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Social Contract and Introspection. A Proposal for an Austrian Welfare Economics

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A considerable part of research in economics deals with issues of a normative character. Economists are supposed to know better than the average lay people, for example, when the central bank ought to expand the quantity of money, how an employer ought to make his hiring decisions, or even which health care services the government ought to provide to the poor. All these problems should presumably be solved so as to make the well-being or welfare of the human beings involved as large as possible. This individualist emphasis is even so strong that economists regularly term "welfare economics" the whole body of their prescriptive inquiries.

Economists are conspicuously eager to give their scientific advice and tell how things ought to be done in an endless number of various situations. This might seem at first sight unexpected as normative statements always depend on moral valuations and the scientific status is thus less secure than in positive statements. The enterprise of welfare economics has retained its fascination because the permission to convey one's own recommendations gives the individual practitioner more scope to do something clearly useful and, to concede the brutal fact, to find good jobs in the labor market.

The members of the Austrian school of economics are often mentioned as strict adherents of valuefree economic reasoning. For example, Kirzner (1976, p. 75) maintains that "the tradition within Austrian economics has been strongly in support of *Wertfreiheit* as a cardinal precept of scientific propriety." In so far as the practice of scholarly work is concerned, the striving for valuefree economics seems often little more than fine rhetoric. Austrian economists appear to be much as enthusiastic as the rest of the profession to insert personal opinions in their scientific treatises and to blur the distinction between positive and normative statements.

Austrian economists are particularly known for their assured belief in the superiority of the market order in solving social problems. The praise of free markets and the antagonism toward government action is in fact so pronounced that in the eyes of some observers Austrian economics is, rightly or wrongly, mere capitalist apologetics worthy of little scientific attention. The Austrian theorist with perhaps the most unqualified views in this regard is Ludwig von Mises, who may argue inside the covers of one and the same book that the scientific character of an economic inquiry "precludes all standards and judgments of value" and that such inquiry proves "the market economy is the only feasible system of social cooperation" (1933, pp. 36, 196). Hutchison (1981, p. 221) avails himself in full of the tempting opportunity and, prior to citing a similar pair of phrases from the book, says that "there would seem to be a considerable contrast, not to say contradiction, between the following two statements of Mises".

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Austrian economists are fully aware that others consider their policy prescriptions often extremist and at least inconsistent with their criteria of demarcating neutral science. Still it seems pertinent to argue that the upholders of the school have not shown enough interest in the criticisms. Vaughn (1995, p. 109) hits the crux of the problem by pointing out that "Austrians have not spent much time developing a corresponding theory of welfare to support their view of the superiority of market economies over interventionist regimes." There are attempts to find a firm Austrian foundation for normative economics, but as Cowen (1994, p. 307) concludes his dictionary entry, "Austrian welfare economics is an area in disarray."

My aim in this paper is to take Austrian welfare economics one step away from the state of confusion. I examine in the following where the Austrians should seek for a foundation of their welfare economics or whether such a search is at all a worthwhile undertaking. The examination serves mainly the purpose of refining the thought of the Austrian school, but it is of advantage to the members of other schools as well. It points out the need of carefulness that economists of every description are inclined to ignore in their normative statements, and the proposal it arrives at is worth incorporating in one shape or another in any economic theory.

There is hardly any disagreement among Austrian economists that subjectivism is the most fundamental premise in their school of thought. The subjectivism of values means that only individuals know how valuable different things are to them, how worthwhile various goals are to strive for and, generally, how "good" can be distinguished from "bad". As an inevitable consequence of their insistence on subjectivism, Austrians are compelled to give up any kind of a welfare economics in which they pronounce, on behalf of others and as scientific truths, what is the best thing for these people to do.

An Austrian economist, anxious to draw normative conclusions but loyal to his methodological principles, can at most try to find out means to make the individuals reveal their own subjective valuations. The point of departure for my subsequent inquiry is the requirement that the government ought to enforce merely laws which all the members of society can unanimously approve. Laws are constraints on behavior common to all individuals, and we have permission to call any particular law good for the people, or society at large, only when indeed everyone subscribes to the appraisal. In the market, individuals have an opportunity to express their views in the sales contracts they choose to enter into with each other. On the institutional level, the social contract serves a similar purpose. Through a chain of this kind of reasoning, the theory of social contract seems to become settled as the basis of Austrian welfare economics.

One of the problems with contractarianism is that due to prohibitive contracting costs the members of a large society will never be able to reach in practice an agreement on the terms of an extensive social contract. My proposal in this paper is that, instead of awaiting for the choices of individuals, the economist should construct the details of the contract in her own mind by imagining herself in the place of those conceived to participate in the process. We are then using our capacity for what Adam Smith calls in *The Theory of Moral Sentiments* "sympathy", the faculty of human beings to understand the feelings of their fellow beings. According to Smith (1976, p. 9), even though "we have no immediate experience of what other men feel", we can by placing ourselves in another's situation conceive "what we ourselves should feel in the like situation" and "become in some measure the same person with him". The contractarian speculations do not entitle an Austrian economist to call for the government to enforce the conceived changes. They merely enable him to forcefully participate in a social debate with his peculiar insights into economic reality.

To begin with I discuss in the next section the main elements of two rival approaches of Austrian economic theory and argue for the superiority of an empiricism, based upon proficient introspection, toward an orthodox apriorism. I then outline my proposal for an Austrian welfare economics and consider its major weaknesses. For the purpose of illustration, I apply the contractarian method to find out a few plausible rules of taxation. Before the concluding remarks I examine briefly alternatives to the theory of social contract.

1. The tenets of Austrian economics

According to one of the principal insights of Austrian economic theory, a society of human beings constitutes an open-ended process of spontaneous discovery. This process is subject to continuous and often abrupt changes, and it is too complex to make a full explanation, to say nothing of a prediction, of any of the details feasible. A community of scientists, such as Austrian economists, are in a similar vein under the influence of perpetual evolutionary forces. They are not necessarily capable of reaching a shared view of the basic postulates of their paradigm and, even if an agreement once came true, the hard core could change at any time. A vital purpose of such ambiguities is that "by providing reserves against some potentially disruptive threats to our structures of knowledge" they make the paradigm more capable of novelty (Loasby, 1991, p. 38). In spite of the apparent difficulties, I attempt in this section to briefly review the main tenets of Austrian economics as the exponents of the school, or at least the majority of them, seem to understand the methodological presumptions of their reasoning.

Austrian economics, as it has been practised since the days of Carl Menger, rests upon the basic idea that the events in society are consequences of the actions of human beings. In line with this individualist way of thinking, Austrian economists never say, except for by mistake or out of laziness, that Finland exports newsprint or that a falling national product increases the rate of unemployment. Social phenomena as economists take an interest in them always require the intervention of a human faculty.

An economic analyst understands an observed phenomenon, such as a rising unemployment rate, in terms of the intentions of the people who have produced the effect as an intended or unintended consequence of their actions. This age-old method of *Verstehen* may at first sight appear inapplicable because, as in fact Austrians themselves repeatedly point out, the intentions like everything else in the human mind are the private knowledge of the individuals. In spite of the subjectivism of knowledge, an economist is able to make at least something out of the observed actions thanks to a more or less similar structure of her own mind. When doing her work, an economist imagines herself in the place of acting individuals and "endows subjects with characteristics that she knows from intuition and experience to exist in the minds of human actors" (Gunning, 1991, p. 20). The relation of an economist to the subject of her inquiry is a bit like the relation of two botanists to a species of plant from which the two men are able to draw reliable conclusions even though they study two different individuals of the species on the opposite sides of the globe.

The views of individual Austrians on methodology become strongly divided when they start discussing how far introspection ought to be extended. According to the orthodox apriorist position, the ends of human beings are absolute givens of which we should state in our capacity as economists nothing beyond what we think they are. It is illegitimate in pure praxeological deduction to try to figure out why economic actors act in particular ways, how they might increase their well-being by acting otherwise, or what their actions will probably be in the future. In the words of the author of praxeology, "it takes the ultimate ends chosen by acting man as data, it is entirely neutral with regard to them, and it refrains from passing any value judgments" (von Mises, 1966, p. 21).

The extreme apriorist branch of Austrian economics is not very useful for the purposes of this paper as it explicitly denies the legitimacy of normative statements, let alone a systematic body of welfare economics. More importantly, not a single economist seems to have followed the prescripts of the approach in actual practice, and by now few appear to believe in it even in theory. Quite apart from this judgment, the apriorism provides a golden point of departure for understanding the alternative position, or complementary one might argue, that Austrian economists usually keep to in various degrees in their inquiries.

According to the empiricist position that inspires my subsequent analysis, an Austrian economist is allowed, and indeed he ought, to penetrate the human mind deeper and to push his theleological explanation further than in apriorism. The more we draw away from pure apriorism, the better we had evidently be conversant with the body of knowledge, psychology, that deals specifically with the workings of the human mind. The tough question is not whether an economist should know psychology, but rather how much he should know it and employ in his research efforts. Even without any special psychological training, an economist often obtains a fairly good idea of the motives for observed behavior by means of his own intuition and experience. Extensive expertise in psychology is, on the other hand, certainly not a disadvantage in economic analysis. To mention one common example, an economist hardly ruins his inquiries by knowing about the "availability effect", that is, the observation that the alertness of people to and their preference for buying, say, a health insurance tends to increase after one of their friends becomes all at once seriously ill.

Austrian economists seem to consider unnecessary the knowledge of a professional psychologist in order to succeed in their normal work. For one thing, the protagonists of the apriorist position are as expected wholly against psychological exploration of any description. In their view, "economics does not need to employ the terminology of psychology" (von Mises, 1966, p. 123), "praxeology and psychology are distinct and separate disciplines" (Rothbard, 1976a, p. 32), and in a welfare economics of the kind I put forth later in this paper "all attention is shifted to economically irrelevant problems in the psychology of knowledge" (Hoppe, 1990, p. 260). Dogmatic criteria of demarcation such as these lead to a dead end in a science like economics, and I prefer to look for orientation in the writings of other authorities.

F. A. Hayek represents among Austrian economists a considerably more permissive view on the role psychology in economic reasoning. He may once have thought that "if conscious action can be 'explained', this is a task for psychology but not for economics" (Hayek, 1948, p. 67). However, later he has made substantial use of psychological ideas in his theory of the market order, and he has extended economics well beyond what he calls the pure logic of choice. He has even published an elaborate treatise on theoretical psychology (1952), the argument of which one specialist in the field advises to investigate as “indispensable to any adequate understanding of Hayek’s work” (Gray, 1984, p. 3). While developing his theory of entrepreneurship, Israel M. Kirzner has met the need of a deeper understanding of the human mind on a more practical level. It would be desirable in his view to go beyond the common sense stage “to identify with precision those human qualities, personal and psychological, which are to be credited with successful entrepreneurial alertness, drive, and initiative” (Kirzner, 1985, pp. 25–26). Further examples of a similar desire to lean on psychological knowledge are not difficult to find in the existing Austrian literature.

The difference between apriorism and empiricism manifests itself clearly in the outlook on ignorance and uncertainty. An apriorist states to start with that the uncertainty of future events is a corollary of the action axiom, as with full knowledge individuals could rationally choose only one course of action like mechanical marionettes and no genuine action would exist at all (Selgin, 1988, p. 47). The apriorist goes on by arguing, for example, that *if* an individual chooses to protect himself against the vicissitudes of life through a purchase of a health insurance, he must pay at least as much as the supply price of the seller. It is not the economist’s business to engage in speculations about whether any particular person, or persons in general, in fact purchase an insurance, what the price might be or, least of all, when an insurance ought to be taken out. For an empiricist, on the other hand, no reason of principle prevents inferences on these lines and a prediction, for example, that in a specific situation moral hazard destroys the insurance market in whole. It is now time to move to a search for the foundations of a welfare economics that is in harmony with the empiricist branch of the Austrian school.

2. The idea of a conceptual social contract

Society is an abstract and ubiquitous entity that affects all its members in many different ways and on many different levels. In an individualist social theory it is natural to require that for anyone to call a society “good” with justice it must be such from the point of view of virtually every single member. The knowledge of what provides the best human well-being, the most of welfare or anything one means by goodness is in the shared Austrian view inherently subjective. The first major proposition of Austrian welfare economics is, therefore, that the private knowledge of the individuals has to be somehow first revealed before an economist can present his appraisals of welfare.

There are not too many ways individuals are able to express their opinion of a society, or the institutions that define it. They may show their approval of an alternative either by supporting it in a referendum or by moving to, or remaining in, the society where it is in force. The result of a referendum is unambiguous only in the special case that all vote for the same alternative and, in other words, perfect unanimity prevails of what is good and desirable. We are not capable of comparing the well-being of separate individuals as we cannot even measure it, and one dissenting vote is enough to destroy the referendum as a means to call out the subjective knowledge of the participants.

The results of the migration from the realm of one society to another depend crucially upon the constraints of the competitive process (Vanberg, 1994, p. 83). Individuals should logically be in a position to pronounce their views of the goodness of these constraints as well and to participate in an international social contract of sorts. Whichever way individuals reveal their valuations, expressed unanimity seems to remain the only and final criterion of welfare. Rothbard (1956, p. 261) reaches by and large the same conclusion in the last paragraph of his classic paper where he maintains that "the tool of Demonstrated Preference, in which economics deals only with preference as demonstrated by real action, combined with a strict Unanimity Rule for assertions of social utility, can serve to effect a thoroughgoing reconstruction of utility and welfare economics." Rothbard applies the criterion to the market, but as to him "the free market is the name for the array of all the voluntary exchanges that take place in the world" (p. 250), his welfare appraisal comprises social contracting as well.

It is all too well known among social scientists that an actual social contract is not, and will never be, feasible in the real world. The contract remains an imaginary construction because we do not know how to make a large number of individuals in practice know enough of the relevant alternatives, consider them carefully and, to crown it all, reach an agreement. This consideration alone is for apriorists enough to give a deathblow to an Austrian welfare economics. Empiricists are more patient on the strength of their readiness to yield to slight compromises.

If it is of no avail to us to wait for real action in order to find out the subjective knowledge of the individuals, we had perhaps best rely on another though a less reliable method. My proposal in this paper for an Austrian welfare economics is that we imagine ourselves in the place of the participants in a social contract and try to figure out on the analogy of our own mind what they *would* probably come to. The ability to understand the human mind is an indispensable requirement in the kind of introspective exercise I am suggesting here, and more intimate knowledge of psychology, both theoretical and experimental, would not certainly hurt the economist.

The proposal of James M. Buchanan in his seminal paper (1959) for a welfare economics is much on similar lines. His starting point is strict individualism, and accordingly "no 'social' values exist apart from individual values" (p. 118). He also underlines that "utility is measurable, ordinally or cardinally, only to the individual decision-maker. It is a *subjectively* quantifiable magnitude" (p. 108). The actual ranking of alternatives remains unknown "until and unless that ranking is revealed by the overt action of the individual in choosing" (p. 108). While diagnosing a specific proposal for a social policy change, the job of the economist is to make "a judgment as to its 'efficiency' on the basis of *his own* estimate of individual preferences" (p. 109). Judgments of this kind "must always be considered as tentative hypotheses offered as solutions to social problems" (p. 110). Finally, the hypotheses "are tested by the measure of agreement reached" (p. 119), and "consensus among individual members of the choosing group becomes the only possible affirmation of a 'social' value" (p. 118).

The main difference between the proposal of Buchanan and my own is that whereas the former was aimed to dampen the illusions of omniscience that social welfare functions had brought to mainstream economics, the latter is directed toward excesses in the other extreme that subjectivism has brought to Austrian economics. Both proposals are compromises between two quite different assumptions of human knowledge, and they endeavor to establish a program that works in practice rather than to spare dogmas of orthodox theory. There are strong Austrian elements in much of Buchanan's work but, as one might expect, in the eyes of Austrian economists "at times his writing seems strictly positivist" (DiLorenzo, 1990, p. 195). From an Austrian point of view, the most vulnerable part of Buchanan's theory of social contract is its neglect of the nature of contracting as an open-ended process of discovering new solutions to social problems. We will shortly see that this criticism applies to the version developed in my paper as well.

The construction of a model constitution to which the existing reality in society is then compared consists conceptually of two separate stages. The primary task of a welfare economist is to figure out the general procedures that the participants would probably prefer in their social contracting. The tracing of the more detailed decisions made under the procedural framework is a more routine job that is suitable for the practical man conversant with the facts of time and place.

The participants are not able to design a very complex social contract and to decide, using the examples of Sen (1970, p. 152), whether X ought to have pink walls rather than white or whether Y ought to sleep on her back rather than her belly. They presumably soon realize that the contract must of necessity take the form of fairly general rules of law instead of particularized case-by-case orders. The idea behind such rules is to define by help of non-specific attributes, or in terms of classes, the kinds of behavior that are permitted or, more often, prohibited in society, and to put off the classification of actual actions until the post-constitutional stage. The rules are typically applied in a large number of cases which share some common features, or belong to the same classes of cases, but which still differ from each other in significant respects. At best the rules enable the members of society to distinguish right from wrong in whatever cases happen to appear, and they cover a far broader range of human conduct than anyone is able to specify in advance.

Without an opportunity to observe an actual contracting process, we do not know for sure what the people choose to agree. There are several reasons to believe that the contract consists of more or less general principles of justice that provide an overall framework for the actions of individuals rather than detailed instructions of how each one of them ought to act. First, contracting costs prevent the attainment of perfection exactly in the same way as Williamson (1985, p. 32) explains such costs cause problems in the market. Second, participants are able to anticipate at least in some degree the consequences of concrete or itemized directions on their own well-being and they therefore fail to reach an agreement on which directions to introduce (Brennan and Buchanan, 1985, p. 29). Third, a very specific contract restricts the freedom of the individuals to adopt novel courses of action at the post-constitutional stage and leads to the loss of those unforeseen discoveries that constitute in the Austrian view the driving force of a dynamic social order (Hayek, 1973, p. 11). General rules are on these grounds for the benefit of the people because they make the contract simple and manageable, the effects of following them in future instances are difficult to predict, and they leave room for everyone to use his or her initiative in an unknown number of new circumstances. A common sense of justice requires that whenever a particular case is decided according to a rule, all other cases belonging to the same class are from then onward decided according to the same rule, or the decisions are "universalized" (Hayek, 1967, p. 168).

The more general the rules are, the less capable the contracting individuals are of predicting the effects on their own well-being and the greater interest they have in the overall effects of the rules. An appropriate formulation of the contracting procedures thus brings the separate interests of the participants closer to their common interest. In so far as a perfect goal congruence is attained through a successful contract design, it in fact no longer matters who participate in the process. The arrangement turns, as it were, all into perfect replicas of each other and induces them to strive for a good society where, in the often-cited expression of Hayek (1976, p. 132), “the chances of anyone selected at random are likely to be as great as possible”. An important thing to note is that I am here not assuming human beings to be something different from what they actually are. I am simply seeking a form of contract that, besides being accepted by them, converts ordinary self-interested mortals into capable of social contracting or, in the words of Harsanyi (1977, p. 45), of “a genuine moral value judgement”.

If we mean by a moral theory something “according to which man should act but does not necessarily always act” (von Mises, 1966, p. 95), and if we think it leans on “the presumptions that moral actions should be unselfish and that moral principles should be fair” (Mackie, 1977, p. 126), the theory of social contract outlined above is certainly a moral theory. The members of society do not necessarily understand without knowledge of contractarianism or “constitutional attitude” what it is in their best mutual interests to do, and the promises they give in the course of contracting are unselfish at least in the sense that they act as if in the common interest, and the rules they agree upon are applied equally to all. I do not go further from here, but there are contractarians such as Rawls (1971) who do and who load individuals with all sorts of moral obligations in social contracting (Boucher and Kelly, 1994, p. 9).

If we choose to develop an extended moral theory like the Rawlsian one, we can avail ourselves of the same introspection that is used in the contractarianism of the present paper. For example, while pondering whether the individuals ought to choose a system where everyone pays from his own pocket for any medical attention he requires, we might benefit from giving a thought to the feelings of one having a child with a fatal disease (Mackie, 1977, p. 90). In the theory of this paper, the most we get is what the contracting individuals think is worthwhile, and morality is nothing beyond the general opinion so revealed.

The discovery of general rules reduces conflict and promotes order by making the participants in a social contract uncertain of the effects of the contract on their own position, or by erecting a “veil of uncertainty” between the pre- and post-constitutional stages (Buchanan and Tullock, 1962, p. 78). Sometimes uncertainty is an impediment to agreement. In so far as the participants do not understand the working of a rule or they understand it in different ways, they may fail to approve the rule even if it offers prospects for the largest average welfare. The task of a welfare economist is in such situations to try to find out the truth through critical analysis and to inform the people of his findings (Vanberg, 1994, p. 175). Those in charge of educating the people should be careful to refrain from indoctrination that endangers the moral legitimacy of the contract (Fishkin, 1989, p. 190).

Another important means for an economist to help the attainment of unanimity is to look for prominent rules on behalf of the contracting individuals. Such rules stand out among all the others as somehow natural and seem in one way or another unique as soon as someone understands to explicitly state them. The power of "focal points" to help solving problems in human interrelations has been mainly studied in coordination games, but as Sugden (1995, p. 548) rightly concludes in his paper, "focal-point reasoning seems to be applicable to games in which there are also conflicts of interest". An understanding of the logic of the human mind assists greatly, as usual, the attempts of the economist to offer her own proposals for solution. My contention is in line with the statement of Sugden in the report on a controlled experiment he made with two of his colleagues that, while formulating the salient rules of coordination, "in part we were guided by introspection" (Mehta et al., 1994, p. 169). I will mention a few examples of the application of these ideas in a later section.

3. The limits of contractarianism

A conceptual social contract as the basis of ethics and politics is a captivating idea that has caught the interest of many social philosophers in the past. Whatever initial enthusiasm there may be for contractarian thinking, it often disappears when one makes an attempt to put the theoretical principles into practice. I examine in the following the main criticisms that have been passed upon the kind of contractarianism brought up in this paper. I also discuss plausible replies to the critique and prospects for a feasible welfare economics founded on the contractarian agenda.

The most fundamental argument against a social contract is that a large number of people are probably unable even in theory, to say nothing of reality, to attain unanimity about any of the conceivable versions of the contract. A welfare economist meets with the problem while testing the popularity of alternative rule designs, workable in his own judgment, and learning time after time that always something is wrong with each of them in the opinion of at least some individuals.

There are several reasons for the lack of agreement. First, as Austrian economics makes exceedingly clear, individuals are ignorant of much that would be useful for them to know, and they may reject a rule design simply because they fail to understand its way of working. I argued above that an economist can help remove such an obstacle to agreement through research and education. Second, self-interested individuals may refuse to approve a design in the hope that by so doing they strengthen their bargaining position and succeed in making another design, more to their own advantage, coming true. Here the role of an economist is to seek better rules the effects of which on particular individuals are more difficult to predict or which command wider support for other reasons. Third, there are always individual persons, a very small minority to be hoped, who are for mental or moral causes incapable of reasonable dealings with other human beings and who are apt to sabotage any options subjected to them for a decision. A solution is to give up strict unanimity in welfare appraisals and to apply a rule that requires slightly less than 100% agreement (Buchanan, 1959, p. 119).

Another problem with a social contract is that the shape it takes depends greatly upon the *status quo* from which the participants start their contracting (Sugden, 1993, p. 147). An economist might try to figure out how the participants would decide in an imaginary prevoting where to start, or which initial entitlements a shared opinion would allow each one to bring along to the negotiations. Here the rule of unanimity provides no solution because the participants in the voting are very cognizant of the effects of the alternatives on their own position and they are not even in principle able to reach an agreement on the issue (Barry, 1984, p. 592). In conditions of this kind, there is nothing for a welfare economist but to propose a rule design, in his honest view acceptable to all, separately for each conceivable *status quo* or, if one is assigned from outside, a design consistent with its entitlements.

From the Austrian point of view, a major flaw in contractarianism is that the establishment of social institutions tends to be conceived in it as a deliberate choice between given alternatives, or as an act of planned design. In reality, institutions develop through a gradual process of evolution in the course of which novel solutions to social problems, maybe known so far by no single individual, are constantly experimented and the best are more or less spontaneously adopted as a result of the trial and error. Unanimity remains the final test of judgment but in a way different from what the theory of social contract seems to suggest at first sight; “To become legitimized, the new rules have to obtain the approval of society at large—not by a formal vote, but by gradually spreading acceptance” (Hayek, 1979, p. 167). Rather than any comprehensive list of detailed rules of law, the social contract is in this conception a general framework, or even a mere way of thinking, which is known from experience to create favorable conditions for institutional discoveries and commands therefore general approval.

There are good reasons to expect that rational participants in a social contract comprehend at least partly the power of the evolutionary mechanism. Aware of the limits of their own reason, they are presumably ready to opt for political procedures that enable the introduction of practices sometimes most displeasing to them at the outset. Also an economist designing the social contract on behalf of the individuals ought to see the need of creating a framework for a process of institutional discovery and making sure that “the individuals within the model can develop rules” (Boettke, 1994, p. 253). For us living under a constant and unexpected change, it will never be enough to find a world that is perfect from the point of view of our current knowledge, but we must always be prepared to adjust the world to whatever changes happen to occur in that knowledge.

The neglect of the open-endedness of social evolution, touched upon above, is by no means the only kind of a bias that an economist can smuggle into his speculations about a unanimous social contract. The contractarian economist leads us astray also when he abuses his method on purpose and presents, for example, his own personal attitudes as the opinions of the people. Without an access to any foolproof method to test them, we have an occasion to beware of the “bland assumptions of universal agreement” that in the view of Rothbard (1970, p. 136) “are one of the most irritating bad habits of the economist-turned-ethicist.” A means to fight misuses of the contractarian approach is to try to free the people from the belief that a conceptual unanimity is alone enough to make the enforcement of the envisioned changes morally legitimate, a belief that to Buchanan (1977, p. 295) represents “a gross perversion of the contractarian position, properly understood.” Much is attained by subjecting all proposals for changes to a critical peer review and by continuing discussion at least until the most obvious oddities have been discarded.

We have been so far dealing with criticisms of the contractarian vision that are mainly about the difficulties in applying it in actual practice. According to some critics, the philosophy is untenable on much more fundamental grounds. In the view of Russell Hardin, for example, contractarianism, “one of the most implausible of all political theories” (1995, p. 204), is alone incapable of establishing what is morally right, and it adds “nothing to our evaluation of the goodness of a political or legal order” (1988, p. 114). Hayek (1960, p. 104) advances a similar argument against the opinion of the majority which “certainly provides no answer to the question of how a man ought to vote or of what is desirable”. Contracting individuals may vote for “wrong” causes because they fail to understand the effects of their decisions, their ends are determined by the cultural evolution they happen to be exposed to, or simply because they do not have moral feelings. As an unfortunate consequence, the lack of moral considerations relieves the people from moral obligations to obey the social contract and jeopardizes in this way the enforcement of its stipulations (Barry, 1984, p. 589).

The need of an ethical theory is most evident when one is choosing from which *status quo* to start the contractarian analysis (Rothbard, 1976b, p. 97). An economist evades the problem, as I explained earlier, by repeating her exercise separately for each conceivable alternative, or by confining herself to the alternative given to her by someone else. My choice in the next section is to examine acceptable rules of taxation by assuming that the participants in a social contract start their dealings from an initial position of natural rights. There exist in social philosophy alternative theories of why the people ought to be entitled to such natural rights, and also some Austrian economists have tried to develop an ethical theory on natural law foundations. According to an idea most interesting for the purposes of a contractarian welfare economics, the principles of natural law are somehow prominent or self-evident (Sugden, 1986, p. 95). On these grounds we have reason to believe that, among all other conceivable rules of law, the rules of natural law are the most likely to obtain unanimous support in a social contract. An implication of this for the subsequent analysis is that there should presumably be particularly strong reasons every time the government introduces a tax and thence deviates from the rights of the people to their private property.

4. Toward acceptable taxation

Many economists and other social scientists take a favorable view of the general idea of a social contract that I have been elaborating so far. Even if the significance of the criterion of unanimity, the general rules of law and other concepts of the contractarian paradigm are by now well enough understood, systematic attempts at an operational welfare economics, or a discovery of what the good law might be in practice, are remarkably few in number. My purpose in the present section is to fill this gap a little bit and at the same time to clarify the main notions of the Austrian version of contractarian welfare economics by means of a concrete example.

The specific aim of the exercise is to find out through introspection, what kind of a system of taxation the participants in an imaginary social contract probably come to or whether any taxes at all are to their mind acceptable. I assume that there already exists a government, maybe as a result of a takeover sometime in the past, which enforces the natural rules of private property and creates in this way conditions for the emergence of a spontaneous order of the market. Taxes mean violation of the principles of natural law as, for example, Rothbard (1978, p. 51) defines it, and taxes are thus justified, given the setup of our inquiry, only to the extent the individuals can conceivably consent to them. It is for the individuals both impossible and unnecessary to attempt agreement on exactly how much each ought to pay taxes, and they are instead in search for general rules under which the government is then supposed to proceed. Central to the derivation of such rules in the following is that they "impose strict limits on governmental powers of taxation" (Gray, 1986, p. 78).

Informed participants in the social contract hardly fail to recognize the enormous potential that a government with a taxing power has for enhancing human welfare. There are many social services that the market will never provide in adequate quantities, and even the market itself cannot exist if the government lacks the resources requisite for enforcing the natural law. It seems conceivable with little uncertainty that the overwhelming majority of the contracting individuals approve without resistance a taking of some of their possessions in exchange for the anticipated benefits. Everyone "knows that compulsion can be applied only if it is applied to all including himself" (Hayek, 1979, p. 44) and a refusal to pay taxes deprives him, like all the others, of the opportunity to gain from a legal reform. The infringement of private property through taxation is logically necessary as there is no property without law, and taxation is thus a very unique, not to say prominent, exception to natural law. The negligible grounds for fearing an escalation of arbitrary power, as soon as the privilege of taxation is conveyed to the government, contribute toward a common opinion sympathetic to taxes.

Individuals learn to pay for goods in the market, such as horses and apples, a price that is equal to the marginal benefit the goods bring to them. Benefits do not here refer to any inmost feelings of utility or other fundamental categories, but they are simply the demand prices that market participants are willing to pay for the goods under the prevailing distribution of property. Following the same logic, the individuals ought to pay for the public goods provided by the government a price, or a tax, that is consistent with their felt marginal benefits. Unfortunately, this utopian train of thought leads us nowhere as we are unaware of any reliable means to ascertain demand prices without real exchange. In contradistinction to prices in the free market, taxes form inescapably according to more or less arbitrary principles and keep the economy far away from what neoclassical economists love to call a Pareto optimum.

In so far as we do not know how much each of the members of society gains from public goods, we must take, one might argue, everyone's benefit as equal. This gives us the first idea of a conceivable principle of acceptable taxation: all ought to pay a tax of the same size. One of the problems with a lump-sum tax is that no sum is more prominent than any other, except for zero, and the participants in the social contract most probably fail to attain unanimity about enforcing one particular tax instead of another. The choice of the tax might in theory be left to the government. However, such an unlimited power would subject the taxpayers to inordinate risks as it could lead to the confiscation of someone's whole property. We are compelled to look elsewhere for finding a tenable solution.

A way to avoid excessive tax burden in individual instances is to make the tax depend on the ability of individuals to pay it. For example, the tax might be levied according to a specified rule on the income of individuals rather than per head. Conceptually, income is anything that enhances the wealth of an individual, such as the pleasure of reading a good book or attending a nice party. In taxation income must be more narrowly defined so as to secure objective measurement. Catallactic income obtained in the market, such as wages and interest, is a good candidate for the tax base of a safe society even though many difficult problems of valuation await satisfactory solution. To mention one example, the pecuniary remuneration drawn by a worker may greatly exaggerate the extent of her true economic income if the work is dangerous and exposes her to a risk of serious injury. Deductions of this kind can be accepted only when tax authorities are able to measure them objectively and no remarkable scope is left for arbitrary estimation.

It is fairly apparent that the participants in the social contract do not allow the government to introduce excise taxes on individual goods such as gasoline and candy. We can without much difficulty imagine the individuals coming to this conclusion because such commodity taxes are discriminatory and therefore arbitrary. One could argue that the tax on gasoline is actually a compensation that motorists are made to pay for the harm they cause to the property of other people. If this is indeed the aim of a tax, we should call it indemnification and submit it to the same rules of law by which damages are generally enforced in the market system. The contractarian argument against excise taxes falls down when they are uniformly levied on all goods and services, but then we actually have an expenditure tax.

There is no immediate reason to regard either income or expenditure tax as a superior form of taxation. It should make little difference whether taxes are paid when income is earned or when it is expended. The choice between the two tax bases mainly depends upon which one of them lends itself to more reliable measurement in practice. A notable advantage of the expenditure tax is that it removes the need to estimate changes in real wealth, an exceedingly tough operation prerequisite for a reliable measurement of income (Meade et al., 1978, p. 186). Irrespective of what are the pros and cons of the alternative tax bases, perhaps only one should be chosen instead of a combination of the two. If the government is free to increase the number of tax bases at will, it can more easily expand total tax revenue without excessively burdening any single tax base and, in this way, arousing political resistance (Brennan and Buchanan, 1980, p. 49). The most effective way to prevent a proliferation of tax bases is to limit them to one which is a very prominent figure.

Besides the tax base, the contracting individuals must determine the rate of taxation. If we should pick one integer from between 0 and 100, excluding both extremes, 10 certainly leaps to the eye because most people have ten fingers and this round figure therefore occupies a prominent place in our thinking. In their bold flat-tax plan, Hall and Rabushka (1995, p. 122) propose for psychological reasons a uniform rate of 19 percent for all income, the integer next smaller to the double of 10. In the probable case that individuals fail to attain unanimity about any particular rate and they hand over the choice to the government, they almost certainly give only a permission to use one tax rate. In the view of Hayek (1960, p. 314), the great merit of proportional taxation is that “it provides a rule which is likely to be agreed upon by those who will pay absolutely more and those who will pay absolutely less”. Even if the government is empowered to choose the tax rate, the system of proportional income or expenditure taxation is safe when compared to lump-sum taxation. Since tax rules are applied equally to all, including the agents of the government themselves, the tax rate will not be set so high as to cause the confiscation of anyone’s whole income.

Proportionality alone is an inadequate safeguard against confiscatory practices because it does not prevent the government from discriminating in the distribution of public services. Buchanan correctly points out that this holds good even without overt favoring of group interests on the expenditure side if the incomes of taxpayers are unequal in size. His solution is to introduce additional constitutional constraints on the level of taxation (Buchanan, 1979, p. 355). The contracting individuals probably meet insurmountable difficulties in agreeing upon any particular level, and the most they get is perhaps a general provision that public funds should only be used for public purposes.

Many economists argue that a more equitable or just system of taxation is attained by introducing progression. Whatever merits abstract theorizing or practical politics attribute to progressive taxation, the participants in the social contract will probably never approve it (Crowley, 1987, p. 48). There does not exist any prominent pattern of progression that the contracting individuals could unanimously agree upon, and they should invest the government with more or less free discretion to lay down which pattern will be applicable. In conditions of this kind, the individuals with high incomes, or merely expectations thereof, face the risk of being excessively taxed as "there would be no assignable limit beyond which progression might not be carried with equal justification" (Hayek, 1960, p. 310). This means that far from being just progressive taxation does not rest on any rule at all, and it is actually a potential source of most inequitable treatment of individual taxpayers. As already suggested, proportional taxation is a good, even though not a perfect, protection against harmful externalities because no group is able to increase the tax burden of the others without at the same time tightening their own taxation.

A ruling theme in the previous discussion has been the urgency to constrain the rights of the government to levy taxes. In the treatises of mainstream neoclassical economics on desirable tax structures, this consideration has been pushed as a rule to the background. The reluctance of economists to recognize the risks of abuse and conflicts involved in unlimited taxing power manifests itself most conspicuously in the standard theory of optimal taxation. Theorists in this peculiar line of thinking, such as Diamond and Mirrlees (1971), conceive of a benevolent government, free from any influences from sectional interest groups, which has access to a well-defined social welfare function. The only thing for the government to do in such an imaginary world is first to calculate the maximum of the function that somehow provides a peaceful solution to all conceivable conflicts, and then to enforce the optimum. As a logical consequence of their assumptions, the theorists advocate at least implicitly highly complex tax systems which give the government almost unlimited powers to change the bases and rates of taxation in accordance with the perceived needs of the day. For example, the rates of commodity taxes ought to be imposed inversely to the elasticities of demand according to one of the best-known results of the optimal tax theory.

A further argument for principled taxation is that besides incentives the government lacks the requisite information to pursue the public interest. All economists are well aware that taxation has an adverse effect on the eagerness of individuals to earn income, and in order to design a truly efficient tax system one should know quite a lot of the probable future conduct of taxpayers under alternative circumstances. However, economists only tend to pay attention to the foreseeable effects of taxation, and underlying their assessment is essentially "the premise that taxes are introduced into a world in which available opportunities for gainful actions are given and known" (Kirzner, 1985, pp. 93–94, emphasis deleted).

In reality, the opportunities that are lost as a consequence of a tax may be yet unknown or even beyond the wildest imagination of government agents or anyone else. For example, a tax imposed on wage income discourages workers from seeking entirely new job opportunities, and its accurate social costs are even in principle impossible to calculate on the basis of the currently available information alone. A practical conclusion from this Austrian remark is that we are probably well-advised to choose rules of taxation which have proved to hamper the discovery process of the market as little as possible in the past and not to attempt optimal case-by-case decisions by means of the limited information we happen to possess at the very moment.

We have now deduced a few basic principles of taxation by imagining ourselves in the place of human beings who are agreeing upon the terms of an imaginary social contract. This Austrian analysis leaves many important questions without a final answer, and it provides no robust philosophical foundation for a productive government. Are the participants in a genuine contracting situation ever able to attain unanimity about the introduction of *any* system of taxation? Does a mere conceptual consensus as social theorists consider it produce a moral obligation for the individuals of *actual* life to pay taxes? Is not the decision of the government to apply a particular rate of taxation thoroughly arbitrary? These open questions make it perhaps easier to understand why some Austrian economists think that there is no justification for any taxation whatsoever and, consequently, even the provision of law and order should be left to competitive enterprise (Rothbard, 1978, p. 218).

5. Are there any alternatives?

Even though no final understanding has yet emerged among Austrian economists about the proper form of normative inquiry, a few distinctive characteristics seem to be present in all treatises of Austrian welfare economics. They are, according to Kirzner (1992, p. 181), methodological individualism, subjectivism and an emphasis on process. Individualism is the constitutive foundation and *sine qua non* of Austrian economic analysis, with regard to which compromises of any kind are totally unthinkable. For example, in the analysis of acceptable taxation in the previous section I took it for granted that the well-being of the contracting individuals, rather than some obscure "social welfare", is the thing of importance. The idea of society as an open-ended process came out in this reasoning as the recommendation that the rules of taxation ought to create, like laws in general, favorable conditions for spontaneous discoveries in the market.

My analysis of taxation in the spirit of contractarianism departs from the strict Austrian precepts of methodology by introducing clearly objectivist elements into economic reasoning. The argument retains a strong subjectivist flavor and it is certainly far more subjectivist than typical mainstream treatments of the issue, but orthodoxy is admittedly sacrificed to the cause of expediency. My reason for proposing a contractarian foundation for normative inquiry is simply that a compromise, however painful it might be to some Austrians, is the only way to establish a robust basis for Austrian welfare economics. Since the Austrians give in any event their policy prescriptions like all the other economists, it seems better to make the necessary concessions as explicit as possible right at the beginning and to construct a coherent system of normative thought, rather than to pretend unqualified adherence to value freedom and in practice to routinely yield to exceptions on an *ad hoc* basis. Exactly in the same way as neoclassical economists are advised to abandon their assumption of equilibrium "at the stage of modeling the system rather than in applying the model" (O'Driscoll and Rizzo, 1985, p. 145), Austrian economists should part with their assumption of *Wertfreiheit* well before normative statements. A systematic construction of a practicable and widely accepted theory of Austrian welfare economics is the only sustained defence against the familiar charge that Austrians allow "themselves access to the levers of social control that they would deny to others" (Hamlin, 1992, p. 193).

The theory of an imaginary social contract as I have presented it in this paper emerges in a reasonably logical manner from the premises universally adopted by the analysts of the Austrian school. There seem to be good grounds for expecting that also other scholars in, or at least close to, the research program reach roughly the same conclusion about the proper foundation of Austrian welfare economics. Sugden (1992, p. 210) is quite explicit in his statement that he sees "the contractarian approach as offering the most promising prospects for an Austrian form of prescriptive economics." Buchanan, whose economics has according to one expert opinion "much in common with modern Austrian economics" (Baird, 1989, p. 201), has developed for decades a contractarian alternative to mainstream welfare economics. Even Hayek himself resorts occasionally to a very contractarian usage especially in his more recent writings, a propensity well known among Austrian social theorists. Vanberg (1983, p. 81) goes as far as to conclude in his comparative study that Hayek "might accept something like a contractarian position as understood by Buchanan" or, as toned down a little in an edited later version of the same paper, "if each were asked explicitly to respond to the other's question, they would probably find little reason for disagreement" (Vanberg, 1994, p. 207).

When an economist strives to put himself in the shoes of the participants in an assumed social contract, he must have a capacity for imagining to himself the thoughts of his fellow beings. The obvious difficulties in such appraisement of other people's reflections and feelings seem to be to many Austrian-style theorists no real obstacle to a viable welfare analysis. For example, Shearmur (1990, p. 200) states that "the idea that we cannot make intersubjective comparisons of well-being at all seems to me incorrect". Prychitko (1993, p. 583, emphasis deleted) follows by remarking that "the unmeasurability of utility gains and losses in no way entails their complete inaccessibility to analysis." Sceptics are free to call the proponents of contractarianism "utilitarians" or other names, provided they understand that our judgments are "radically different from more familiar consequentialist welfare criteria" (Barry, 1991, p. 82). An Austrian political economist, while trying to trace the probable long-term effects of general rules on an anonymous average member of society, has little indeed in common with his colleague in the neoclassical camp where the effects of itemized government acts on named individuals, or the goodness of particular end states, are measured and compared.

Contractarianism is not the only alternative available to Austrian economists. There always remains the option of dismissing normative economic analysis altogether and holding instead strictly to valuefree reasoning. The task of the economist is then to explain, for example, the workings of the market economy in a given framework of law and to abstain from any judgment about how good or desirable the outcomes of the market process are in her own or someone else's opinion. This modest picture of the proper bounds of economic science is in line with the contention of Egger (1979, p. 119) that "the acting economic agent does not see the property rights structure in which he acts as a choice variable."

The imaginary state of general equilibrium or full coordination is the best the market can attain under the prevailing knowledge and institutions. An analysis of how well the market participants actually succeed in coordinating their plans and, at the same time, in achieving their own individual aims provides some scope for a welfare appraisal. We might argue, for example, that an unemployed worker intent upon contacting potential employers persistently, alert to reading job advertisements in the newspapers and active in improving her professional skills does better in the open labor market than her timid and inefficient associate out of work. Kirzner (1976, p. 85) proposes such a "coordination approach to normative economics" on the ground that interpersonal comparisons of welfare and maximization of aggregate welfare are then not needed. A fundamental prerequisite for the unemployed, like the rest of the people, to make plans and coordinate them is a well-defined system of property rights that render the actions of others predictable (Cordato, 1992, p. 67).

The reasons Kirzner gives for excluding the appraisal of the institutional setting itself from scientific scrutiny are in my view not fully sufficient. At least as I have set forth the contractarian approach, it leans on valuations of utility but not on their quantitative comparison nor aggregation. Even though I am concerned about the common welfare of the people, it is sufficient for me by virtue of the formulation of the problem to seek an order that provides "the best chance for any member selected at random successfully to use his knowledge for his purposes" (Hayek, 1967, p. 163) and, in other words, to consider the issue essentially from the point of view of one single individual.

A conceivable option for an Austrian economist, anxious to submit his own recommendations for policy despite their problematic scientific status, is to disclose his personal biases at the outset of each research paper and to renounce any pretence of valuefree normative economics. It is my personal feeling that the mere decision of an economist to include in a sympathetic tone the word "Austrian" into the title of his paper is to many social scientists a clear signal of an assured pro-market treatment of the subject. This simple rule of preconceiving the presumptions of an individual scholar produces an unfortunate underestimation of the value of Austrian economics to an overall understanding of social reality. It is certainly of some avail to social scientists in their desperate attempt to find relevant items amidst the modern explosion of scientific research. The last and worst option is to practise welfare economics without much bothering about the ethical considerations or even to publish normative statements as if no value judgments were at all involved.

6. Conclusion

An Austrian economist wanting to be loyal to the basic postulates of his school of thought seems to have a difficult choice between two poor alternatives. He can either strictly adhere to the principles of subjectivism which make a welfare economics of any useful kind even in theory infeasible, or he can compromise with some of the most stringent requirements of the subjectivist way of thinking and, at the same time, renounce the safe basis of the praxeological reasoning that, in the confident words of von Mises (1966, p. 67), is “proof against any criticisms and objections.” I have in this paper opted for the latter alternative on the ground that Austrians set forth in any case their views on the benefits of government interference with the free market or of other policies, and an explicit theory of normative economics is surely superior to a series of casual remarks on the subject.

The theory of social contract as James M. Buchanan and other modern theorists put it forth provides in my judgment the most promising point of departure for an Austrian welfare economics. According to the version most useful for the purposes of practical decision-making and least inconsistent with the tenets of Austrian economics, a welfare economist gets at least some impression of which rules of law enhance best the well-being of the people, or of which rules the government ought to enforce, by imagining herself in the place of the participants in an imaginary social contract. The products of such an introspective process of reasoning are mere tentative hypotheses that are not corroborated until the real acts of approval on the part of the individuals. Furthermore, they may give little more than information on what the individuals will at least not attain unanimity about. Even so the contractarian approach is of great potential use by compelling the economist to base her opinions of policy on a coherent system of theoretical thought and to avoid plain ideological propaganda.

The contractarian welfare economics is like all compromises not a perfect solution to our problems. It seems to be, however, the best of the alternatives we have available to us. The theory of social contract has a strong subjectivist flavor even though it does not subscribe to the most unqualified interpretations of the Austrian economic theory. By choosing a middle way it avoids the exaggerations of standard neoclassical welfare economics and still derives full advantage from the unique Austrian insights into social reality.

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