (2004) rightly note that European venture capitalists fund less than one third of the projects financed by their American counterparts. Contrary to common beliefs, however, this does not imply that Europe is lacking entrepreneurship or that free enterprise in Europe is about to die. For different capitalist practices are just one of the consequences of the deep institutional disparities between – say – Continental Western Europe and the US. Indeed, differences in financing, formal and informal company structures and industrial specialization are the logical responses to diverse incentive structures. By developing Baumol's original insight, this paper has claimed that such responses can be framed and understood according to the features of entrepreneurial efforts. One way or another, individuals that engage in productive efforts frequently – perhaps always – engage in some kind of destructive and/or defensive activity as well. And the presence of venture capitalism depends on the mix of the varieties. Put differently, institutional features affect agents' behaviour, which in turn determines to what extent cooperation with VCs is mutually profitable. As a result, institutional incentives and financing options lead to alternative structures of development and different potential feed-back effects upon the institutional context.

Further insights on the nature of the interaction between venture capitalism and entrepreneurship can be produced by testing the implications of the arguments outlined in the previous sections and developing the work pioneered by Jeng and Wells (2000). For instance, the presence of entrepreneurship could be further explored by comparing the dynamics and features of newly-formed companies with the prevailing rules of the game (institutions). The role and industrial concentration of VCs across countries could be explained by referring to the formal and informal institutional features of each area, as hinted in section 5. In this light the nature of regulation, the role and effectiveness of the judiciary system, informal contracting, the extent of corruption are all obvious explanatory variables. The indirect causal links between VC intervention and family business (size, funding, informal networks) is an additional area where the theoretical instruments proposed in the previous pages could be applied.

More challenging from a speculative viewpoint is however the analysis of the eventual feedback mechanisms, which also lies beyond the scope of this work. Still, one normative clue of some consequence seems apparent at this stage already. In partial contrast with the recent literature – see for instance Antonelli and Teubal (2007) – venture capitalism *per se* is not the solution to stagnant growth, in Continental Europe or elsewhere. But it does signal the presence of a healthy business environment where entrepreneurial energies are more likely to be channeled towards productive purposes.

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Collective Consumption Externalities and Charitable Giving[i]

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Abstract: Charitable giving suffers from market failure, which means government redistribution and other forms of social insurance can be justified. According to market failure theorists, charitable giving for poverty alleviation suffers from a free-rider problem. In a free market, giving will, therefore, be underprovided. Using insights from public choice theory and Austrian economics, our paper finds market failure arguments to be an insufficient justification for government intervention. Private charity and redistribution respects autonomy and is more robust in creating incentives for people to help the poor.

i An earlier version of the paper titled "Help Me Help Myself: The Economics of Private Charity and Redistribution" was presented at the fourth annual Mises Seminar in Sestri Levante. The authors would like to thank Pierre Garello and other seminar participants for their helpful comments and suggestions.

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1 Introduction

In America today, classical liberals and conservatives are alarmed by the runaway level of government involvement in our lives. Interventions affect and complicate nearly every facet of our lives and impose tremendous explicit and implicit costs. The sheer number and complexity of the rules governing our behavior seems to be at an all-time high, and the rapid increase of government interventions in our everyday lives in order to "make them better off" deserves explanation.

Alternative opinions about the overall scale and scope of government intervention depend, of course, on one's more general theoretical understanding of the welfare state. Analysis of the current state of poverty alleviation programs in America cannot be separated from one's general model of the welfare state. We take as our point of departure Thomas Sowell's discussion of the welfare state (2003, B7). According to Sowell, "The welfare state is not really about the welfare of the masses. It is about the egos of the elites." Like Sowell, we think government intervention hampers people's lives and increases in intervention beget more intervention. Our main purpose is to critically examine one argument for government intervention into the market for charitable giving to the poor.

Historically, the economic justification for government involvement in programs for the poor was based on public goods theory. In his classic book, *Capitalism and Freedom*, Milton Friedman (1962, 191) discussed the public goods justification for poverty alleviation when he wrote, "I am distressed by the sight of poverty; I am benefited by its alleviation; but I am benefited equally whether I or someone else pays for its exclusion."

Friedman's claim was picked up by others.[1] Shortly after Friedman, Hochman and Rodgers (1969) claimed that private charity and transfers were underprovided in a free market because of people free-riding on the donations of others. At the core of their argument was the notion that people have interdependent utility functions, i.e., the utility of person A is dependent in part on the utility of person B.

[1] Lee and McKenzie (1990) credit Friedman for being the first to make this connection.

In this paper, we question whether charity will be underprovided in a free market because of free-riding on others donations. We first look at the overall role interdependent utility functions play in a person's decision to give. Most charitable giving seems to occur because of the direct benefits received by the donor. To the extent people do have interdependent utility functions, interdependence does not seem to matter *on the margin* since most attempts to solicit donations do not appeal to the welfare of those helped by the additional donation. Private motivations for giving significantly reduce the argument for government intervention because private charity will reduce or eliminate the gap between the "market failure" level of charity and redistribution and the socially optimal level of charity and redistribution.

Second, *even if* interdependent utility functions exist and free-riding occurs, the resulting outcome is not inefficient because no resources are misallocated. Interdependent utility functions generate pecuniary externalities, which do not misallocate resources. The "ideal" condition, where no free-riding occurs, is analogous to a market environment with no competition. Just as an absence of competition would not be good for competitive markets, an absence of pecuniary externalities in charitable consumption would not be good because much of the innovation in charitable fund-raising flows from the pecuniary externality associated with charitable giving.

An economic analysis of charitable giving yields important insights into the proper role of government towards charity and redistribution from the rich to the poor. The desire to help the worst-off in society is strong and can engender considerable support for the welfare state in its various forms, from transfer programs to a paternalistic regulatory state. We maintain that the best approach to helping people help themselves is through decentralized markets.

The remainder of our paper proceeds as follows. Section 2 discusses market failure theory in the context of helping others in society. Section 3 critically examines the notion that charitable giving suffers from a market failure, while Section 4 concludes with some policy implications of our analysis and some insights from private charity and paternalism.

2 Helping Others and Market Failure Theory

The paternalism of contemporary America comes from an obvious and pernicious source: politicians. Politicians – both liberal and conservative – have been promising voters a world of increased health, safety, and wealth, but they never succeed at fulfilling their promises because of the elastic and fleeting nature of the goods they are asked to provide. But, in their attempt to satisfy our every desire, politicians have made good on delivering one thing to voters: a massive increase in the scale and scope of government. In a fundamental sense, Americans are afraid to be free. Politicians are often the "messengers" delivering policies that exploit our fears.[2]

On the opposite side of the political process, voters themselves often contribute to a more expansive state.[3] When it comes to economic policy, the general public exhibits a tremendous amount of ignorance that borders on irrationality (Caplan 2007). Numerous contradictions can be found in the general public's social welfare function. The general public wants higher levels of education and defense spending, but lower taxes. They want higher levels of economic prosperity, but believe in a more progressive system of taxation. Thus, while politicians are often acting as "political entrepreneurs" (Wohlgemuth 2002) interested in discovering new political opportunities, they are at times simply responding and giving voters the policies they want and deserve.

The promises made by paternalistic politicians have led to a large increase in government. In addition to growing in overall size, the government has become increasingly concentrated at the Federal level because more local sources of authority cannot make sense out of all of the contradictory regulations being created by politicians. For those trained in Austrian economics, power becoming increasingly concentrated comes as no surprise. As Mises (1983 [1944]), 3) put it when describing the bureaucrat,

> He has arrogated a good deal of legislative power. Government commissions and bureaus issue decrees and regulations undertaking the management and direction of every aspect of the citizens' lives. Not only do they regulate matters

[2] Buchanan (2005) argues that big government will remain an enduring problem because of man's yearning to escape, evade, and even deny the responsibilities that come with being free.

[3] We thank an anonymous referee for pointing out and encouraging us to discuss the "double-sided dynamic" of the political process.

> which have hitherto been left to the discretion of the individual; they do not shrink from decreeing what is virtually a repeal of duly enacted laws... Every day the bureaucrat assumes more power... There cannot be any doubt that this bureaucratic system is essentially anti-liberal, undemocratic, and un-American ...

Over time, piecemeal interventions beget more interventions, and the interventions continue until we have arrived at a totalitarian state.

While man's desire for more regulation has played an important role in the rise of the regulatory state, the market failure literature in economics has also helped to justify and make popular many government proposals. According to market failure theory, people do not care about the spillover benefits/costs of their behavior. Therefore, government must enter markets with externalities to correct for the alleged failures. The remedies to market failure can take many specific forms, but, in general, disincentives are necessary to curb negative externalities and positive incentives are needed to subsidize markets where positive externalities are present.

For advocates of market failure theory, correcting for market failures was a rather straightforward task (Samuelson 1947; 1961). More sophisticated critics of market failure theory recognize the epistemological challenge involved in sorting out the failing and well-functioning markets, estimating the size of the failure, and prescribing corrective remedies (Wagner 1989). Public choice economists also criticized market failure theorists for their naiveté: even if bureaucrats and politicians had the necessary information about external costs, they lack the proper incentives to be correcting for market failures (Shleifer and Vishny 1998).[4]

Over time, policymakers in Washington have ignored the criticisms of market failure theory and latched on to the academic writings of market failure theorists. The new literature on market failure theory helped politicians justify interventions, and it undoubtedly affected the general public's attitude towards government. As Lord Keynes (1936, 383) put it:

> [T]he ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood.

[4] Levy (2002) and Boettke and Leeson (2004) argue for a "robust" approach to political economy that makes "worst case" assumptions where politicians and bureaucrats are said to be both non-benevolent and non-omniscient.

> Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist.

Hayek (1960 [1949], 371) concurred with Keynes, when he wrote, "… [intellectuals] have probably never exercised so great an influence as they do today … by shaping public opinion."

For both Keynes and Hayek, the views of the intellectual come to shape the political landscape in an extremely watered down fashion. When policymakers latch onto an academic idea, errors often occur. Many of the ideas selected by policymakers are not the "best" ideas or the "right" ones, but, rather the ideas progressive intellectuals and policymakers stand behind. Market failure theory is one such idea. It is hard to imagine there ever being a time where a majority of economists supported widespread interventions to correct for market failure. Yet, market failure arguments gained traction because they provided intellectual support for a variety of government interventions.

The implicit assumption of the market failure literature is that with enough regulation, all problems can be solved. By constantly passing new laws and massaging our fear to be free, politicians supply the false sense that government is "solving" market failures. Like Demsetz (1969), we think market failure theory suffers from the nirvana fallacy. In its simplest form, the nirvana fallacy is a comparison of real markets with perfect government. When it comes to charity and redistribution, the public good characteristics of charity makes it prone to free-riding behavior. The mere *possibility* of public good characteristics in charity is then taken as sufficient proof of the need for government intervention.

But, government interventions are determined by fallible men and women with their own biases and agendas. A proper stocktaking of the desirability of intervention would: (1) evaluate a market failure argument on its own terms (i.e., is it really a market in the sense of misallocating resources), and (2) compare the robustness of markets and government in addressing the failure in the short and long run. Comparing the robustness of markets over the short and long run is important because government could be more efficient in mitigating the short-run effects of a market failure but crowd out the evolution of decentralized institutional mechanisms, which would be superior in the long run. With an eye towards both market and government failure, we critically evaluate one of the most prominent arguments for government involvement in charity and redistribution

3 Collective Consumption Externalities and Helping the Poor

One of the primary economic arguments for the public provision of charity is that it the supply of charitable activities will be underprovided in a free market because charitable giving has the properties of a collective consumption good. Technically speaking, collective consumption goods are those for which a many people can simultaneously consume the good without reducing the amount available for consumption.[5] National defense is the classical example of a collective consumption good. An increase in a country's population increases the number of people consuming national defense without reducing any other citizen's consumption. The incentive to free ride increases with collective consumption goods, such as national defense, because people can enjoy the benefits of national defense without contributing to it. If we make a few simplifying assumptions about a person's willingness to pay for collective goods, government interventions, such as compulsory taxation, can improve upon the voluntary outcome.

People donate time and money to charitable organizations for many reasons. Some donate for personal edification while others donate because they care about the increased utility of those helped through an organization's programs. When a person's utility depends on the utility of others, they are said to have *interdependent utility functions*. Charitable donations increase the utility of people with interdependent utility functions because when we know the recipients of charity are better off; we are made better off. *If* donors have interdependent utility functions, charitable giving is a collective consumption good where all potential donors benefit when

[5] In his seminal paper that essentially created public goods theory, Samuelson (1954, 387) describes collective consumption goods as those "which all enjoy in common in the sense that each individual's consumption of such a good leads to no subtractions from any other individual's consumption of that good…."

someone gives to charity. If I am a potential donor whose utility depends on the utility of the African poor, my utility increases when The Bill and Melinda Gates Foundation donates $47 million to help treat tropical diseases plaguing Africa's poor (Dugger 2006).

Just as in the case of national defense, people can enjoy the "warm glow" from knowing the poor are being made better off without having to contribute. According to Hochman and Rodgers (1969), some people will free ride on the charitable donations of others, which means the supply of charitable giving in a free market will be underprovided. Maximizing utility, they argue, requires government intervention to ensure the "optimal" level of transfers is made to the poor (Holcombe and Sobel 2000). The possibility of an insufficient supply of giving has led to government programs that aim to increase giving, such as the charitable deduction (Hochman and Rodgers 1977).[6]

There are many problems with this argument. At the most basic level, what if people do not have interdependent utility functions? Or to put it another way, why don't all donors free ride? Many people obtain personal pleasure in giving even though they cannot observer the effect of their actions on the welfare of the recipients (Arrow 1972). While Arrow's formulation of donor motivation is surely not true for all donors (Rose-Ackerman 1982), a considerable amount of donor motivation for giving does not appear to be about the welfare of the recipient. Donors appear to care about the "warm glow" associated with charitable giving, and benefit from the wealth signal they send when they give (Glazer and Konrad 1996).

When we look at the way in which charities solicit donations, they are clearly not appealing to donors' altruistic motives. Development officials do not rely primarily on stories regarding the charity's work to raise money. While the charitable works are always part of the marketing campaign, the actions of development officials point towards donors being motivated by the approbation flowing from giving or the signaling value of a donation. One manifestation of the signaling motivation is in "naming rights," where a new facility or program is named after a donor. Or charities provide different "tiers" of giving, with the choicest of status gifts being given to the high-

[6] Gergen (1988) provides an excellent discussion of arguments for and against the charitable deduction, including that of Hochman and Rodgers (1977).

est donors (e.g., "gold circle members receive regular updates from the president *and* monthly donor receptions").

The warm glow is also a powerful motivator. Donors not only want to see the poor better off, but they want to feel good about having been part of the effort. Andreoni (1990) quotes the Red Cross using the slogan "Feel good about yourself – Give blood!" Donors appear to be motivated by many reminders of their charitable deeds, either for internal reasons or because of external approbation of their efforts. Spreading charitable giving around instead of focusing on the one cause a person feels "best" about is more evidence against the altruistic giving explanation.[7] McGranahan (2000) examines seventeenth-century English wills and finds more bequests left to the poor when the deceased had fewer immediate family and friends. Even in death, people appear to be more concerned with how they are perceived by others.

In economic models where preferences are modeled as being purely altruistic, public giving reduces private giving dollar-for-dollar: if all you care about is the welfare of the recipient, government financed transfers will cause you to reduce your voluntary donation by the amount of the forced transfer. Yet field tests fail to find considerable "crowding out" of private charitable donations (Clotfelter 1985; Kingma 1989; Ribar and Wilhelm 2002).[8] The fact that there is not complete crowding out suggests that donations to private charities are often motivated by factors other than the welfare of the recipient.[9] If for example, you also care about the warm glow you receive from donating to help the poor, you are not going to stop doing so because the government is now taxing you to provide charity.[10]

We are not making a normative claim about people's motivations for giving.

[7] This argument is made by Landsburg (1997), who argues that if our motivations were purely altruistic, we would give all charitable donations to the charity we think does the greatest good. Giving to ten different charities is evidence, Landsburg argues, that people care about their own sense of self-satisfaction.

[8] At best, the evidence on crowding out is mixed. Some recent papers by Andreoni and Payne (2003) and Gruber and Hungerman (2005), for example, show strong evidence of some crowding-out.

[9] As pointed out by an anonymous referee, the sphere of charitable giving is wide and motivations for giving vary considerably across individuals and organizations. Crowding out could be high in certain contexts such as religious giving where fundraising efforts are based on observable need. This, for example, could explain the high-levels of crowding out found by Gruber and Hungerman (2005) in Depression-era churches in response to the New Deal.

[10] It should be clarified, however, that the low level of crowding out does not mean that government charitable activity is not harmless. There is the not so insignificant matter of the administrative and

Rather, we are arguing against the idea that people are primarily motivated by altruistic concerns. We do not believe giving for purely altruistic reasons has any moral superiority over other kinds of giving. Adam Smith (1759 [1790], section III.I.6) said it best in *The Theory of Moral Sentiments* when he wrote,

> To be amiable and to be meritorious; that is, to deserve love and to deserve reward, are the great characters of virtue; and to be odious and punishable, of vice. But all these characters have an immediate reference to the sentiments of others. Virtue is not said to be amiable, or to be meritorious, because it is the object of its own love, or of its own gratitude; but because it excites those sentiments in other men.

Giving in order to be perceived in a favorable light by others is not lacking in virtue, and in fact is far more virtuous than any other alternative.

Compared to private charity and redistribution, transfers to the poor done through democratic means are almost certainly less virtuous. The replacing of voluntary transactions with a compulsory democratic one transforms helping the poor from a virtuous activity into an obligatory one. The self-reinforcing cycle where people give because they seek the approbation of their fellow citizens is instead replaced by representative democracy, where resources are often transferred to the middle class in the name of helping the poor. While giving for purely altruistic reasons might be nice to contemplate, we do not live in such a world and charities must appeal to self-interest as well as altruism in order to get donations. If it were possible to compare the transfers to the poor under a completely private system of charity versus a more public system, a completely private system would be superior because of closer link between donation and outcome. Even if many United Way fundraisers are organized by real estate agents and owners of car dealerships because it is good for business (Hartford 2006), a less than ideal arrangement is superior to a world where people have no incentive to become involved in private charity at all.[11]

deadweight losses associated with raising tax revenue for alleviating poverty. In addition, government solutions typically prevent the institutional experimentation that might lead to institutional innovations (such as mutual aid societies) that found voluntary solutions to the problems associated with poverty alleviation.

[11] Lee and McKenzie (1990) show that once private benefits from charitable giving are taken into account, the public good argument for redistribution is hard to justify.

Even if people gave out of entirely altruistic reasons and had interdependent utility functions, however, government intervention is not warranted because there is no misallocation of resources.[12] The collective consumption externality pointed out by Hochman and Rodgers (1969) is a pecuniary externality, which does not lead to market failure (Holcombe and Sobel 2000). In fact, pecuniary externalities are necessary for competitive markets. To understand why pecuniary externalities do not lead to economic inefficiency, it is important to better understand the distinction between pecuniary and technological externalities.

Nearly every activity in markets generates effects on third parties. There are two types of third-party effects (also called externalities): technological externalities and pecuniary externalities. Technological externalities are externalities that directly affect the production of the individual or firm. For example, suppose a factory moves next door to a dry cleaning establishment and begins emitting pollution. The emissions make it impossible for the dry cleaner to launder clothing while the factory is operating. As a result of the externality, the profits of the dry cleaner owner fall.

Pecuniary externalities, on the other hand, are third-party effects transmitted through prices. Instead of a factory moving next door to a town's only dry cleaner, let us suppose that another dry cleaning establishment quickly engaged the incumbent dry cleaner in a price war. As competition occurs, the profits of the incumbent dry cleaner fall by the same amount as in the factory example. Clearly both pecuniary externalities and technological externalities lead to welfare losses for the dry cleaner.

The policy implications for different types of externalities vary. For example, technological externalities can lead to market failure because resources are misallocated. When factory owners do not take the effect of their pollution into account, there may be too much pollution. In the pecuniary externality case where a new dry cleaner comes in next door, however, no resources were being misallocated and no inefficiency resulted. In fact, the truth is exactly the opposite. Pecuniary externalities are necessary for the efficient operation of markets as they are the byproduct of competition.

[12] Reece (1979) finds, using the Bureau of Labor Statistics Consumer Expenditure survey, that people *do not* have interdependent utility functions. His evidence is that there is no relationship between charitable giving and the consumption level of potential recipients of said charity.

Holcombe and Sobel (2000) take the distinction between technological and pecuniary externalities from the production literature and extend it to the consumption literature. In their analysis, consumption externalities, such as the case of interdependent utility functions identified by Hochman and Rodgers (1969), are pecuniary externalities because they do not directly affect household production. Individuals maximize their utility by allocating household resources to various activities based on the shadow prices of those activities (Becker 1981). Given a fixed set of inputs, free-riding does not influence a household's level of charitable giving. Instead, utility falls because the actions of others lower the return associated with a particular set of inputs. Just as intervention is not required because competition among dry cleaners reduces economic profits, neither is intervention required when the actions of others reduce the utility a person receives from charity. Contrary to Hochman and Rodgers, Holcombe and Sobel (2000) conclude that the Pareto-optimal public policy is to have no government intervention.

To further illustrate this concept, imagine a world with two income groups – rich and poor – both groups having interdependent utility functions *a la* Hochman and Rodgers (1969). In this world, every rich person free-rides off the charitable giving of other rich people and the level of charitable giving is zero. In such a world, the utility of both the rich and the poor would be reduced because of the free riding. From the perspective of Hochman and Rogers, government transfers from the rich to the poor can make both parties better off.

This perspective, however, overlooks the distinction between technological and pecuniary externalities. Placing it in the Holcombe and Sobel (2000) framework, the larger charitable donation has merely changed the "price" of charitable giving, not the amount of charitable activities that a household can undertake given the resources at their disposal.[13] A household charitable donation of $1000 produces $1000 of charity regardless of whether other individuals decide to donate or not.[14] The actions of

[13] On the recipient side, recipients of charity have lower utility because they have less money (because of reduced transfers), but their household production function is not affected at all by the interdependent utility function. For any given set of household inputs they can produce the same level of outputs.

[14] To make a clearer analogy to household production, a household purchasing $1000 of food receives $1000 worth of groceries. The utility derived from that bundle of goods depends on the relative prices of different food stuffs in the household's consumption bundle. An increase in the relative price of

others might affect the utility *received* from giving, but from the standpoint of public policy that change in utility is the result of a change in the relative price of giving and thus is not Pareto-relevant.

This should not be taken to imply that pecuniary consumption externalities do not have real effects; they certainly do. Just as pecuniary externalities can reduce a firm's profits they can also reduce a household's utility. From the standpoint of public policy, however, these harms are not policy relevant. In fact, they are necessary for the efficient operation of markets because it is pecuniary externalities that cause firms and, we would argue, households to engage in entrepreneurship that that is the wellspring of progress.

Just as the dynamic nature of the market process causes firms to come up with new products and new ways of doing things, pecuniary externalities cause individuals concerned for the poor to be "social entrepreneurs." If pecuniary consumption externalities reduce charitable donations, then those wanting to help the poor have to take advantage of other facets of individuals' utility functions, such as the warm glow received from giving. Making high levels of donations status goods, for example, links donors' interests in being seen as someone who can afford to give a lot with the interests of the poor. The bundling of desired goods (such as public recognition or exclusive access to social networks) with donations is another such innovation. In finding new ways to align the self-interest of potential donors with the interests of the poor, development officials help to expand the level of charitable giving in an economy through experimentation. While government officials can raise taxes or reallocate funds to the poor, they do not have the same ability to innovate and find solutions to the free-rider problem. Moreover, taking and redistributing does not create a "culture of giving" where others give out of a desire for approbation (and might, in fact, crowd out future giving).

groceries, to the extent it lowers household utility is not Pareto relevant because no resource misallocation has occurred.

4 Conclusion

This paper has examined a particular economic justification often given for government involvement in helping the poor. The lack of charitable giving may not be a market failure at all. In addition, it is unclear that interdependent utility functions are as rampant as some theorists suggest. Moreover, even if the collective consumption characteristics of charity did lead to a reduction in charitable giving because of interdependent utility functions, the undersupply of charitable giving would not be economically inefficient in the sense of misallocating resources. More importantly, private charity and redistribution are more “robust” in the sense of finding ways to align the incentives of potential donors and the poor. In doing so, free markets help to foster sympathy for the less well-off and a culture of approbation for those who help them. Government intervention, on the other hand, transforms a private, voluntary transaction into a public obligation. This places a strong presumption in favor of laissez-faire.

Ultimately, the difference between those who want government involved in charity and redistribution and those opposed comes down to a belief in the individual’s ability to help himself and his fellow man. Just because some people are different than others is not, *ipso facto*, an argument for paternalism, but, rather, an argument for leaving people alone. Efforts to force people to contribute to anti-poverty programs takes away from the richness and general culture of society and inhibits trial, error, and learning.

Those in favor of government involvement in poverty alleviation are guilty of making the perfect the enemy of the good. This attitude regards almost all government intervention as desirable and sees many areas where more government involvement could improve market outcomes. But, it suffers from the same problem that all arguments for big government encounter: it assumes other people – the experts – are outside and above the economic order. The experts are said to be better at deciding for everyone what’s best. By trying to make their values (or, to be more precise, the values of the “rational actor”) the values everyone should live by, they are failing to recognize the beauty of millions of people pursuing their own interests according to their own values.

Government as a corrective to market failures is an inferior solution to alleviating poverty problems when compared to the private sector. The crowding out of a whole range of private charitable organizations – most of which were quite effective at dealing with "free riders" and deviant behavior – is one of the greatest, and largely unaddressed, costs of big government. In the absence of government, we do not and cannot know what specific mechanisms might arise to deal with the "free rider," but we do have some historical experiences where mutual aid arrangements worked quite well (Beito 2000; Chalupníček and Dvořák 2007; Friedman 1962, 190-91).

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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 Rothbards'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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In Defense of Rothbardian Welfare Economics

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Abstract: Murray Rothbard offered a twofold defense of the unhampered market economy. He argued that it upholds natural rights and promotes the life and flourishing of persons more fully than any other social system. His welfare economics was not a defense of the unhampered market economy, but a critique of mainstream economists' use of welfare economics to promote state intervention. He argued that mainstream economists accept the subjectivity of value by adhering to the Pareto rule in welfare economics. In doing so, however, they must embrace all the implications of the subjectivity of value and not just the impossibility of interpersonal utility comparisons. They must accept also the principle of demonstrated preference. Recasting welfare economics along the lines of demonstrated preference reorients it away from artificial models of the economy based on fictitious economic agents toward the real economy of actual human persons. Rothbard's demonstration that *laissez-faire* renders the greatest social welfare in the real economy is shown to be valid.

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> I begin by observing that you cannot find out what a man means by simply studying his spoken or written statements ... In order to find out his meaning you must also know what the question was ... to which the thing he has said or written was meant as an answer.[1]

1 Rothbard's Defense of the Unhampered Market

Murray Rothbard's defense of the unhampered market economy is based on the philosophy of natural law and the ethics of natural rights. Natural law holds that reason can discover the characteristics, or natures, of the different entities in the world and how these entities behave and interrelate, i.e., natural laws. The natural law ethic is that the good for each entity is what fulfills its nature. Man, too, has a nature and thus, reason can determine what is good for man. "The natural law," Rothbard wrote, "elucidates what is best for man – what ends man should pursue that are most harmonious with, and best tend to fulfill, his nature."[2]

Salient among the characteristics that constitute man's nature is reason itself. Human action is guided by reason. By it, man learns which ends satisfy him more fully and by it, he identifies the causal connections between things in the world and his ends. In other words, reason discovers means. To act, man must do more than merely recognize the existence of means; he must control the use of, in other words, own, means he deems helpful in attaining his ends. He naturally owns his mind and body, but man cannot fulfill his nature by attempting to act with labor alone. He must produce to sustain himself through consumption. Production requires that he appropriate natural resources and use them with his labor to produce goods. To fulfill his nature, man must have such natural or personal ownership of property. He must own his labor, the natural resources he homesteads, and the goods he produces.

Man exists as individual human persons each possessing the same nature. If each person lived in isolation, then each one would act with his own personal property and there would be no question of one person interfering in the natural development of another. When persons interact, however, one may aggress against the per-

[1] Collingwood (1939, p. 31); quoted in Gordon (1993, pp. 104-105).
[2] Rothbard (1982, p. 10).

sonal property of another and thereby, disrupt another person's natural process of life. Rights each person has to his personal property protect each person in the fulfillment of his nature. Natural rights declare it immoral for other persons to aggress against a person by using or threatening to use violence to interfere with his acquisition, use, or disposal of his naturally-owned property. The rights of private property include unilateral and bilateral transfer of ownership between willing persons. Bilateral transfers or voluntary exchanges constitute the unhampered market economy. The hampered market economy grants legal privileges of some persons to aggress against the private property of other persons and the command economy denies the natural rights of persons altogether. Rothbard's main argument in favor of the unhampered market economy is that it upholds each person's natural rights of private property and thereby, achieves the ethical use of interpersonal violence more fully than another other social arrangement.

The role economics plays in Rothbard's defense of the unhampered market is subsidiary to that of ethics. Rothbard wrote, "[Superior productivity is a] … result of the free market, but it is not, to the libertarian, the *prime* reason for his support of the system That prime reason is moral and is rooted in the natural-rights defense of private property we have developed above."[3] While natural law philosophy delineates the natural rights by which man upholds the ethical use of interpersonal violence in society, economics delineates the natural laws by which man produces, exchanges, and consumes in society.

Economics demonstrates that the unhampered market promotes human life and flourishing to a greater extent than any other social arrangement. The diversity of labor skills among persons and the diversity of productivity of natural resources in the world imply the greater productivity of the division of labor. The division of labor furthers the life and flourishing of man by sustaining a vastly larger number of persons at far greater levels of material wellbeing than other social arrangements and by making a place in production suited to each person's talents and personality. For the division of labor to advance beyond a primitive level and continue to progress there must be a market economy. The monetary prices that emerge from the voluntary exchange of private property can be used by entrepreneurs to make economic

[3] Rothbard (1978, p. 40). Italics original.

calculations of the net income of producing goods and the net worth of acquiring assets. Within the framework of net income, entrepreneurs can determine which goods people in society value more highly and which combinations of factors of production used to produce the higher-valued goods they value less highly. By comparing the anticipated revenues from selling goods to the anticipated costs of hiring the factors of production, entrepreneurs can economize production in the division of labor. Within the framework of net worth, entrepreneurs can determine which lines of capital investment people in society value more highly and the liabilities they associate with each line. By comparing the anticipated asset value of the investment with its anticipated liability value, entrepreneurs can economize the construction of the capital structure. The command economy eliminates economizing the division of labor for people in society by abolishing economic calculation and the hampered market economy impairs economizing by distorting economic calculation.[4]

Rothbard's achievement was to show that these two arguments, the ethical and economic, are grounded on the same praxeological foundation. Both are constructed from the nature of man and human action. This approach has been called a "science of liberty" because both its parts are objectively established. It was Rothbard's acceptance of an objective ethical system that was the basis of his critique of Ludwig von Mises's defense of the unhampered market economy. He embraced Mises's economic argument, but chided him for his inadequate ethical claims for advocating *laissez-faire*.[5] As Rothbard wrote:

> Thus, while praxeological economic theory is extremely useful for providing data and knowledge for framing economic policy, it cannot be sufficient by itself to enable the economist to make any value pronouncements or to advocate any public policy whatsoever. More specifically, Ludwig von Mises to the contrary notwithstanding, neither praxeological economics *nor* Mises' utilitarian liberalism is sufficient to make the case for *laissez-faire* and the free market economy. To make such a case, one must go beyond economics and utilitarianism to establish an objective ethics which affirms the overriding value of liberty, and morally condemns all forms of statism...[6]

[4] Mises (1998, pp. 211-232, 258-311, 694-711, and 736-773).
[5] Rothbard (1982, pp. 205-212).
[6] Rothbard (1982, p. 212).

Kvasnička incorrectly juxtaposes Rothbard's welfare economics against Mises's approach. He writes, "Both Rothbard's method and its outcome (the welfare theory) differ significantly from Mises' own ones."[7] But Rothbard accepted and defended Mises's praxeological method and the economic theory Mises built by it as vigorously as anyone. He saw his own role as adding to Mises's theoretical edifice. In the preface to his own economic treatise, Rothard wrote:

> Professor Paul Samuelson has written rhapsodically of the joy of being under thirty at the time of publication of Keynes' *General Theory*. I can say the same for the publication of Ludwig von Mises' *Human Action* in 1949. For here at last was economics *whole* once more, once again an edifice … Suffice it to say that from now on, little constructive work can be done in economics unless it starts from *Human Action* … In one sense, the present work attempts to isolate the economic, fill in the interstices, and spell out the detailed implications, as I see them, of the Misesian structure … it is my hope that this work may succeed in adding a few bricks to the noble structure of economic science that has reached its most modern and developed form in the pages of *Human Action*.[8]

2 Welfare Economics and the Defense of the Market

Rothbard's welfare economics, then, was not an alternative to Mises's economic defense of the unhampered market, which Rothbard accepted. It was, instead, a critique of mainstream welfare economics. It was directed at mainstream economists, a very limited audience that held a narrow set of presuppositions and thought about social welfare within a restrictive framework. Rothbard's welfare economics was not an argument aimed at the general public, which would fail to grasp it. For that audience, he wrote, *For a New Liberty*. Rothbard's welfare economics was not even aimed at academicians in general, who would see its shortcomings all too well. For that audience, he wrote, *The Ethics of Liberty*. Given the limited task Rothbard was trying to accomplish and the narrow audience he was trying to reach with his welfare economics, the import of Kvasnička's criticism of him loses its force. He writes,

[7] Kvasnička (2008, p. 43, fn. 2).
[8] Rothbard (1970, p. xi). Italics original.

> 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.[9]

Presumably by "sound ideas" Kvasnička means *laissez-faire* or the unhampered market economy. But, as shown above, Rothbard's arguments for the unhampered market economy were that it upholds natural rights and fosters the life and flourishing of man. Even if his welfare theory were invalid, then, it would matter little to Rothbard's defense of "sound ideas."[10]

Rothbard's reconstruction of welfare economics attempted to show mainstream economists that the only sound basis for both utility and welfare economics is the fundamental principles of human action. To the extent that mainstream economists were dissatisfied with the disarray in which both fields found themselves in 1956, Rothbard was offering a corrective. As he wrote:

> Both theories have lately been floundering in stormy seas. Utility theory is galloping off in many different directions at once; welfare theory, after reaching the heights of popularity among economic theorists, threatens to sink, sterile and abandoned, into oblivion.
>
> The thesis of this paper is that both related branches of economic theory can be salvaged and reconstructed, using as a guiding principle of both fields the concept of "demonstrated preference."[11]

[9] Kvasnička (2008, p. 42).

[10] Rothbard himself lamented just such confusion about the role of welfare economics in his defense of the unhampered market economy. Edward Stringham cites an audio tape of a speech Rothbard made in a lecture series "A Short Course on Free Market Economics," on which Rothbard states:

> Unfortunately ... it has been maintained that my whole basis for *laissez-faire* rests on this whole social utility nonsense. Of course it really doesn't. It's all really a gimmick to show that if you really go along with this whole Pareto-optimality-social-utility then you have to confine yourself to *laissez-faire*. It's not my major argument for *laissez-faire*. At any rate, the trouble with those people who think it's my major argument are so inamorate [sic] that that's all they can focus on. (Rothbard, Tape 6, "Cost of the Firm" Side B, 35:57 to 37:44 in Stringham 2007, p. 27)

[11] Rothbard (1997a, p. 211).

Rothbard began by attempting to establish the proper meaning of the concept of preference.[12] He argued that the meaning of preference can be found in its role in human action. Action is purposeful behavior. Given the circumstances that make up the situation in which a person finds himself, his action aims at attaining an end. The situation of acting contains both general conditions, elements of the situation a person does not control in his action, and means, elements of the situation he does control. Action is using means in an attempt to attain an end. For something to be a means, the person must own it, i.e., control the use of the thing in action. Because of the scarcity and diversity of means, action requires choice. A person must choose among competing ends to pursue with each set of means and among competing sets of means capable of attaining each end. Preference is the judgment a person makes in ranking the value of alternatives in action.

There are several distinguishing characteristics of preference. Preference is the logical requisite of choice, which is necessary for action. If a person could not establish a preference in his mind, then he could not choose and therefore, could not act. Choosing only requires establishing a rank order of alternatives; one option is better another not as good. Preference does not measure value. It grades it. Preference is established within the circumstances of action, both the psychological conditions internal to the mind and the means and general conditions external to the mind. Preference does not refer to a hypothetical state of affairs in which the actor achieves bliss or happiness or even a state of affairs that he likes. It is not wishful thinking about what one would do if conditions were more favorable. Preference is not a stipulation made by the economist about a person's state of mind. Preference refers to the rank order of more preferred and less preferred alternatives that a person makes in his mind as the basis for choosing in action. It incorporates, therefore, all possible cases of psychological disposition. Preference, being a state of mind, is known experientially only by the person acting and no one else. Only he can know the level of utility he enjoys from attaining his higher-valued alternative and how much more value he gets from it than from his lower-valued alternative. Another person's knowledge of the preferences of a person acting is limited to the evidence empirically available from

[12] On these basic principles, see Rothbard (1970, pp. 1-66).

his action and what can be logically inferred from this evidence and the conceptual meaning of action. That objective knowledge can be acquired from a person's action about his preferences is the basis of the concept of demonstrated preference.

Demonstrated preference, then, is not a special concept of welfare economics, but the basis of all action. Rothbard wrote, "The concept of *demonstrated preference* is simply this: that actual choice reveals, or demonstrates, a man's preference; that is, that his preferences are deducible from what he has chosen in action."[13]

Because a person's preference can be deduced from his action, someone observing his action can have objective knowledge about it. The deduction comes from combining the conceptual meaning of action and the empirical evidence of the action. For example, a farmer plants a corn crop. An economist can deduce from this action that the farmer preferred planting a corn crop to the next best alternative that he considered. This conclusion is not evident from empirical evidence alone, but implied from conceptual understanding of action, specifically the understanding that any action aims at a preferable state of affairs. That to be scientific a treatment of a subject must be objective, i.e., based on facts and reason, is the source of Rothbard's claim that a scientific treatment of utility and welfare economics can include only demonstrated preference.[14]

Although there is no welfare economics of the person acting in isolation, Rothbard claimed that the economic theory of the person acting in isolation is the foundation for welfare economics since it underlies any and all action, including social interaction. Thus, voluntary exchange is mutually beneficial because in choosing to exchange ownership of goods both traders aim at a preferable state of affairs. Kvasnička himself, along with most other economists, accepts these basic principles.[15] Rothbard's welfare economics was an appeal to mainstream economists to make these fundamental principles of economics that they accept the foundation of welfare economics. In advancing this line of argument, Rothbard was hoping to bring mainstream economists around to accepting the *laissez-faire* conclusions that stem from

[13] Rothbard (1997a, p. 212). Italics original.
[14] On his view of science, see Rothbard (1997b, pp. 32-34).
[15] Kvasnička (2008, p. 46) writes, "[Rothbard's first welfare theorem] is derived 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."

basic economic theory. In retrospect, Rothbard's quest may seem quixotic, but not, I think, incoherent as Kvasnička claims.[16]

Voluntary and involuntary interactions are defined in economics to recognize the distinction between cases in which it is possible to deduce that a person is better off from an interaction with another person and cases in which it is possible to deduce that he is worse off. Each person comes to an exchange with his naturally-owned property. A voluntary exchange occurs when neither trader uses or threatens violence against the property of the other. If the two persons trade the ownership of property without aggressive violence, then the exchange is voluntary. Given their natural ownership of property, each person chooses an alternative he prefers more than the non-interaction alternative. Both traders benefit. If one person violently aggresses against the property of the other person, then the exchange is involuntary. Given their natural ownership of property, the aggressor chooses an alternative that he prefers more than the non-interaction alternative and the victim is forced to choose an alternative that he prefers less than the non-interaction alternative. The aggressor benefits and the victim loses.

These conclusions must be deduced from the conceptual meaning of action and the empirical evidence of the action. They are not evident from the empirical evidence of the action alone. The mutual benefit of voluntary exchange is deduced from the understanding the economist has that each person in any action he takes, given its circumstances, chooses what he prefers. That deduction is necessary to arrive at social welfare conclusions has particular importance in the case of involuntary exchange. What one observes about involuntary exchange appears on the surface to be no different than what one observes about a voluntary exchange. In both cases, a person chooses to transfer the ownership of something to another person. That he is not demonstrating a preference for the transfer in the case of aggressive violence used against him is inferred from his initial property ownership and that aggressive violence is an implicit, non-consensual claim on his property. Without such conceptual understanding, the economist could not deduce the harm to the victim from aggression. It cannot be seen from the empirical evidence of involuntary exchange alone.

[16] Kvasnička (2008, p. 43).

Determining the social welfare consequences of voluntary exchange and involuntary exchange relies upon another basic principle about preference that economists generally assent to, viz., its subjectivity. As discussed above, value is a state of mind. As such, it has no extensive property that can be measured. For this reason, there can be no interpersonal comparisons of utility. To conclude that social welfare has improved from a social interaction, therefore, it must be shown that the interaction makes at least one person better off and no one worse off. Such interactions can be called Pareto superior. If a social interaction makes some persons better off and others worse off, then it cannot be concluded that social welfare has improved. Such interactions can be called Pareto inferior.[17]

Even though it can be deduced that both traders benefit from a voluntary exchange, the consequences for social welfare are indeterminate until third-party effects are considered. It is possible that a third person who is not a party to the exchange made by two other persons has an adverse psychological response to the exchange. He is envious, let us say. The economic-theoretical meaning of this case is that the conditions of action external to his mind, and which he does not control, have changed for the envious person. Other persons have used their personal property in a way that he does not like. The relevant question for determining the effect on social welfare is: Does this psychological change affect his preferences? If it does not, then his action does not change. He demonstrates that he is no worse off in preference than before and, to reiterate, preference is the objective standard for social welfare considerations. If the feeling of envy is strong enough to change the person's preferences, then he changes his action toward a more preferred alternative, say complaining to his friend. In this case, too, his action, given the new circumstances, is more-preferred, not less. It can be conceded, though never objectively established, that his level of utility is higher before the voluntary trade of others than after it, but that does not imply that the voluntary trade of others made the envious person worse off in preference. Preference refers to the judgment a person makes in his mind comparing the value of alternatives in action given the circumstances of the action.

[17] Kvasnička seems to think that in using the phrase Pareto inferior to describe cases of state intervention, I meant that a reduction of social welfare had occurred. Pareto inferior, however, refers to cases in which it cannot be concluded that social welfare has improved. No cases could exist for the definition Kvasnička implies for the phrase Pareto inferior, because the only way to have an unambiguous deterioration in social welfare is if both parties to a social interaction are made worse off. Obviously, neither party would act to bring about such a result. See Kvasnička (2008, p. 49, fn. 6).

Deducing the effects on social utility from voluntary and involuntary exchanges requires considering each action in turn given the conditions as they are at that point. Nothing can be deduced about the level of utility a person has at the beginning of a series of actions compared to the level of utility he has at the end of the series of actions. For example, a person having dinner with his friends orders steak from the menu. The economist observing him can objectively conclude that, given his options, he selected what he preferred. He is enjoying the conversation when it turns to a subject he dislikes, but he stays and endures it. The economist observing him, lacking access to what he is experiencing in his mind, can objectively conclude that he prefers to continue dining with his friends. At some point, one of his companions makes a remark so objectionable to him that he says, "Anymore such talk and I shall leave." The economist observing him can objectively conclude that he preferred to make this remark. The economist cannot objectively conclude that this line of conversation has lowered the level of his utility. To conclude that would require the economist to make a judgment about his utility. The economist would have to interpret the meaning of the remark as it relates to his utility. The economist would have to decide whether it was a serious remark or a joke and if it was serious did making the remark push his utility up or down. Bullies, after all, like to intimidate others with such remarks. No such judgments are necessary for the economist to conclude that he preferred making the remark. It follows from the objective evidence of his action and the conceptual meaning of action. And so it goes for the rest of the evening with the level of his utility sometimes rising and sometimes falling, but he continues dining with his friends and leaves only after the party breaks up. Is he enjoying a higher level of utility after the evening is over compared to before it began? Who can objectively say but the person himself? He is the only person with experiential knowledge of his own utility. What another person can objectively deduce is that he preferred what he did each step of the way.

Moreover, recognizing that the given conditions of a social interaction are necessary to determining its social welfare consequences leads to a regression theorem of social interactions. The action taken by the envious person occurred in the conditions that existed because of the prior voluntary exchange of other persons. But that voluntary exchange occurred in the conditions that existed because of the prior actions of other persons and so on. Tracing these interactions backwards step-by-step leads to the starting point of each person's ownership of his mind and body. Each person's ownership of his labor is the initial endowment of property in which he begins the process of social interaction. Each step of acquisition of property in its natural state by someone demonstrates that he gains in preference and no one is demonstrably worse off in preference. With their naturally-acquired property, persons exchange voluntarily and thereby, demonstrate that they prefer their social interaction while no one is demonstrably worse off in preference.[18]

The determination of social welfare is not an end-state of optimality to be achieved. Instead it is a step-by-step comparison of whether or not any particular social interaction improves social welfare. To be consistent with fundamental economic principles, the analysis can use the concepts of Pareto superior and Pareto inferior, but not Pareto optimal. In each voluntary exchange on the unhampered market traders attain what they prefer more without third-parties suffering what they prefer less. Each step taken in the market economy improves social welfare and hence, is Pareto superior. In each involuntary exchange aggressors attain what they prefer more and victims suffer what they prefer less. Each step taken by the state fails to improve social welfare and hence, is Pareto inferior.[19]

3 Kvasnička's Critique

Kvasnička claims that his critique differs from the criticism of Rothbard offered by others in that "they analyze a broad context of the theory, or even question Austrian

[18] See, Herbener (1997, pp. 98-101). That naturally-owned property is the initial endowment from which the process of social interaction begins is the Rothbardian rebuttal to justifications for state redistribution of income that mainstream economists make in their welfare economics to achieve equity. See note 43 below.

[19] In writing about welfare economics, a leading historian of economic thought recognizes this distinction between the step-by-step process analysis of Austrian economics and the end-state equilibrium analysis of mainstream economics. He wrote:

> [Adam Smith] held what I have elsewhere called "a process conception of competition," nowadays associated with Austrian economics, in contrast to the orthodox "end-state conception of competition," in which all emphasis is directed to the nature of the final equilibrium, regardless of how that equilibrium is attained. (Blaug 2007, p. 189).

economics as such... Our analysis is based on a detailed study of Rothbard's own arguments only. We have only checked the coherency of his arguments."[20]

The main thrust of Kvasnička's critique, however, is not to point out internal inconsistencies in Rothbard's argument, but to criticize him for holding a distinctly Austrian instead of mainstream view of utility. In the mainstream view, economic theory consists of models constructed by the economist to explain market phenomena. The model contains "agents" whose "actions" are determined by stipulating mathematically tractable utility functions for them. "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," Kvasnička writes, "The indifference curves just describe the agent's inner world, in which Rothbard takes no interest, or rather denies its existence altogether."[21] Concerning welfare economics, Kvasnička writes, "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..."[22] Setting aside the question of the scientific validity of this approach, Rothbard rejects it in favor of praxeology, which builds economic theory as a body of logical implications from the nature of human action as set out above. As a praxeologist, Rothbard is interested in the inner world of real human beings in so far as they establish preferences. He has no interest in the inner world of economic agents, which is nothing more than mathematically tractable utility functions invented by mainstream economists. It is not clear that by being interested in the inner world of agents of their own invention that mainstream economists themselves have any interest in the inner world of real human beings. In any case, with this line of criticism, Kvasnička can, at most, merely show that Rothbard's conclusions are inconsistent with mainstream analysis, but not that they are internally inconsistent.

Because he sees utility as a mathematical function stipulated by the economist, it appears to Kvasnička that Rothbard is merely asserting the concept of demonstrated preference as a constraint on the utility function necessary to permit him to make

[20] Kvasnička (2008, p. 43).
[21] Kvasnička (2008, p. 44).
[22] Kvasnička (2008, p. 46).

social welfare claims in the face of the difficulties of interpersonal utility relationships such as third-party envy. He writes,

> 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 … Rothbard believed he could get a determinate solution in more cases with the tool he called *demonstrated preference*.[23]

But, Rothbard did not invent demonstrated preference as a means of creating a class of events that satisfy the Pareto criterion as Kvasnička implies. Demonstrated preference was, for Rothbard, a fundamental concept of human action. And it is precisely Rothbard's acceptance of demonstrated preference as a concept logically established before the chain of logic reaches the question of interpersonal utility relations that leads him to deny that envy of a third party constitutes an exception to the Pareto superior status of a voluntary exchange.[24]

Kvasnička then poses two interpretations of what Rothbard meant by the concept of demonstrated preference. The first is "we can know nothing that was not demonstrated in an action" and the second is "there is nothing more than what was demonstrated in an action." Kvasnička claims that Rothbard held the second view.[25] But, he clearly held the first view. Rothbard wrote:

> Now since praxeology shows, by the concept of demonstrated preference, that both the newsdealer and I gain in utility from the exchange, and nothing has demonstrably happened to anyone else, we can conclude scientifically, as praxeological economists, that social utility has increased from the sale and purchase of the newspaper – since we have defined social utility in the Paretian manner. It is true, of course, that third parties may well be grinding their teeth in hatred

[23] Kvasnička (2008, p. 43). Italics original.

[24] Even the typical mainstream treatment of utility in welfare economics does not include third-party envy in utility functions. As Blaug (2007, p. 185) writes, "The first fundamental theorem states that, subject to certain exceptions – such as externalities, public goods, economies of scale, and imperfect competition – every competitive equilibrium is Pareto-optimal." Third party envy is not on the list of exceptions and, save for such exceptions, every competitive equilibrium is Pareto optimal. If mainstream economists would have taken Kvasnička's view of the pervasiveness of third-party envy, they would never have developed welfare economics at all since under this view the social welfare consequences of every social interaction are indeterminate.

[25] Kvasnička (2008, p. 44).

> at the exchange. There may be people, for example who through envy suffer psychic loss because the newspaper dealer and/or I have gained. Therefore, if we employ the Paretian definition of "social utility" in the usual psychologizing sense, 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. Still further, we may know as historians, from interpretive understanding of the hearts and minds of envious neighbors, that they do lose in utility. But we are trying to determine in this paper precisely what scientific economists can say about social utility or can advocate for public policy, and since they must confine themselves to demonstrated preference, they must affirm that social utility has increased.[26]

Rothbard's point in insisting on the use of demonstrated preference is precisely that it is consistent with the empirical evidence from an action and the conceptual meaning of action and, therefore, it can be part of a scientific, i.e., praxeological, treatment of human action. Rothbard does not "ignore all changes of a person's utility except those the person demonstrates through his actions," as Kvasnička claims; he just recognizes that they play no role in the logical structure of action and hence, are not part of economic theory.[27] This distinction between the abstract and concrete aspects of action is the key to solving Kvasnička's puzzlement that Rothbard can hold at the same time that aspects of action beyond demonstrated preference can be known or understood by the historian while only demonstrated preference can be accepted as objective evidence by the economist.[28] The difference is like a scientist who is conducting a controlled experiment to determine the physical effects of smoking. He may know a lot about the lifestyle of his grandfather, who has smoked for forty years with no obvious physical repercussions, but he cannot include this knowledge in his scientific study. As a scientist, he can only include data that has been scientifically generated in his experiment. Another analogy is a mathematician who deduces the Pythagorean Theorem from prior postulates and theorems of geometry. Whatever can be know about actual right triangles drawn on paper or embedded in architecture is not relevant for his proof. He is not ignoring, and does not need, other knowledge about right triangles that he may have acquired from drawings and architecture in making

[26] Rothbard (1997c, pp. 88-89).
[27] Kvasnička (2008, p. 44).
[28] Kvasnička (2008, p. 44, fn. 3).

his proof. In like manner, the economist is not concerned with the particular, concrete aspects of action as the historian is, but with the universal, conceptual structure of action.[29]

Kvasnička's god-like approach does not avoid this distinction between the conceptual and concrete and its consequent difficulties. This approach does not say that the economist should conduct utility and welfare economics using every aspect of what he can actually come to know about real human persons. Instead, it counsels him to construct mathematically tractable utility functions for mythical economic agents and deduce, by the use of mathematics, utility and welfare theorems from them. Such constructs are held up as a model by which the economist is to understand the action of real human persons. He is still left with the question of how these models relate to the human action of real persons.[30]

Kvasnička backs up his view that Rothbard held the position that "there is nothing more than what was demonstrated in action," by claiming that Rothbard argued that "there is no way to *demonstrate* indifference, hence there *can be no* indifference at all."[31] But, Rothbard did not deny that psychological states of indifference can exist. He wrote:

> The concept of "indifference" may be important for psychology, but not for economics. In psychology, we are interested in finding out intensities of value,

[29] As with economic theory, Rothbard accepted Mises's views of the relationship between theory and history. See his preface to Mises (1985).

[30] Blaug claims that mainstream economists have used the difficulty of reconciling the abstract and the concrete as an opportunity to push their own ideologies. He writes,

> This sort of intellectual schizophrenia [of mainstream economists over the Coase Theorem] would be excusable provided it were well understood that the irrelevance of the initial distribution of property rights to a final allocation of resources is, like Pareto-optimal properties of competitive equilibrium, a truth about economic models and not a truth about the real world. But I doubt that is sufficiently underlined, because such underlining would destroy the ceremonial value of formal theorems in a subject like economics. Many economists know in their heart that the market is efficient, and know it as an unexamined ideological belief but do not want to admit to themselves that it is ideological. So they revel in mathematical theorems that satisfy their self-respect … [They] accept the judgment that the theorems are close to reality, while those that distrust markets do not. (Blaug 2007, p. 201)

[31] Kvasnička (2008, p. 44). Italics original.

> possible indifference, and so on. In economics, however, we are only interested in values revealed through choices. It is immaterial to economics whether a man chooses alternative A to B because he strongly prefers A or because he tossed a coin. The *fact of ranking* is what matters for economics, not the reasons for the individual's arriving at that rank.[32]

What Rothbard claimed was that indifference has no relevance for the conceptual structure of action. If such states of indifference mean that no preference exists then no action can come from them since preference is the requisite for choice. And if in such states of indifference a person can still establish a preference, then action can take place. In the first case, indifference is not part of the conceptual structure of action and in the second case it is just one of the many psychological, physiological, and other conditions influencing the establishment of a preference. As such, no reason exists to single indifference out of the multiplicity of other such conditions for special treatment. Even in the indifference curve approach of mainstream economists, a person could not choose, and therefore could not act, on the basis of an indifference curve alone. He chooses from among the combinations of goods that give him the same utility, the one that he can obtain for the lowest budgetary expenditure. Or, what amounts to the same thing, for a given budgetary expenditure he selects the combination of goods that places him on the indifference curve which gives him the greatest utility. Either way, he chooses what he prefers, either the same utility with a smaller monetary expenditure or greater utility for the same monetary expenditure. Indifference, as such, has nothing to do with choosing between alternatives even in the mainstream approach. The assumption of indifference is made, instead, to justify the use of a utility function. Indifference in the mainstream approach means, not merely that a person cannot choose between alternatives, but that the utility of the alternatives is equal. If the utility of alternatives is equal, then utility can be presumed to be cardinal. Cardinality is required to establish utility functions and work through the mathematical logic of the utility-function approach.

There is one more point of indictment against Rothbard that Kvasnička infers from his discussion about indifference. Against the claim that indifference might be demonstrated by repeated trials of action in which a person chooses each alternative

[32] Rothbard (1997a, p. 226). Italics original.

half the time, Kvasnička says that "Rothbard argues such a comparison is not possible because over time the agent's preferences might have changed."[33] Once again, the problem with Kvasnička's claim is that Rothbard's praxeological approach develops the conceptual structure of the action of real human beings. It is not a model of economic agents. Of course, it is possible to invent agents with utility functions that give statistical results of whatever type the economist wants. But with a real human person, the economist cannot presume that in repeated trials (even those in which every external circumstance is the same) his preference with respect to the circumstances of action remain the same. On this point, Rothbard is again following Mises who argued that functional analysis of human action is ruled out by the lack of constants. Functional equations have variables and constants, but in human action nothing exists but variables. No constant quantitative relationships exist between a dependent variable (e.g., the quantity of a good a person purchases) and independent variables (e.g., the price of the good) because the quantitative effect on the dependent variable of a change in an independent variable depends on the judgment made in the mind of the person acting which can change over time.[34]

Although Rothbard claims that the economist cannot compare the results of real actions at different times as a means of determining a person preferences or indifferences, he does not hold that "we cannot compare a real situation with another hypothetically the same," as Kvasnička claims.[35] Precisely such comparisons are the basis for many economic laws, e.g., the law of demand. The law is logically deduced from the concept of diminishing marginal utility by posing a hypothetical situation different from the actual buying situation in only one way, viz., that the price is conjectured to be lower. A person would have bought at least as much of the good in the hypothetical case compared to the amount he actually bought. Rothbard accepts such *ceteris paribus* comparisons in cases for which it is acceptable to say that a person's preferences cannot change, e.g., at the moment a person buys a good.[36] He does not, however, accept the presumption that a real human person's preferences cannot change over time in a series of buying opportunities.

[33] Kvasnička (2008, p. 45).
[34] Mises (1998, pp. 347-354).
[35] Kvasnička (2008, p. 45).
[36] Rothbard (1970, pp. 91-108).

Kvasnička then turns to what he considers the limitations of the concept of demonstrated preference. First, he claims that "an agent can demonstrate only those changes of his utility … 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."[37] Rothbard, he asserts, uses demonstrated preference to ignore the utility losses of persons who do not actively demonstrate their losses but passively accept them. He writes, "the possibly losing non-involved third party *cannot demonstrate* it loses because it loses *passively* – there is no action that can prove it …"[38] Action, however, can be either "active" or "passive" and hence, can demonstrate a preference in either case. As discussed above, preference is inferred from what we know about action conceptually and the empirical evidence from an action. It cannot be known from empirical observation alone, e.g., that a person is passive. Second, Kvasnička writes, "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."[39] His examples of being offered a gift and not resisting aggression do not show that demonstrated preference is of no use in social welfare analysis, but that one must take account of the circumstances of action in addition to demonstrated preference in such an analysis.[40] As discussed above, there must be circumstances of each action and some of them are outside the mind and control of the person. Welfare economics takes these circumstances as given and deduces a person's preferences from what we know conceptually about action and what the person chooses to do in the given circumstances. This point also applies to Kvasnička's claim that Rothbard "ignore(s) the impact of a change of the income and wealth distribution on individual's [sic] utilities under Pareto's rule" because "distribution is not independent from production and exchange … and that a change in the distribution is caused by voluntary-made exchanges."[41] Rothbard's argument, however, is that changes in income and wealth distribution are conditions of action in which a person chooses what he prefers. Each social interaction is a separate event with its own conditions determined by prior actions. When an interaction takes place it changes the conditions for future actions.

[37] Kvasnička (2008, p. 45).
[38] Kvasnička (2008, p. 48). Italics original.
[39] Kvasnička (2008, p. 45). Italics original.
[40] Kvasnička (2008, pp. 45-46).
[41] Kvasnička (2008, p. 47).

Social welfare consequences can be deduced for each action, one at a time, as persons face changing circumstances. Kvasnička's claim that "Pareto's rule looks for *all* subjects' utility increases or decreases in comparison to the status quo, despite their cause," may be true in the mainstream approach with the caveat that what counts as a factor changing utility is stipulated by the economist in the agents' utility functions.[42] The typical treatment of income distribution in mainstream welfare economics, however, is not to include it as a factor in utility functions as Kvasnička implies, but to see it as an initial endowment that conditions the particular Pareto optimal point that is reached by voluntary exchange. Such a treatment permits the state to select what it considers the preferable Pareto optimal outcome and to redistribute income to set the initial conditions so that the process of the market achieves the selected Pareto optimal point. Even if the state cannot intervene in the unhampered market to improve social welfare, it can redistribute income to achieve equity while letting the market achieve efficiency.[43]

Kvasnička then applies the limitations that he claims for demonstrated preference to the two theorems of Rothbard's welfare economics. The two welfare theorems are "that the free market always increases social utility" and "that no act of government can ever increase social utility."[44] His argument about the first welfare theorem is that Rothbard uses demonstrated preference to ignore the utility losses suffered by

[42] Kvasnička (2008, p. 47). Italics original.

[43] Blaug writes:

> Modern welfare economics is formally summed up in two so-called fundamental theorems. The first fundamental theorem states that, subject to certain exceptions – such as externalities, public goods, economies of scale, and imperfect competition – every competitive equilibrium is Pareto optimal. The second fundamental theorem states that every Pareto-optimal allocation of resources is an equilibrium for a perfectly competitive economy, provided a redistribution of initial endowments and property rights is permitted; alternatively expressed, every Pareto-optimal allocation of resources can be realized as the outcome of competitive equilibrium after a lump-sum transfer of claims on incomes. (Blaug 2007, p. 185)

An example of what Blaug is referring to can be found in a leading Intermediate Microeconomics textbook. About the Pareto criterion, the authors write, "it evades most of the interesting questions about the distribution of income. The criterion has nothing to say about a change that benefits one group of people and harms another." They then provide an example from Hal Varian of how different initial endowments of income permit the satisfaction of both equity and efficiency goals. See, Mansfield and Yohe (2004, pp. 612-613).

[44] Rothbard (1997a, p. 243).

third parties when others voluntarily exchange. He writes, "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."[45] To illustrate his point, Kvasnička applies his analysis to Rothbard's welfare economics of a voluntary cartel. Kvasnička agrees that members of a voluntary cartel demonstrate their benefit in forming the cartel when selling to consumers at higher prices but that "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."[46] But consumers are demonstrating their preferences. By purchasing the good, consumers demonstrate that they prefer to buy at the current prices. Determining this is done in exactly the same way as it would be before the cartel formed and prices were lower. In that case, too, consumers demonstrated that they preferred to buy at the current prices, even if they were also higher than previous prices. Social welfare consequences can be determined only for each action, one at a time. The conditions of a person's action determined by other people are given to him for each action. As discussed above, whether or not consumers have higher utility or lower utility from the beginning of a series of actions compared to its end cannot be objectively determined. For this reason, Rothbard does not include such comparisons over time in welfare economics. To do so, the economist would have to account not only for the effect higher prices have on consumers' states of mind, but any other factor affecting their utility in the interim between buying at lower and buying at higher prices. Of course, in the abstract and *ceteris paribus*, consumers always prefer lower to higher prices but welfare economics is about the consequences of real actions in their actual circumstances and not about *ceteris paribus* conjectures.

Turning to the second welfare theorem, Kvasnička argues that Rothbard switches uses of the Pareto criterion from one based on demonstrated preference, used to eliminate third-party losses of utility from voluntary exchange, to one based on the god-like view of utility, used to show that a person coerced by the state loses. He writes, "[Rothbard] uses Pareto's rule in its usual meaning now … because under demonstrated preference the losing party *cannot prove* it loses because it suffers the loss

[45] Kvasnička (2008, p. 48). Italics original.
[46] Kvasnička (2008, p. 49). Italics original.

passively …"[47] In applying this analysis to Rothbard's case of the voluntary cartel, Kvasnička concludes that Rothbard has not shown that a state enforced breakup of the cartel fails to improve social welfare. Perhaps this would be correct if Rothbard was claiming that "producers lose [because] they can charge only competitive prices again" as Kvasnička cites as the source of loss.[48] But Rothbard argued that the loss to members of the cartel can be inferred from the coercion the state uses to prevent them from doing what they prefer to do in the given situation and not from comparing the higher cartel prices before state intervention to the lower non-cartel prices after state intervention.[49] Kvasnička himself characterizes Rothbard's argument in this way: "the government's action coerces someone else to do what he does not want to do, or abstain from an action he would like to do. This person loses."[50] Rothbard did not switch meanings of the Pareto rule in his second welfare theorem, but consistently applied the concept of demonstrated preference, that a person's preference can be deduced from the empirical evidence of his action and the conceptual meaning of action.

Kvasnička makes two criticisms of Rothbard's welfare economics that do not stem from his claim that Rothbard's views should be assessed in terms of the mainstream approach.

First, he claims that Rothbard ignores the effect negative externalities have on the welfare improving character of the unhampered market because they are "caused by ill-specified property rights" and hence, "ruled out of the free market by definition."[51] Rothbard's argument, however, is that the welfare loss of negative externalities cannot justify government intervention to correct it because the cause of negative externalities is not the working of the market but the failure of government to enforce property rights or government interference in the establishment and defense of property rights. In other words, Rothbard is saying that to correct the inefficiency of negative externalities, the state must remove its own inefficiency-generating activity. State intervention into the activity of the market will not correct negative externalities

[47] Kvasnička (2008, p. 48). Italics original.
[48] Kvasnička (2008, p. 49). Parentheses removed.
[49] Rothbard (1997a, pp. 242-243).
[50] Kvasnička (2008, p. 48).
[51] Kvasnička (2008, p. 47).

but impose its own additional inefficiency on the market. Kvasnička's argument that "since the definition and enforcement of property rights is [sic] costly, they cannot be complete in the real world," and therefore, Rothbard's claim that negative 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" misses the mark.[52] Even if Rothbard were trying to argue for the superior welfare results of the unhampered market versus the hampered market with respect to negative externalities, all he would have to show is that the former results in smaller welfare losses than the latter, not, as Kvasnička claims, that there are no such welfare losses in the unhampered market. The unhampered market need not achieve Nirvana to be justified.[53] It only needs to be better than any other realizable arrangement.

Second, Kvasnička claims that Rothbard's welfare economics contradicts his general economics. Following Barnett and Block, he claims that Rothbard's welfare economics must conclude that an increase in money production by the state cannot improve social welfare while an increase in money production by private enterprise does improve social welfare. Rothbard, however, did not follow his own welfare economics in this case. On the basis of his general economics, he argued instead that any amount of money is socially optimal.[54] The apparent inconsistency can be cleared up by removing the ambiguity in the phrase "socially optimal." Rothbard meant by this phrase that any amount of money can perform the entire medium of exchange function in society.[55] The entire set of exchanges people desire to make can be made with any amount of money. No inconsistency exists between the claim that any amount of money is socially optimal in this sense and the existence of social welfare effects from money production described by Barnett and Block. To demonstrate that any amount of money is socially optimal, the economist postulates a given amount of money and underlying preferences and other conditions that give rise to particular demands for goods and factors which result in particular prices of those goods and factors. If each person's money holdings were instead twice as large, with the same underlying con-

[52] Kvasnička (2008, p. 47).

[53] On the Nirvana Fallacy, see Demsetz (1969).

[54] Kvasnička (2008, p. 50). See Barnett and Block (2004).

[55] "Any amount" of money means any amount larger than a technologically necessary minimum if such exists. The argument refers to the adjustment of prices to different amounts of money, not to the implications of a technologically minimum amount of money.

ditions, then prices would be twice as high and if they were half as large, prices would be half as high. But no matter the amount of money, people would be able to make all the exchanges they desire to make. There are no social welfare implications of this analysis. It is designed to compare end- states that the market arrives at from given initial conditions that differ in one respect. It shows that in contrast to consumer and producer goods, a larger stock of money in society does not permit people to attain to a greater extent the end to which they put money. To demonstrate the social welfare effects of money production, the economist postulates given market conditions and then that more money is produced by money producers and spent by them on some goods and factors, which in turn is spent by the producers of those goods and factors on other goods and factors and so on. In this case, there are social welfare consequences to be analyzed. The analysis traces the step-by-step process by which the market moves from one end-state to another.[56]

4 Conclusion

Rothbard's main argument for the unhampered market economy was that it achieves the ethical use of interpersonal violence more fully than any other social arrangement. Working within natural law philosophy, he showed that this ethic requires the defense of natural rights against aggression and that the unhampered market economy is integral to the free society in which there is no legitimate aggression against natural rights. Complementary to his main argument concerning ethics was his economic argument that the unhampered market promotes the life and flourishing of man more fully than any other social arrangement. Working within praxeology, he accepted Mises's argument that the life and flourishing of man is promoted by the development of the division of labor and that the unhampered market develops the division of labor more fully than other social arrangements by bringing decisions concerning it under economic calculation as completely as possible. His welfare economics was not written as a defense of the unhampered market but as a critique of mainstream welfare economics. By grounding welfare economics in fundamental economic principles, he showed that every interaction on the unhampered market improves social

[56] Admittedly, Rothbard's discussion of this matter lacks his usual clarity. See Rothbard (1970, pp. 670-671).

welfare and no interaction of the state can improve social welfare. He offered his argument to convince mainstream economists to follow through the logic of what is implied by the fundamental economic principles they hold to be true to its *laissez-faire* conclusion. Mainstream economists have failed to embrace Rothbard's welfare economics because they reject his praxeological method in favor of a modeling method. As a praxeological exercise, however, his welfare theorems are valid.

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Book Review

Christopher Coyne. *After War: The Political Economy of Exporting Democracy*. Stanford Press, 2007.

West Germany, Japan, Somalia, Haiti, Afghanistan and Iraq. What do these six countries have in common? Each of these countries has been the site of a U.S. led post-war military occupation and reconstruction. At various points in the past century, the United States has endeavored to export liberal democracy to nations abroad. While some of these reconstructions have succeeded – West Germany and Japan are clear success stories – others, like Somalia, have failed miserably. The outcomes of other endeavors, specifically Iraq and Afghanistan, are still undetermined. When looking at the various outcomes in these countries, an important question arises: What factors contribute to successful installation of liberal democracy; and conversely, what factors doom reconstruction to failure?

After War: The Political Economy of Exporting Democracy, is the latest attempt at understanding the spread of liberal democracy. Christopher Coyne, author of the book and professor of economics at the University of West Virginia, explains the dynamics behind post-war reconstruction using tools from economics and game theory.

After War, Coyne examines the "economics of reconstruction" (31). The book uses game theory tools to better understand the strategic interaction between the participants in the reconstruction process. The book looks at post-war reconstruction as a game involving several players – citizens of the occupied country, the occupier and its agents (military officials, politicians), and international parties like the United Nations. Each actor has his own agenda; each player pursues a set of goals to the best of their abilities and within the constraints that he faces. The simultaneous pursuit of different objectives by different actors creates a shaky interplay that influences the outcome of the reconstruction.

After War has a neat structure. The book comprises four parts. The introduction defines the reconstruction and lays out the main lessons of the book. Then, in chapters two through four, the book defines relevant tools from economics and game theory and identifies how these tools can contribute to our understanding of the reconstruction process. Chapters five through seven engage in a comparative study of sixty-years worth of reconstructions. In this section, the author looks at six cases, divided into three categories – successes, failures, and undetermined – and discuss the factors that influenced the varying outcomes using the logic he develops in previous chapters. The book concludes in chapter eight by recommending new approaches to exporting democracy.

According to the book, citizens of an occupied country face two choices during reconstruction: a) to cooperate, by working with occupying forces and by bargaining with rival factions; or, (b) to defect, or to create conflict through obstructive behavior such as corruption, infighting, and breaking agreements. Each citizen's choice depends upon the potential rewards and costs, which, in turn, are influenced by the choices made by other citizens in the country.

Furthermore, *After War* underscores that the goal for occupiers is to make the reconstruction process a game of cooperation rather than defection. The author notes that when conflict is the dominant choice among the citizens of the occupied country, those who cooperate face huge costs. If people in the occupied country perceive the occupier as an invader rather than a liberator, then individuals who cooperate with the occupier will attract hostility from others. In addition, those who invest in liberal democratic institutions will receive no returns in the absence of credible adoption by a majority of the citizens of the occupied country. *After War* emphasizes that cooperation is only beneficial for the individual under a scenario of collective cooperation.

On the same note, the book asserts that a major factor for successful reconstruction is the "art of association" (51), a tendency for citizens of a country to interact and to create meaningful social networks. The author borrows this concept from nineteenth century political theorist Alexis de Tocqueville, who lauded Americans for their "capacity for interaction" that created a "robust civil society" in America (51). These "associations" exist at the midway point between the public and private sectors and provide individuals a forum in which they can address the relevant issues without government interference. According to the book, countries that have mastered this art are more likely to turn reconstruction into a game of cooperation. It is the author's view that these associations "create a shared identity that facilitates social interaction and allows individuals to cooperate to get things done." (52)

The book offers some relevant examples that help clarify this concept. The author asserts that, in the cases of Japan and West Germany, strong associations among the citizens facilitated the reconstruction of democratic institutions following the Second World War. In Japan, a strong sense of national identity existed prior to the war, and revealed itself in the country's economic and social institutions. Coyne offers the example of the *zaibatsu*, large industrial conglomerates that dominated the Japanese economy in the nineteenth century. These conglomerates, which began as exclusive family operations, evolved over time into more public enterprises supported by external managers. Over time, the liberalization of Japanese *zaibatsu* produced a widespread culture of cooperation in Japanese society. According to Coyne, the development of these associations prior to the war, contributed greatly to the achievement of credible collective cooperation in the post-war reconstruction game.

Similarly, the book points out that West Germany benefited from a preexisting art of association that contributed to the success of reconstruction after the war. In the case of Germany, associations had grown out of the nineteenth century liberalization of the economies of the members of the German Confederation. Increased trade between the German economies strengthened the connections between members of German society and spurred the development of liberal political institutions that would serve as the foundation for new institutions installed during reconstruction.

The book contrasts these successful cases with reconstruction failures such as Somalia. Somalia did not benefit from a culture of cooperation that pervaded civil society in Japan and Germany. Coyne points out that because Somali society comprises many different clans with varying historical allegiances, the art of association is much weaker. Prior to independence, there was little economic or political cooperation between clans. Clans existed within their own political and economic institutional structure. The book argues that because of the entrenched separatism in Somalian society, democratic institutions formed after independence emphasized clan identity rather national identity. The failure of Somalia's reconstruction is linked to a preexisting system of exclusion and a widespread lack of the art of association.

Additionally, *After War* emphasizes that expectations and credibility can play a critical role in the reconstruction process. In the reconstruction game, the actions taken by the various agents are dependent on the outcomes each expects. Coyne presents his central point regarding expectations as such: "if the expectations of the citizens of the country being reconstructed are aligned...with the aims of the reconstruction, there will tend to be a greater degree of coordination and cooperation" (73). Along the same lines, the book argues that if expectations of the indigenous population does not match the outcome of the reconstruction, conflict persists. Coyne asserts that expectations should be low, but not so low as to dissuade credible commitment by agents involved in the reconstruction.

The book offers a good example of how low expectations can prohibit the establishment of liberal democratic institutions. *After War* points to the case of Haiti where the "repressive history of national institutions" marked by "coercion and predation" have fundamentally altered citizen perceptions, creating widespread doubt in government institutions (151). The mid-1990s U.S. occupation of Haiti was met by widespread defection by indigenous actors. Coyne attributes this to pervasive skepticism among Haiti's lower class toward the reconstruction process. Due to historical patterns of repression, the Haitian elite lack credibility, and were seen as selfish players in the reconstruction process. The book claims that as a result, even though the occupation succeeded in keeping U.S.-backed leader Aristide in power, it did not succeed in strengthening liberal democratic institutions in Haiti. Worse, Aristide continued on to siphon international aid money and suppress the domestic population.

The spread of liberal democracy has received some attention in recent literature. *Democracy without Borders,* by Mark F. Plattner, discusses the relationship between liberalism and majority rule. The book argues that the ideals of liberal democracy – the individualism of liberal society and the collectivism of majority rule – are not inherently compatible, and this incoherence makes it difficult to build new democracies. The 2006 release, *The Spirit of Democracy,* by Larry Diamond, holds a more optimistic view of the global desire for democracy. The book argues that liberal democracy can spread under the right conditions, namely, in an environment that promotes good governance and shared economic prosperity.

A major message from the book is that the dynamics of reconstructions are changing. The successes of previous reconstruction are not good predictors for future endeavors. Cultural and historical forces that affect reconstruction have changed in the past sixty years. The world has changed since the Cold War when two world superpowers created a geopolitical stalemate. Today, the author argues, failed and corrupt states present the major challenge to America.

After War concludes by offering two alternative means to social and political reform: principled non-intervention and unilateral free trade. The author asserts that these two alternatives offer "liberal means to liberal ends" (173). The book emphasizes that because free trade is voluntary, political change that stems from free trade will lack the bitter aftertaste typical of military occupation. Free trade also provides mutual economic and cultural gains. Countries exchange not only goods and services, but moreover, countries exchange ideas and institutions and incorporate the best aspects of each culture to produce greater efficiency in both societies. The book notes that although non-intervention and free trade are not the most direct route to liberal democracy, these strategies sidestep many of the geopolitical problems that can impede reconstruction.

The book's great weakness is that its discussion overlooks relevant actors in the reconstruction game. *After War* takes a two-pronged approach which looks at agents of the occupying country and indigenous actors in the occupied county. Unfortunately, this approach does not sufficiently address the role of third party actors in the process. Third parties comprise international agents like the United Nations. International institutions play a key role in reconstruction because they influence the foreign relations between countries. Third parties also include regional powers, such as Iran in the case of the Iraq reconstruction. These third parties are relevant players in the reconstruction game. They often have a vested interest in the outcome. In the case of a regional third party, failed reconstruction can produce dreadful spillover effects that threaten a region's stability.

After War is a sophisticated piece of writing. Although the book packs in a lot of theory, it is never inundating. It draws upon many schools of thought and requires the reader to integrate various concepts in order to fully digest the book's message. The book benefits from its evolving structure. After three chapters emphasizing theoretical arguments, the historical narratives of the third section are a welcomed surprise. The author does a great job of reintroducing the central themes in each chapter; and because of this, the book's message resonates throughout. By identifying the motivations behind the actions of participants in post-war reconstruction, one can design policy that will build a cooperative environment and ensure liberal democracy will prosper.

After War is an essential read for students of economics and public policy who wish to gain a better understanding of the forces that affect the spread of liberal democracy. Even the casual reader will find some thought-provoking asides that will add to any coffee table discussion of America's role in the world. The book is a refreshing look at the spread of liberal democracy.

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