

Austrian Economics and Value Judgments: a Critical Comparison with Neoclassical Economics

SANDYE GLORIA-PALERMO* & GIULIO PALERMO**

* LEAD, University of the French West Indies, Guadelupe, French West Indies,

** Department of Economics, University of Brescia, Italy

ABSTRACT *This article points out the limits of Austrian economics as far as the passage from positive to normative economics is concerned. We propose a comparison with neoclassical economics and discuss the different theoretical solutions adopted by these two schools of thought in their legitimization of the normative discourse. The bridge from positive to normative economics is analyzed as resting upon two interdependent pillars, one of a technical nature, the other of an ethical one. In neoclassical theory, these two pillars are, respectively, the Pareto principle and the so-called minimal benevolence principle. In the case of Austrian economics, they are the coordination principle and a set of value judgments considered to be 'quasi-universal'. One problem for Austrian economics is that the coordination principle turns out to be incompatible with process analysis, the latter being a central tenet of the Austrian theory. A second problem, which creates serious difficulties for both schools, has to do with distribution. Our thesis is that whereas the neoclassical solution of the distributive problem is formally consistent (although deeply unrealistic), the Austrian solution is theoretically untenable and based on strong, although implicit, value judgments.*

1. Introduction

The intrusion of value judgments into economic analysis can take place at different levels. As Myrdal (1969) has pointed out, value judgments necessarily come into play at the decisive step of the choice of the problem to investigate. At this level, the only thing to do in the attempt to separate ideological statements from scientific investigation is to explicitly state, right from the beginning, the motivations and reasons that underlie the choice of the field of investigation and the particular definition of the problem adopted. At a subsequent stage, when the aim is to define a body of normative economics to appraise the different policies of a capitalist state, stronger value judgments are implicitly introduced, since capitalism as a system is taken as given: one of these value statements is that remuneration

Correspondence Address: Sandye Gloria-Palermo, LEAD, Campus de Fouillole, BP 270, 97157 Pointe-à-Pitre, Cedex, Guadelupe, French West Indies. Email : spalermo@univ-ag.fr

should depend on performance. That remuneration depends on performance is a *fact* in capitalism (a fact that is not necessarily consistent with the marginalist theory of income distribution based on productivity, but that perhaps depends more on institutional factors and power relations), and the value judgment in question is simply the *moral approval* of it (Harsanyi, 1976). Finally, the approaches that build their positive frameworks on the assumptions of methodological individualism (which is the case of both Austrian and neoclassical economics) often also espouse some form of ideological individualism when passing to normative analysis: it is one thing to say that economic processes and states of affairs must be explained starting from the individual, and another thing to say that the individual is the best judge of his own wellbeing. The former is a methodological position, the latter an ideological one (Blaug, 1980).

In this paper, we do not focus on these levels of intrusion of value judgments in economics. Instead, with Myrdal, we concede that there is an inescapable *a priori* element in all scientific work; and, since we are interested in the legitimacy of different normative positions *within* capitalism and not in the moral legitimacy of capitalism, we also accept, for the sake of argument, the ethical principle that remuneration should depend on performance.¹ Finally, although with greater reservation, we accept the ideological individualism that characterizes both Austrian and neoclassical economics.

Even with these concessions, however, we claim that the passage from positive to normative analysis is still problematic for Austrian economics. To demonstrate this, we propose a comparison with neoclassical economics, and discuss the different theoretical solutions adopted by these two schools of thought in their attempt to legitimize their normative discourse.

The positive question examined consists of the determination of the mechanisms of the working of the market. The normative question that flows from it consists of appraising the desirability of such mechanisms. The passage from positive to normative claims obviously implies the introduction of value judgments, even leaving aside the three levels of ideological intrusion mentioned above. The scientific problem is thus one of minimizing these value judgments by leaning as much as possible on an efficiency criterion, which is presumably neutral from the viewpoint of values. The bridge between positive and normative analysis rests in this way upon two interdependent pillars, one of a technical nature (the efficiency criterion), the other of an ethical nature (a set of value judgments) (see Table 1). From a methodological viewpoint, the normative discourse is legitimate in the same degree as the role of the first pillar is important and that of the second one is weak.

Unlike neoclassical economics, Austrian economics does not constitute a unified paradigm. Before proceeding, it is therefore necessary to identify the basic features of the Austrian tradition and the authors to whom we shall refer. Notwithstanding the differences among Austrian economists, for the purposes of this paper, we may adopt the following characterization: Austrians do not adhere to the formalist program endorsed by neoclassicals, which in general

¹See Palermo (2004) for a critical discussion of the ethics of capitalism and the mystified representations of it presented by Austrians and neoclassicals.

Table 1. The terms of the problem

Positive analysis	Bridge		Normative analysis
	Technical pillar	Ethical pillar	
Theory of market interaction	Efficiency criterion	Strictly necessary value judgments	Desirability of the market

terms aims at determining the conditions under which a competitive equilibrium is reached; the Austrian research program may be defined instead as an attempt to analyze the market mechanism from a dynamic perspective, by defining competition as a disequilibrium *process* rather than a *state of affair*.² This distinctive position directly flows from the specifically Austrian conception of subjectivism (see O'Driscoll & Rizzo, 1985). The economic actor is the engine of change, the dynamic force of the market process; the market process is the outcome of the interaction of individual subjective plans and the theoretical problem is to appraise the mechanism through which the market realizes an efficient coordination of these plans.³ Neoclassical economics, by contrast, starts directly from an equilibrium configuration and examines the relationships between economic variables that characterize such a configuration.⁴

To be more precise, in what follows, by Austrians we basically refer to Mises (with his economic theory of human action), Hayek (with his knowledge-based theory of competition) and their modern followers, that is to say Rothbard (faithful to the praxeological logic of Mises) and Kirzner (at the junction of Mises's principle of human action and Hayek's knowledge problem). We deliberately exclude Lachmann and his followers from this definition: as argued elsewhere (Gloria-Palermo, 1999), Lachmann may well be considered, from a historiographical point of view, the most faithful follower of Menger, carrying the subjectivist program to its furthest implications. However the theoretical results to which this approach leads are extremely troublesome, since it becomes impossible to prove that the market process is equilibrating (Lachmann, 1969, 1986). This is perhaps why Lachmann and his followers are considered by Rothbardians and Kirznerians to be Austrian dissenters (Gloria-Palermo, 2002).

We proceed as follows. In Section 2, we present the pillars of the neoclassical and the Austrian bridges that sustain the passage from positive to normative analysis. A first problem for Austrian economics is that the adoption of the

²The interest in process analysis as a tenet of Austrian economics was clearly stated for the first time by Mayer (1932), who criticized the formalist approach, or 'functional theories', concerned with describing price relations in an equilibrium situation. Mayer proposed instead to focus on the *process of price formation* by adopting a 'causal-genetic' approach.

³Beyond this general proposition, however, substantial differences remain among Austrian authors, concerning in particular two points: (1) the characteristics of the equilibrium reference, which vary from one author to another, and even within the work of the same author from one period to another and (2) the theoretical role played by this equilibrium reference (cf., for instance, Vaughn, 1994).

⁴This is not to say that neoclassical economics is not interested in disequilibrium processes as well, as the research on stability testifies. It means simply that welfare economics is static in its foundations.

coordination principle turns out to be incompatible with process analysis. This problem is discussed in Section 3. A second problem, which creates serious difficulties for both schools of thought, has to do with distribution. The discussion of the distributive issue is perhaps the hardest test for ethical neutrality, since it involves an explicit social appraisal of individual utilities and values. The theoretical solutions offered by the two schools are presented in Section 4. Our thesis is that, whereas neoclassical economics formally passes the test, managing to preserve its theoretical consistency (although at a dear price on the ground of realism), Austrian economics does not pass it, its normative prescriptions resting upon strong, although implicit, value judgments.

2. The Bridge Between Positive and Normative Analysis

The necessity for eliminating value judgments from economic theory is an old idea whose origin goes back to Hume's postulate that it is not scientifically legitimate to deduce *what ought to be* from *what is*. Facts and values should be rigorously separated; science should concentrate on facts and be value-free, whereas value judgments should enter the domain of art, which focuses on what should be. This idea has been advocated in economics through the distinction between positive economics, which should be value-free, and normative economics in which value judgments should be made explicit. The persistence of this position during the 20th century finds its greatest systematization in the doctrine of *Wertfreiheit* (value-freedom) developed by Max Weber. According to Weber, the social scientist should remain value-free and, parallel to this, the moral scientist should develop a coherent discourse on ethical values (*Wertungsdiskussionen*).

The neoclassical response to the problem of value judgments was the development, in the 1930s, of the so-called new welfare economics, based on the efficiency principle of Pareto and the ethical principle of 'minimal benevolence' (see Table 2). Austrian economics has remained attached to the Humean guillotine by proposing, for its part, the 'coordination principle' and what are often called 'quasi-universal value judgments' as technical and ethical pillars of its bridge to normative analysis (see Table 3).

2.1. Pareto Principle and Minimal Benevolence

An influential criticism against the epistemological basis of Pigouvian welfare economics, based on interpersonal comparisons, was raised by Robbins (1932),

Table 2. The neoclassical solution

Positive analysis	Bridge		Normative analysis
	Technical pillar	Ethical pillar	
Competitive equilibrium theory	Pareto criterion	Minimal benevolence	Desirability of competitive equilibrium

Table 3. The Austrian solution

Positive analysis	Bridge		Normative analysis
	Technical pillar	Ethical pillar	
Market process theory	Coordination criterion	Quasi-universal value judgments	Desirability of the market process

who defended the objectivity of economic analysis by proposing to exclude from economics not only value judgments, but also the discussion of value judgments. The idea that Paretian welfare economics is value-free was then defended by Archibald (1959) and Hennisman (1976), who argued that Paretian welfare economics simply studies the effectiveness of alternative configurations, by comparing the utilities of each individual taken separately (cf. Blaug, 1980, ch. 5). No value judgment is required to establish a comparison according to the Pareto principle. Value judgments enter only at the crucial step of normative prescription. To put it differently, to say that *B* is Pareto superior to *A* involves no value judgment; to prescribe *B* when *A* and *B* are both feasible necessarily involves value judgments. But if prescriptions are left aside, the propositions of Paretian welfare economics are susceptible to empirical testing like any other positive proposition. In this sense, according to Archibald, welfare theorems must themselves be considered theorems of positive economics.⁵ If, however, prescriptions are to be derived from these positive statements, then value judgments must be introduced in one form or another: what is needed is, in fact, a simple value judgment according to which it is desirable to eliminate the inefficiency stemming from the existence of a potential Pareto improvement. Such a value judgment flows from the apparently innocuous moral principle of ‘minimal benevolence’: *other things being equal, it is a morally good thing if people are better off.*⁶

This principle, according to the neoclassicals, contains the minimal ethical position necessary to translate the positive statements of the new welfare economics into normative propositions. With the acceptance of minimal benevolence, Pareto improvements are also moral improvements and Pareto efficiency is morally desirable.⁷

⁵This is not entirely true in the sense of Myrdal. Why should one be interested in Pareto efficiency if not for normative purposes? On closer analysis, the perfect competition model itself can hardly be considered a useful tool from a purely positive viewpoint, if one thinks of its highly unrealistic assumptions of perfect information and complete markets. If this model makes any sense, it is only as a response to a normative question.

⁶For a critical discussion on the role of minimal benevolence in the passage from positive to normative economics, see Hausman & McPherson (1996, ch. 4).

⁷In light of the limited applicability of the Pareto criterion, neoclassical economics has developed along two alternative paths: (1) the definition of a social welfare function, which explicitly introduces value judgments and is, among other things, subject to the Arrow’s impossibility theorem if one tries to build it as an aggregation of individual preferences (Bergson, 1938; Samuelson, 1947; Arrow, 1951); and (2) the elaboration of compensation criteria *à la* Kaldor and Hicks, which, however, may be subject to theoretical paradoxes (Kaldor, 1939; Hicks, 1940; Scitovsky, 1941; Little, 1950; Samuelson, 1950).

2.2. Coordination Principle and Quasi-Universal Value Judgments

Despite the tendency of the normative discourse to favor the free market, an Austrian welfare economics can hardly be said to exist (Cowen, 1991, 1994). It is, however, possible to identify some common features among Austrian authors, in particular their reliance upon the principle of coordination as efficiency criterion (if this principle is understood in a very general sense) and their reliance upon a set of value judgments derived from classical liberalism.

Mises (1949) characterizes the Austrian position as a formal ‘praxeological system’. Praxeology is ‘the general theory of human action’ (Mises, 1949, p. 3). It concerns the set of implications logically deduced from the sole axiom of *human action*, according to which *action is purposeful*. The whole set of praxeological sciences is built upon this subjectivist dimension, according to which human choice must be distinguished from passive response to the environment. Praxeological propositions are made up of universally valid statements, completely independent of the personal values of the scientist, for individuals’ goals and means are not the object of investigation. Economics is a component of praxeology that focuses on a particular type of human action: market interactions.

According to praxeology, the criterion used to appraise the efficiency of an economic configuration should meet two requirements, namely subjectivism and value freedom. An economic system is efficient insofar as it allows individuals to follow their subjective plans. Accordingly, an efficient situation is one in which individual plans are fully compatible, namely, a situation of coordination.⁸

As Rothbard (1956, 1976) underscores, praxeology (and thus economics) is not sufficient by itself to enable the theorist to make any normative statement. The passage to policy pronouncements requires the prior establishment of an explicit ethics, as Mises (1949, pp. 153–154) makes clear:

Liberalism (i.e. *laissez-faire* liberalism) is a political doctrine. [...] As a political doctrine liberalism (in contrast to economic science) is not neutral with regard to values and ultimate ends sought by action. [...] The champions of liberal doctrines are fully aware of the fact that their teachings are valid only for people who are committed to their ethical principles. While praxeology, and therefore economics too, uses the terms happiness and removal of uneasiness in a purely formal sense, liberalism attaches to them a concrete meaning. It presupposes that people prefer life to death, health to sickness, nourishment to starvation, abundance to poverty. It teaches man how to act in accordance with these valuations.

According to Rothbard, Mises introduced the minimal possible degree of value judgment in his application of the results of praxeology to politics: ‘his value judgment is the desirability of fulfilling the subjectively desired goals of the bulk of the populace’ (Rothbard, 1976, p. 105). This statement plays the

⁸On closer scrutiny, the praxeologically-based defense of the free market turns out to be built on a tautology: if the unhampered market is defined as a system in which people interact peacefully, without violence, through voluntary agreements (Rothbard, 1962) and if voluntarism is considered ethically good because it enables individuals to fulfill their goals whatever they be (Mises’s minimal value judgment), then, *by definition*, the unhampered market is desirable.

same role as the minimal benevolence principle in the neoclassical framework. It simply means that it is desirable that people can act according to their will. This is nothing other than the classical liberal doctrine that morally supports the values of liberty, of individual sovereignty and promotes the voluntarism of choices. These values are presented as being so innocuous that almost nobody would question them and are in this sense said to be 'quasi-universal'.⁹

Although they discard the praxeological framework, Kirzner and Hayek reach similar results. In line with Austrian subjectivism, these authors replace the Pareto principle with the coordination criterion, which strictly respects 'the individuality of individual purposes' (Kirzner, 1976, p. 85). The notion of coordination is understood simply as the fulfillment of the unaggregated preference structure of the individuals and refers to a situation in which there is full compatibility among individual plans.¹⁰ What is the set of value judgments associated with this efficiency criterion? According to Kirzner and Hayek, what is good is the efficiency criterion itself, or, in other words, coordination is good *per se*. This ethical position is very close to the neoclassical minimal benevolence principle: it is a morally good thing if people realize their subjective plans of action.

At a strict positive level, Hayek and Kirzner analyze the market process as a procedure that is more efficient than alternative arrangements in discovering and disseminating new knowledge that can be used by all the members of the system to modify their plans toward a better fulfillment of their respective ends (Hayek, 1978, p. 180; Kirzner, 1992, p. 60). To put it differently, competition is successful in disseminating new knowledge and leads to increasing degrees of coordination. According to Kirzner and Hayek, this positive result provides scientific support to those who promote a society of unhampered markets as soon as one espouses the liberal doctrine that underpins the values of individual sovereignty and voluntarism of action (Kirzner, 1976; Hayek, 1979).¹¹

To recap, all modern Austrians examined here accept the replacement of the Pareto criterion with the coordination principle if this principle is understood in a very general sense as the fulfillment of individual plans. The associated ethics is made up of a set of value judgments derived from the liberal doctrine and presented as arousing quasi-unanimous consent. The combination of these two

⁹Blaug's comment on this characterization of value judgments is straightforward: 'This is a silly characterization of value-judgments for, by definition, value judgments are ethical prescriptions that are much debated!' (Blaug 1980, ch. 5).

¹⁰Kirzner (1987, p. 11) affirms that 'modern Austrians have converged on the notion of *coordination* as the key to normative discussion'. This concept can already be found in Hayek's (1937) 'Economics and knowledge' and is made explicit in particular in Kirzner (1973).

¹¹The difference however between Mises and Rothbard, on the one hand, and Hayek and Kirzner, on the other, is that praxeology maintains that *by definition* when a person acts, his *ex ante* utility increases (Rothbard, 1976, p. 98). In other words, for Mises and Rothbard the very fact of being engaged in a transaction means that a more coordinated situation is *expected* by the participants. This expectation however does not guaranty that coordination will actually increase, putting some doubt on the coherence of their pro-market normative stance. Hayek and Kirzner on the contrary make the case for the free market on the basis of the positive results of their theories of convergence of the market process, by using the knowledge problem to articulate the idea of convergence toward coordination.

pillars is the ultimate theoretical support of the Austrian normative defense of the free market.

3. The Coordination Principle and Disequilibrium Analysis

The problem of convergence of the market process concerns the effects of market interactions on the compatibility of individual plans: the market process is said to be convergent if it generates processes of revision of individual plans that lead progressively to the elimination of all (eventual) incompatibilities. For the market process to converge, it is necessary that (1) by interacting in the market, individuals modify their plans according to the signals provided by market interactions; and (2) such signals be sufficient to lead individuals to formulate increasingly compatible plans.

Hayek and Kirzner analyze the process of convergence by focusing on the effects of market interactions on individual knowledge. Their idea is that market interactions spread knowledge among individuals leading them to modify their plans towards higher and higher degrees of compatibility. According to Hayek (1945, 1949, 1978), knowledge is time and place specific, and the potentiality of the market process lies in the possibilities it creates for the exploitation, as opposed to the elimination, of such specificities. Indeed, the convergence of the market process does not imply at all that individuals end up with a common knowledge; on the contrary, it is their different knowledge that allows them to formulate plans that, in the course of the market process, become more and more compatible. The process of convergence is specified in more details in Kirzner's theory of entrepreneurship (Kirzner, 1973), where the *alertness* of individuals (of entrepreneurs in particular) assures the convergence of the market process: alert entrepreneurs perceive the existing profit opportunities and by exploiting them, progressively eliminate all the manifestations of disequilibrium.

The objective here is not to criticize the explanatory power of the Austrian theory of the market process.¹² Let us proceed instead *as if* this theory were analytically satisfactory and let us focus on the relation between the theory of convergence and the use of the principle of coordination as a technical pillar of the bridge to normative analysis.

Remember that in the Austrian framework, the market process is, by definition, a process in which individuals *do not* realize their plans. Indeed, the analysis is coherent only to the extent that equilibrium (or full coordination) is not reached, otherwise there would be no market *process*: if plans became compatible during the market process, the process itself would end. The market process is instead characterized by continuous unexpected change, which prevents full coordination from being attained. But now, if the positive framework is developed to analyze the *process*, the normative evaluation too should refer to the *process* and not to a hypothetical (never reached) *final state*.

The contradiction is therefore straightforward: on the one hand, the Austrian theory rests on the necessary assumption that individuals act in a situation of

¹²Criticisms of this sort are developed by Cowen & Fink (1985) and Ioannides (1992), who direct their arguments at Mises's and Hayek's theories respectively.

dis-coordination, but, on the other hand, the market is considered efficient (and desirable). However, if the normative criterion is *coordination*, how can one argue for the desirability of a system that, by assumption, is *dis-coordinated*?

From an analytical viewpoint, this contradiction is the result of the assumption of a dynamic positive framework and of an efficiency principle for normative analysis that resembles too much the static concept of equilibrium. As a matter of fact, if coordination might ever be reached, i.e. if plans might effectively become fully compatible, the concept of coordination would coincide with that of equilibrium. On the other hand, if the concept of coordination is defined in such a way as to allow some forms of plan incompatibilities, then it can no longer be accepted as a pure efficiency pillar of the bridge to normative analysis.

The hypothesis that full coordination is never reached considerably undermines the internal consistency of the coordination principle as a technical pillar of the bridge between positive and normative analysis, and casts doubts on the Austrian defense of the free market. Rigorously speaking, the Austrian theory implies a negative evaluation of the free market system: if the market process is presumed to work as the Austrian theory represents it, and its efficiency is to be appraised according to the coordination principle, then the free market system is inefficient (and, thus, according to Austrian quasi-universal value judgments, undesirable).

A way out of this dilemma might be to adopt a soft interpretation of the Austrian theory: one might argue that, among all institutional systems, the free market is perhaps the least bad. But is it possible to make such an institutional comparison within the Austrian framework? As argued above, the coordination principle is inadequate, since it is inconsistent with one of the methodological tenets of the Austrian theory (in the Austrian dynamic framework, individuals, at least partly, do not realize their plans). The only way out would be to measure the *degree of dis-coordination* in order to compare different systems from the viewpoint of their relative ability to make individual plans compatible. Then what the Austrians would have to prove is that the unhampered market process produces *less dis-coordination* than other forms of social and economic organization (planning for instance). Such a project, however, raises two problems: (1) the problem of identifying the agents whose plans can remain unfulfilled without undermining the overall desirability of the system (or, symmetrically, identifying the agents whose plans must be fulfilled in order that the system be considered desirable); (2) the problem of determining a critical measure of plan inconsistency marking the formal passage from coordination to dis-coordination. These problems however cannot be handled without introducing (1) a criterion for interpersonal comparisons, and (2) value judgments about the content of individual plans that are necessarily stronger than the uncontroversial quasi-universal values. All this would put a weight on the bridge between positive and normative analysis that the coordination principle and the quasi-universal value judgments cannot sustain.

4. The Problem of Distribution

One of the fields of normative analysis in which ethical positions can hardly be left aside is the discussion of distribution. In capitalism, production and distribution are two interdependent processes. Private ownership of the means of production

implies that economic agents can claim a reward for the services of their productive factors. Participation in the production process is thus itself based on the conditions that regulate the distribution of the product. Special cases apart, interventions in the sphere of production have distributive effects, and interventions in the sphere of distribution have effects on production, so that production and distribution cannot, in general, be analyzed separately.

At an intuitive level, the interdependence of production and distribution may create problems as far as value-neutrality is concerned, since even apparently technical issues, such as the determination of the conditions for efficient production, have distributive implications. This means that even normative prescriptions at the production level might not be neutral in terms of distributive justice.

Neoclassical and Austrian economics offer different solutions to this problem: neoclassical economics has managed to determine the conditions under which production and distribution can be analytically separated, and in this way, has found a formal solution to the problem of value judgments. The neoclassical solution however is obtained at a dear price in terms of realism. Austrian economics, on the contrary, has developed a theory based precisely on the interdependence between production and distribution; this approach, however, surreptitiously introduces value judgments.

4.1. Production and Distribution in the General Equilibrium Model

In the general equilibrium model, production and distribution are interdependent: given technology, individual endowments and preferences, the equilibrium configuration simultaneously determines both production and distribution. The fact that production and distribution are determined simultaneously might create ethical problems if the production solution (which, under opportune conditions, is Pareto efficient) were not also ethically acceptable. However, thanks to the two fundamental welfare theorems, neoclassical economics can formally separate the questions of production and distribution. Let us see how.

These two theorems state that (1) general equilibrium is Pareto efficient and (2) every Pareto efficient allocation can be obtained as a solution of a general equilibrium model.

If the minimal benevolence principle is accepted, these theorems have direct normative implications. The first theorem implies that, other things being equal, perfectly competitive equilibria are morally desirable and market imperfections that interfere with their achievement are morally undesirable;¹³ among the 'other things that must be equal' in order to translate the Pareto principle into a moral principle, there are, however, things that are more ethically controversial than minimal benevolence, like justice and, more specifically, distributive justice: a Pareto improvement that leads to distributive injustice might be morally undesirable. Here, however, the second welfare theorem enters the scene: all moral concerns about distributive justice can be solved by adjusting initial endowments (by means of lump-sum taxes/transfers) and letting perfect competition do the rest.

¹³Of course, given the unrealism of the general equilibrium model, this theoretical defense of perfect competition is not necessarily also a defense of real markets.

These theorems constitute a powerful apolitical shield against potential ethical attacks. There exist two separated problems, the production of a big pie and the distribution of the pie. The second fundamental welfare theorem states that for each ethical judgment about the criterion for the distribution of the pie, the market mechanism leads to the attainment of the largest possible pie. If we are not satisfied with the existing distribution, the neoclassical economist argues, let us change it, but, after that, it would be irrational (and immoral) to be satisfied with a pie which is not the largest one possible. Therefore, although production and distribution are interdependent processes, the two fundamental theorems of welfare allow us to analyze them separately.¹⁴

It is appropriate at this point to draw attention to some conditions that are necessary for the two welfare theorems to hold. There must be: (1) no increasing returns to scale, (2) no externalities and (3) no public goods. Notwithstanding the lack of realism of these conditions (the problem is not simply that there exist markets which do not respect these conditions, but rather that there is practically no market in which the three conditions hold), neoclassical economics formally solves the problem of distribution.¹⁵

Some skepticism should also be directed at the supposed value-freedom of the approaches aiming at more realistic analyses developed as extensions of the pure Walrasian model. Here, we refer not only to the neoclassical literature on the second best, but also to the New Keynesian and the New Institutional economics, in which imperfect information, bounded rationality or some other imperfection prevents Pareto efficiency from being obtained in the Walrasian framework. In these conditions, the prescription of Pareto improvement cannot be considered neutral because its distributive implications have to be taken as they come. If we do not like a particular distributive arrangement, the argument 'let us change it, but, after that, it would be irrational (and immoral) to be satisfied with a pie which is not the largest one possible' no longer works. In this case, there is thus a theoretical contradiction: on the one hand, the theoretical context is a complex one in which the two welfare theorems do not hold; on the other hand, however, Pareto efficiency is still used as a criterion for normative prescriptions.

To recap, the passage from the positive interpretation of Paretian welfare economics to the normative one is based on the acceptance of a relatively weak value judgment (the minimal benevolence principle). This implies that Paretian

¹⁴One manifestation of the possibility of separating production and distribution can be found in the so-called Coase theorem – formulated by Stigler (1989), who drew on the work of Coase (1960) – which asserts that the initial distribution of private property rights does not influence the production configuration of the system. Notice however that Coase himself, in his 1960 article, insists upon the paradoxical character of such a result, which depends on the highly unrealistic assumption of the absence of transaction costs.

¹⁵It should also be recalled that the comparative static method presupposes not only the existence of an equilibrium, but also its uniqueness. Moreover, in order for the model to serve as a normative guide for intervening in real markets, equilibrium should also be stable. Unfortunately, as Sonnenschein (1973) has shown, multiple and unstable equilibria are perfectly compatible with the assumptions of the Arrow–Debreu model. For a critical evaluation of the theoretical results within the general equilibrium framework, see Guerrien (1985).

welfare economics cannot be considered rigorously value-free. However, by restricting its operational relevance to a context in which the two welfare theorems hold, neoclassical economics can go much further on the normative ground, overcoming one of the main problems of welfare economics: the problem of distribution.¹⁶

4.2. *Production and Distribution in the Austrian Theory*

The interdependence of the processes of production and distribution is at the core of Austrian normative economics. Let us examine the main contributions of Mises and Hayek on this issue.

In line with the coordination principle, Mises defines the efficiency of an economic system as depending on the possibility for individuals to pursue their goals freely in the spheres of consumption and production. Individual sovereignty is thus not limited to consumers, but is extended to the whole set of economic agents. Consumers' ability to achieve their goals depends on the ability of producers to offer the appropriate goods. Efficient entrepreneurs are those who best anticipate the wishes of consumers and find the best means to realize them. In this way, the efficiency of the overall system amounts to the efficiency of production. The efficiency of production, in turn, is the result of a process of competition among entrepreneurs motivated by the prospect of making profits:

The more successfully [the entrepreneur] speculates the more the means of production are at his disposal, the greater becomes his influence on the business of society. The less successfully he speculates the smaller becomes his property, the less becomes his influence on business. If he loses everything by speculation he disappears from the ranks of those who are called to the direction of economic affairs. (Mises, 1936, p. 206)

Contrary to the neoclassical position synthesized in the welfare theorems, Mises rejects any kind of redistribution, i.e. any distribution different from that which directly flows from the production process. The production process, in its (supposed) efficient working, determines income distribution too. Efficient production is an indisputable social objective, which implies that its consequences in the sphere of distribution must be accepted as they come. In this way, the *Wertfreiheit* principle assumes a very particular form in Misesian comparative analysis: it leads to the neglect of any autonomous relevance of the distributive issue.¹⁷

¹⁶If the first and second welfare theorems provide a solution to the problem of analytically separating production and distribution, the impossibility theorem (Arrow, 1951) affirms that there is no logically infallible way to aggregate the preferences of diverse individuals and there is thus no logically infallible way to solve the problem of distribution by means of democratic voting. This result (known also as the third welfare theorem) qualifies the message of the first two welfare theorems about the supposed desirability of *laissez-faire* in capitalist democracies: it is true that the market mechanism does not raise distributive problems if the two welfare theorems hold, but it is also true that because of the third theorem, such a mechanism is incompatible with the principles of democracy.

¹⁷Rothbard (1956, p. 251) puts it as follows: 'There is no distributional process apart from the production and exchange processes of the market; hence the very concept of "distribution" becomes meaningless in the free market'.

According to Hayek, the efficiency of an economic system depends on the solution it can offer to two general problems: the problem of incentives and the problem of knowledge. These problems are strictly interrelated. An efficient economic system should display a mechanism that allows individuals to discover the most relevant bits of knowledge, and an efficient incentive device should ensure that scarce resources be allocated to the most competent agents with respect to their skill in discovering, diffusing and using the relevant specific knowledge. According to Hayek, the market process, if not hampered, automatically transfers resources from less competent individuals (with respect to their contribution to the knowledge problem) to more competent ones, efficiently solving in this way the knowledge problem. This result is based on the twofold assumption of non-appropriability of knowledge and appropriability of profits: as soon as new knowledge becomes available, the whole society may enjoy its beneficial effects in terms of social coordination, but the discoverer alone enjoys its beneficial effects in terms of profits.

Market incentives are efficient only if there are no obstacles to the appropriation of profits. In Hayek's theory, the economic objective of society can be defined as the *production of a big pie* (or, rather, the *discovery of a big pie*) and, consequently, scarce resources should be allocated according to the contribution of each person (in terms of knowledge discovery) to the production of the pie. Kirzner (1989, p. 8) summarizes the Austrian position as follows:

The market system is seen in this discussion as not only producing a social 'pie', but at the same time slicing up that pie and assigning the respective slices to the specific individuals who participate in the market process. [...] In fact the size and composition of the pie are as much dependent upon the pattern of income 'distribution' as the latter depends on the size and composition of the pie.

Unlike the neoclassical case, redistribution is considered, by definition, scientifically illegitimate.¹⁸ Although both neoclassical and Austrian economics accept the general principle that remuneration should depend on performance, the latter pushes the principle further, putting even the notion of redistribution out of any ethical inquiry. The fact that the only tolerated social objective is efficient production in a context in which distribution is just a by-product of production allows clarification of the Austrian position with respect to the distributive issue: Austrian economics does not really neglect the distributive problem, it simply approves the free market solution and denies the legitimacy of any redistributive intervention.

5. Conclusion

In as much as the Pareto principle and the coordination principle can be applied without the need to make interpersonal comparisons, some of their proponents have maintained that they are value-free. This position is, however, untenable.

¹⁸According to Hayek (1976), social justice is a harmful concept. For Hayek, it basically means one thing: the protection of particular groups in the sense of maintaining or increasing their material position. Any intervention of this kind leads to the destruction of the foundations of the market order, i.e. to be more precise, to the destruction of the incentives of each person to discover what is of value to others.

At a general level, both neoclassical and Austrian economics rest on value judgments, not least because the principles that remuneration should depend on performance and that the individual is the best judge of his own wellbeing are themselves value judgments. These general principles, however, are still insufficient to allow neoclassical and Austrian economics to build a legitimate normative theory.

In the attempt to introduce only the value judgments that are strictly necessary to support a normative position, the neoclassicals and the Austrians have introduced, respectively the minimal benevolence principle and the quasi-universal value judgments. Even with these explicit ethical positions, however, the normative discourse remains largely unfounded in both the approaches, although for different reasons (see Table 4). In the case of neoclassical economics the main problem is one of realism. In the case of Austrian economics it is one of internal consistency.

In order to point out these problems we have considered the ways in which the two approaches discuss the distributive issue, which constitutes the field in which the value judgment problem takes its starkest form.

In capitalism, production and distribution are interdependent processes. In principle, this interdependency is sufficient to create problems for the economist in his attempt to provide an objective normative criterion at the level of production (because this interdependency implies the acceptance of the distributional consequences of production). To overcome this problem, neoclassical economics has determined the conditions under which production and distribution can be analyzed separately and, in doing so, has confined its applicability to an abstract world that has little in common with the real one (in which production and distribution continue to be interdependent). What is scientifically questionable, however, is that having affirmed the legitimacy of the Pareto principle in the particular abstract world in which the two welfare theorems hold, neoclassical economists have then pretended that the Pareto principle can also be applied to the real world.

Austrian economics, on the contrary, has accepted the theoretical challenge by building its theory precisely on the interdependence of production and distribution. But it failed to meet the challenge because its position on distribution cannot be coherently defended simply on the basis of the weak quasi-universal value judgments. The ethical pillar has thus proved unable to support the Austrian

Table 4. Results

	Positive analysis and the technical pillar	Normative analysis and the ethical pillar
Austrians	Inconsistency between disequilibrium analysis and the coordination criterion	Surreptitious introduction of additional value judgments in the analysis of distribution
Neoclassicals	Consistency between equilibrium analysis and Pareto efficiency	Coherent but unrealistic analysis of the distributive issue

normative position in favor of the free market, and the result is a normative framework in which strong value judgments are indeed present, although awkwardly hidden.

However, the consequences of the fragility of the other pillar are perhaps even more disastrous for the internal consistency of the Austrian theory. The coordination principle indeed ends up being logically inconsistent with Austrian positive analysis, and this inconsistency even impedes the appraisal of efficiency (which is the first step for the appraisal of desirability).

At the analytical level, what is interesting is that the Austrian normative criterion, if rigorously applied, ultimately leads to opposite results with respect to the liberal doctrine that it supports: all that can be deduced from the Austrian theory is a negative evaluation of free competition. Moreover, any attempt to go beyond this negative result requires the introduction of stronger value judgments and creates internal consistency problems for those who affirm that no such values should be introduced.

We therefore conclude that the normative engagement of Austrian economics in favor of the free market and *laissez-faire* is the result of a mix of strong ideological positions and weak theoretical elements and is ultimately untenable on scientific grounds.

References

- Archibald, G. C. (1959) Welfare economics, ethics, and essentialism, *Economica*, 26, pp. 316–327.
- Arrow, J. K. (1951) *Social Choice and Individual Values* (New York: Wiley).
- Bergson, A. (1938) A reformulation of certain aspects of welfare economics, *Quarterly Journal of Economics*, 52, pp. 310–334.
- Blaug, M. (1980) *The Methodology of Economics* (Cambridge: Cambridge University Press).
- Coase, R. H. (1960) The problem of social cost, *Journal of Law and Economics*, 3, pp. 1–44.
- Cowen, T. (1991) What a non-Paretian welfare economics would have to look like, in: D. Lavoie (Ed.) *Economics and Hermeneutics* (London: Routledge).
- Cowen, T. (1994) Austrian welfare economics, in: P. Boettke (Ed) *The Elgar Companion to Austrian Economics* (Aldershot: Edward Elgar).
- Cowen, T. & Fink, R. (1985) Inconsistent equilibrium constructs: the evenly rotating economy of Mises and Rothbard, *American Economic Review*, 75, pp. 866–869.
- Gloria-Palermo, S. (1999) *The Evolution of the Austrian Tradition: From Menger to Lachmann* (London: Routledge).
- Gloria-Palermo, S. (2002) Introduction, in: S. Gloria-Palermo (Ed.) *Modern Austrian Economics. Archaeology of a Revival*, Vol. 1 (London: Pickering & Chatto).
- Guerrien, B. (1985) *La Théorie Néoclassique* (Paris: Economica).
- Harsanyi, J. C. (1976) *Essays in Ethics, Social Behavior and Scientific Explanation* (Dordrech: Reidel)
- Hausman, D. & McPherson, M. (1996) *Economic Analysis and Moral Philosophy* (Cambridge: Cambridge University Press).
- Hayek, F. A. (1937) Economics and knowledge, *Economica*, 4, pp. 33–54.
- Hayek, F. A. (1945) The use of knowledge in society, *American Economic Review*, 4, pp. 519–530.
- Hayek, F. A. (1949) The meaning of competition, in: *Individualism and Economic Order* (London: Routledge & Kegan Paul).
- Hayek, F. A. (1976) *Law, Legislation and Liberty: a New Statement of the Liberal Principles of Justice and Political Economy*, Vol. 2: *The Mirage of Social Justice* (Chicago: University of Chicago Press).
- Hayek, F. A. (1978) Competition as a discovery procedure, in: *New Studies in Philosophy, Politics, Economics and the History of Ideas* (London: Routledge & Kegan Paul).

- Hayek, F. A. (1979) *Law, Legislation and Liberty: a New Statement of the Liberal Principles of Justice and Political Economy*, Vol. 3: *The Political Order of a Free People* (Chicago: University of Chicago Press).
- Hennipman, P. (1976) Pareto optimality: value judgment or analytical tool, in: J. S. Cramer, A. Heertje & P. Venekamp (Eds) *Relevance and Precision: From Quantitative Analysis to Economic Policy* (Amsterdam: North-Holland).
- Hicks, J. R. (1940) The valuation of social income, *Economica*, 7, pp. 105–124.
- Ioannides, S. (1992) *The Market, Competition and Democracy: a Critique of Neo-Austrian Economics* (Brookfield, VT: Edward Elgar).
- Kaldor, N. (1939) Welfare propositions of economics and interpersonal comparisons of utility, *Economic Journal*, 49, pp. 549–552.
- Kirzner, I. M. (1973) *Competition and Entrepreneurship* (Chicago: University of Chicago Press).
- Kirzner, I. M. (1976) Philosophical and ethical implications of Austrian economics, in: E. Dolan (Ed) *The Foundations of Modern Austrian Economics* (Kansas City: Sheed & Ward).
- Kirzner, I. M. (1987) The economic calculation debate: lessons for Austrians, *Review of Austrian Economics*, 2, pp. 1–18.
- Kirzner, I. M. (1989) *Discovery, Capitalism, and Distributive Justice* (Oxford: Basil Blackwell).
- Kirzner, I. M. (1992) Subjectivism, freedom and economic law, *South African Journal of Economics*, 60, pp. 44–62.
- Lachmann, L. M. (1969) Methodological individualism and the market process, in: E. Streissler (Ed) *Roads to Freedom: Essays in Honour of Friedrich A. von Hayek* (London: The Free Press of Glencoe).
- Lachmann, L. M. (1986) *The Market as an Economic Process* (Oxford: Basil Blackwell).
- Little, I. M. D. (1950) *A Critique of Welfare Economics* (London: Oxford University Press).
- Mayer, H. (1932) Der Erkenntniswert der funktionellen Priestheorien [trans. as ‘The cognitive value of functional theories of price’], in: I. M. Kirzner. (Ed.) *Classics in Austrian Economics*, Vol. 2 (London: Pickering & Chatto, 1994).
- Mises, L. von (1936) *Socialism: an Economic and Sociological Analysis* (London: Jonathan Cape).
- Mises, L. von (1949) *Human Action, a Treatise on Economics* (London: William Hodge).
- Myrdal, G. (1969) *Objectivity in Social Research* (New York: Pantheon).
- O’Driscoll, G. & Rizzo, M. (1985) *The Economics of Time and Ignorance* (Oxford: Basil Blackwell).
- Palermo, G. (2004) *Il Mito del Mercato Globale. Critica delle Teorie Neoliberiste* (Roma: Manifestolibri).
- Rizzo, M. (1992) The morality of profits, and the struggle for existence, *Working Paper 92–17* (C. V. Starr Center for Applied Economics, New York University).
- Robbins, L. (1932) *An Essay on the Nature and Significance of Economic Science* (London: Macmillan).
- Rothbard, M. N. (1956) Towards a reconstruction of utility and welfare economics, in: M. Sennholz (Ed) *On Freedom and Free Enterprise* (Princeton: D. Van Nostrand).
- Rothbard, M. (1962) *Man, Economy and State: a Treatise on Economic Principles* (Princeton: D. Van Nostrand).
- Rothbard, M. (1976) Praxeology, value judgments, and public policy, in: E. Dolan (Ed) *The Foundations of Modern Austrian Economics* (Kansas City: Sheed & Ward).
- Samuelson, P. A. (1947) *Foundations of Economic Analysis* (Cambridge, MA: Harvard University Press).
- Samuelson, P. A. (1950) Evaluation of real national income, *Oxford Economic Papers*, 2, pp. 1–29.
- Scitovsky, T. (1941) A note on welfare propositions in economics, *Review of Economic Studies*, 9, pp. 77–88.
- Stigler, G. J. (1989) Two notes on the Coase theorem, *Yale Law Journal*, December, pp. 631–633.
- Sonnenschein, H. (1973) Do Walras’ identity and continuity characterize the class of community excess demand?, *Journal of Economic Theory*, 6, pp. 345–354.
- Vaughn, K. (1994) *Austrian Economics in America: the Migration of a Tradition* (Cambridge: Cambridge University Press).