BOOK REVIEWS

Welfare Economics and Externalities in an Open-Ended Universe: A Modern Austrian Perspective

Roy E. Cordato
Dordrecht, Netherlands: Kluwer Academic Publishers, 1992, 140 pp.

Roy Cordato has written a provocative and valuable book. He has dealt exhaustively, competently, and patiently with important and subtle issues. His treatment is, at key points, thoroughly original, and he has consistently tackled difficult conceptual themes with rare depth of insight. As a scholarly contribution to modern Austrian economics, Cordato's book is a solid performance, demonstrating impressive mastery of both the Austrian and neoclassical literatures. It is very much to be hoped that this fine work will spark additional research into the difficult, but crucially important areas of economic and social theory on the part of the new generation of Austrian economists.

This reviewer finds himself extremely impressed by this work and particularly by Cordato's devastating critique of standard welfare economics and (with relatively minor reservations) by the statement of his own carefully crafted concept of catallactic efficiency. Yet it must be confessed that this reviewer leaves the book not without a certain sense of unease. The overall message of the book, for all its courageous debunking of orthodox sacred cows, for all its sensitive extensions of Austrian insights, yet raises certain troubling questions. The quality and integrity of this work demands that these questions be honestly raised. The following pages briefly set forth the core of Cordato's own contribution, spell out the problems with which this reviewer finds himself confronted in Cordato's presentation of his thesis, and suggest (with some confession of elements of vested interest on the part of this reviewer) how what is most important and original in Cordato's valuable thesis can perhaps better be preserved within a restated "coordination" approach to welfare economics—an approach which Cordato considered but felt compelled to set aside.

Cordato's signal contribution consists in his superb articulation of the Austrian critique of mainstream welfare economics and of his deploy-

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ment of that critique to develop his own concept of catallactic efficiency. (Cordato devotes much effort to exploring the welfare implications of externalities, by diligently and consistently applying his criterion of catallactic efficiency. It is, however, in this part of his work that those problems arise to which we shall turn in the next section.)

As is made clear in the book's title, we live in an open-ended universe of continuous trial and error, of continuous disequilibrium generated by continual changes in the underlying data, reflected in continual changes in the knowledge and expectations of market participants. In this open-ended world, individuals pursue their own objectives in the light of what they believe to be the opportunities made available by other individuals pursuing *their* objectives. To judge the efficiency of such a system *as a whole* in the same way an individual may judge the efficiency of his own plans for action—as standard welfare economics seeks to judge the efficiency of the system—is to do violence to the reality of the market. An individual judges the extent to which his means-allocation pattern is geared towards the efficient achievement of his objectives (in terms of his own ranking of the relative importance of these conflicting objectives). A society never does face such a problem: (a) there is no single social "mind" that ranks the relative "social" importance of the objectives independently pursued by the individual members of society; (b) with information unavoidably dispersed among the members of society, there is no single mind to which all the relevant resources and all the relevant objectives are simultaneously given. The device employed by mainstream welfare economics—i.e., the setting up of the model of perfectly competitive equilibrium as the perfect standard of efficiency, against which all real world situations can in principle be compared—is wholly irrelevant to the conditions of real world open-endedness and thus offers no valid basis for reaching welfare judgments. "By abstracting from the passage of time and by focussing on a perfectly competitive end-state, the orthodox welfare standard judges market phenomena using a model of the world in which many of the most important elements of real market are defined out of existence" (p. 5).

A particularly interesting feature of Cordato's criticism is that it clearly identifies in the Coasean approach to social-efficiency questions exactly those central features that render mainstream welfare economics unacceptable. Despite the validity of Coase's own criticism of Pigouvian welfare economics in regard to the treatment of externalities, the truth remains, as Cordato cogently makes clear, that Coase believes it possible to treat the social benefits and costs (generated in the course of behavior that results in external effects) as if they are objectively comparable (see also R. Cordato 1992; and G. North 1992: chap. 3 and 5).

Instead of this mainstream perspective on social efficiency, Cordato develops his own concept of catallactic efficiency, building on the writings of Friedrich v. Hayek and other Austrians who have perceived the market economy as a catallaxy and emphasizing the Austrian tenet of subjectivism and methodological individualism. "A catallaxy is a social order generated by the market activities of separate individuals and organizations, each pursuing their own purposes" (p. 58). Efficiency theory cannot, in dealing with a catallaxy, make reference to any social hierarchy of values. Nor, most importantly, can it "make assumptions concerning the amount of knowledge that is 'given' to market participants" (p. 60). Catallactic efficiency is to be judged "by the extent to which the catallaxy encourages individuals existing in a social context, to pursue their own goals as consistently as possible" (p. 62). Such encouragement must proceed by providing the institutional setting, (a) "that will allow individuals to gather the necessary physical resources" for the achievement of their goals, and (b) that "will best facilitate the use and discovery of information" (p. 63).

In Cordato's discussion it turns out that the institution of private property with freedom of competitive entry provides the ideal setting "within which individuals, as social beings, are able to most efficiently pursue their goals" (p. 65). Within this setting, "mutually agreed upon market prices will reflect as much information about market participants' preferences, expectations, and perceptions of resource scarcities as possible" (p. 67). Catallactic inefficiency occurs when market prices have captured "erroneous" information about supply and demand conditions, resulting from "false perceptions of individual traders" (p. 68). The incentive to make entrepreneurial profit and to avoid losses tends to bring about corrective revisions of these false perceptions. "Because of the open-ended nature of catallaxy, though, this is a continuously unfolding process where new, false information is always being filtered out" (p. 68). Catallactic inefficiency may, however, also occur as a result of institutional flaws in the security of private property rights. It is only the latter type of inefficiency that may be relevant to policy—for example, in regard to the treatment of certain externalities.

Cordato pursues these valuable ideas with careful consistency in seeking to apply them critically to the manner in which externalities provide mainstream welfare economics with justification for interventionist policies supposedly designed to enhance social welfare. It is here that some disturbing questions arise, to which we now turn.

It is clear that Cordato's criterion for catallactic efficiency is concerned with a totally different dimension of social well-being than that dealt with in standard welfare theory. Standard theory is concerned with enhancing some variant, or proxy for "aggregate utility." Cordato's criterion, denying any scientific meaning to concepts such as aggregate utility (or any of its proxies), confines itself to the question of enhancing the environment within which individual goal-seeking behavior can be facilitated in society (especially by facilitating the discovery of relevant information upon which mutually beneficial exchanges can be based). As Cordato seems to recognize at several places, the questions dealt with in standard welfare economics are in fact questions that must be dealt with *as ethics*, rather than as questions of economic science. "Every time an economist views policy analysis in terms of social costs and benefits, the ends of different actors are being compared to determine their relative 'value' to society. From the perspective taken in this book," Cordato comments, "this is inherently an ethical question, the answer to which cannot be grounded in economics" (p. 113). That observation is entirely appropriate.

But to identify certain question as being beyond the scope of the tools of economic science is, of course, not at all the same as to assert that economic science has demonstrated that these questions are not worth asking. To show that the criterion of catallactic efficiency fails to identify any *catallactic inefficiency* in a particular market phenomenon (let us say, a good not having been produced as a result of free-rider complications) is of course not to declare that economic science has demonstrated the *ethical desirability* of that phenomenon. The methodological individualism that, for Austrians, is the beginning of economic science—and thus of Cordato's carefully devised criterion for catallactic efficiency—does not and cannot declare it illegitimate, *as a matter of ethics*, to treat society as a single, integrated entity attaining some level of aggregate well-being (somehow conceived, ethically, in supra-individual terms). Economic science is neutral with respect to such ethical questions. There is nothing in Cordato's valuable notion of catallactic efficiency that is necessarily inconsistent with these obvious observations. Yet, at certain stages in his arguments, Cordato seems to come perilously close, in effect, to denying them.

In all candor, it must be conceded that this complaint against Cordato is not easy to document. Although Cordato freely and frequently declares situations, pronounced as inefficient by standard welfare economics (and therefore as calling for corrective intervention), as in fact being fully efficient and therefore justifying no such intervention, this can (and presumably should) be interpreted as meaning that *from the point of view of the catallactic criterion,* no intervention is called for. But the overall thrust of his exposition leaves one decidedly uncomfortable. Cordato does seem to believe that where a free-market outcome cannot be pronounced as traceable to catallactic inefficiency, this at once categorically establishes the economic error of any interventionist policy in regard to that situation.

In dealing with the free-rider explanation of why a good might go unproduced in a market, for example, Cordato insists that this "has no normative implications. A production level of zero is no less optimal than any positive level of production. In fact, so long as that outcome reflects a market process that was the result of decisions made within the context of the [ideal institutional setting], the process *and therefore the outcome* would have to be judged efficient" (p. 83, emphasis added). Here Cordato has perhaps transgressed the spirit, at least, of his catallactic efficiency criterion. Surely his criterion refers strictly to the environment within which the market *process* unfolds, rather than with any efficiency or inefficiency of market *outcomes*. If citizens are convinced (on ethical, not scientific grounds) that an outcome in which some pure public good goes unproduced would be unanimously pronounced sub-optimal (as compared with some hypothetical state in which that good were somehow being produced, say, through state subsidy), Cordato cannot pronounce them to be *wrong;* he can merely say that the catallactic efficiency criterion gives the economic scientist qua scientist no license to comment on the situation. It may be true that the economic scientist may point out that the transactions costs required, within a market, to organize defenses against the free-rider problem (and thus to permit market production of the good) may be too formidable to justify spontaneous market production of the good. The market environment has indeed not "failed"—but neither has it succeeded (under the circumstances here postulated) in arranging the flow of resources along channels unanimously held (on *ethical* grounds, remember) to be the most desirable ones for society as a whole.

There is an irony here, which Cordato at one stage (p. 84) seems himself to have sensed. After all, the very institutional setting required for catallactic efficiency, viz., the securing of the rights of private property and freedom of competitive entry, could hardly have emerged without somehow overcoming (usually in fact by the use of state coercive power) obvious public goods problems. Cordato properly argues that we can discuss the efficiency of catallactic processes only on the assumption that the right to trade somehow already exists. But once we recognize that extra-(catallactic)-efficiency considerations may have to be invoked to justify the institutions that permit catallactic efficiency to flourish, it becomes difficult abruptly to ignore the possibility of extra-(catallactic)-efficiency considerations that may, under specific circumstances, justify suspension of or interference with market processes.

Our point is not, of course, to argue for such interventions. It is easy, having doffed one's scientist's hat, to supply possible *ethical* grounds for resisting such interventions. We wish only to point out that Austrian welfare economics must necessarily—for all the good reasons so well articulated by Cordato—be confined to a rather narrow band of questions. The fact that these questions are important ones, and the fact that Austrian arguments refute standard welfare theory based over-ambitiously and uncritically on imprecise conceptual foundation, renders Cordato's catallactic efficiency criterion a valuable and significant tool. It would be a great pity if the value of Cordato's work comes to be dismissed as result of a possible (and entirely unnecessary) impression that exaggerated claims are being made on behalf of the criterion.

It is with some diffidence that I suggest (as a result of the concerns just expressed) the following modification of the way in which Cordato's catallactic efficiency criterion is presented. I believe that the criterion will gain in understandability and will carry more conviction if presented explicitly in terms of the *coordination* of individual decisions in respect of exchange. What is meant by coordination, in this context, refers, it must be emphasized, strictly to the *process* through which individuals, between whom exist the potential for mutually gainful exchange, *come to be made aware of this mutually gainful possibility.* Once it is made clear that "efficiency" is being discussed solely in terms of the promotion of gainful trade, there is little danger that demonstrated absence of "inefficiency," will be interpreted as implying a claim that we live in the best of all possible worlds.

Cordato does consider such a coordination formulation, but rejects it on a variety of grounds. The principal objection (see p. 52) appears to be the following. Let us imagine two separate markets for the same good, each in complete equilibrium. With different prices for the same good in these two markets, an entrepreneur now discovers the profit possibility and moves to exploit it by buying in the one market and selling in the other. Surely this discovery and profit-making move are consistent with catallactic efficiency—yet it appears to involve the discoordination of plans for exchange that had been made earlier within each of the separate markets. Apparently a catallactically efficient event may be discoordinating. I believe this reasoning to be incorrect—or, rather, to be based on an apparent misunderstanding of the relevant coordination concept.

It is quite true that an entrepreneurial discovery may disrupt plans that had been made for exchange. A buyer who had confidently expected to buy the good (let us imagine it to be a resource) in the low-price market, now finds that the sellers are selling to the new entrepreneur at a higher price. It may certainly be said that the entrepreneur has disappointed those potential resource buyers. And, as Cordato points out, such disappointment may extend to those who might have bought the goods (from the aforementioned potential resource-buyers) that might have been produced by using the low-priced resource (that has now become a higher priced resource, used only for other goods). What must be emphasized, however, is that such disruptions of plans and such disappointments have not discoordinated exchange plans, in the relevant sense, one iota. The new entrepreneur by bringing together sellers (in the low-price market) with buyers (in the high-price market) has coordinated these buyers and sellers (by making them aware of the possibilities for mutually gainful exchanges—these possibilities having already existed unbeknownst to the potential beneficiaries).

Those buyers in the low-price market, disappointed in their hopes of buying the resource cheaply, have not been "discoordinated" (although, to be sure, they have been disappointed and their plans have been disrupted). This is because discoordination does not, in the present sense of the term, refer to the disappointment of *plans*; it refers to the frustration of potentially gainful exchange between possible participants. What has happened in the presently considered case is that the entrepreneur who engages in arbitrage between the two markets has revealed *that no possibility for mutually gainful exchange exists any longer at* *the old low price.* This indeed disappoints those who made their plans in error but it has not frustrated any present possibilities for mutually profitably exchange. Catallactic efficiency may well bring disappointment to those who have made entrepreneurial errors; but it never, insofar as it promotes entrepreneurial discovery, discoordinates (in the important sense here described).

The adjective "catallactic" is used by Cordato to remind us of Hayek's important distinction between "catallaxy" and "economy." By focussing on the coordination involved in catallactically efficient market processes, we can add emphasis to the goal of effectuating all opportunities for mutually gainful *exchange.* Emphasizing this goal will on the one hand draw attention to the genuine power and clarity of Cordato's catallactic efficiency criterion; on the other hand, such emphasis will discourage misinterpretation of the criterion as implying more than it can possibly deliver. This can only enhance the worth of Cordato's valuable contribution to Austrian economics.

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References

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Combating Poverty: Innovative Social Reforms in Chile during the 1980s

Tarsicio Castaneda
San Francisco: ICS Press, 1992, 259 pp.

This book summarizes and analyzes the remarkable reforms of social welfare programs that occurred in Chile during the 1980s. The reforms covered are in the areas of education, health and nutrition, housing, social security, and interrelations between the central and local governments. While there is a considerable emphasis on reforms related to poverty alleviation, two of the areas—social security and intergovernmental relations—have rather little direct relevance to poverty. The social security reform gave some emphasis to the alleviation of poverty, but the social security system is primarily a middle-class issue or perquisite.

The author states (p. 13) that the social reforms were based on five common principles:

> First, the government should target subsidies to the poorest segment of the population rather than attempt to meet the basic needs of the entire population. . . . Second, social services should be