

# Back to the BOG, Austrian-style<sup>1</sup>

J. Robert Subrick

© Springer Science + Business Media, Inc. 2006

**Abstract** Robust political economy begins with assumptions of self-interested planners who lack perfect information. In such a world, the social planner does not necessarily outperform the decentralized outcome. Crampton and Farrant (2005) argue that the inability to engage in economic calculation reduces the ability of social planner to extract consumer surplus. Thus, the lack of calculation improves the welfare of the median citizen which contrasts with conventional wisdom. We argue that they overstate their results. First, the calculation argument fails because of its underdevelopment, not because of the empirical record. Second, the welfare implications cannot be adequately addressed by assuming diminishing marginal utility of income or using the median welfare standard. Third, robust political economy has not developed a model that yields meaningful welfare comparisons. Thus, robust political economy remains in its early stages.

**Keywords** Political economy · Calculation · Welfare economics

**JEL Code** P0, P16, P50

## Introduction

The positive and normative implications of the socialist calculation debate continue to elicit discussion. A full understanding of the Austrian position continues to emerge as scholars attempt to evaluate the strengths and weaknesses of the participant's arguments (Boettke 2001). On the one hand, Oskar Lange and Abba Lerner articulated a clear plan of how a socialist economic system might work based on the simple exposition of the emerging general equilibrium framework. On the other hand, the Austrian position provided a general

---

J. R. Subrick (✉)  
Department of Economics, George Mason University  
e-mail: jsubrick@gmu.edu

<sup>1</sup> With apologies to Gordon Tullock.

framework that differed significantly from the general equilibrium approach of the market socialists that offered both conflicting predictions and welfare implications (Lavoie 1985).

Inspired by the Austrian emphasis on the division of knowledge and mixed with a healthy dose of Virginia Political Economy, a new research agenda has emerged—robust political economy (RPE). This research program focuses on the robustness of political institutions to changes in assumptions regarding informational constraints and agent motivation (Boettke 2001; Levy 1990, 2002). In particular, RPE stresses the welfare implications of altering assumptions about the political policy making process. Thus, it offers an alternative to conventional welfare economics.

Crampton and Farrant (2005, henceforth CF) have provided an interesting and provocative critique of the nascent RPE research program. They have challenged the importance of the arguments put forth by Mises and Hayek as well as the recent extensions by Peter Boettke (2001) regarding both the positive and normative implications of the impossibility of economic calculation in the socialist commonwealth. CF argue that

Without the assumption of benevolent public agents, however, *planner inability to engage in economic calculation ceases to be a relevant argument against the desirability of economic planning.*

Self-interest trumps calculation and the Austrian argument fails; it represents an interesting but minor contribution to the study of political economy. As such, it belongs as an episode in the history of economic thought not a foundational piece of RPE.

We argue that although CF provides a provocative analysis and in some respects correct; they overstate the implications of their results. In particular, we examine three of their propositions. First, the positive implications of the Austrian theory have not been refuted by the empirical record. Second, the welfare implications of the monopolist model cannot be adequately evaluated by invoking diminishing marginal utility of income and the use of the median as a welfare standard. Third, the stationary bandit model put forth by Mancur Olson does not necessarily support their claims. Olson's bandits both have perfect information and act in their self-interest yet two different outcomes emerge. Furthermore, the relaxation of the perfect information assumption does not yield unambiguous welfare comparisons.

One caveat remains in order: we do not claim that CF's analysis lacks insight or does not rightly highlight missing aspects for a theory of robust political economy. In fact, they push the research agenda in the correct direction. Rather we argue that their analysis represents a special case of exposing a larger problem within attempts to develop an RPE.

### Do the worst get on top?

The Austrian argument put forth during the socialist calculation debate begins with the assumption of benevolence on the part of social planners in a world of imperfect information. The cognitive limitations of the social planner force a shift from benevolence to self-interest. Boettke (2001, 52) summarizes Hayek's argument as follows:

... since the economic knowledge necessary to plan the economy rationally will not be available to planners, these decision-makers will be forced to rely on the forms of information that are readily available, which in this context comes in the form of incentives to exercise political power.

Boettke's and the Austrians' point seems straightforward. Suppose that well-intentioned people attempt to plan the entire economy at its initial stages. Without market prices, the relevant opportunity costs do not emerge in order to best allocate resources. In order to make decisions, the social planners use information that they obtain cost-effectively. The information obtained reflects the interests of the planners which do not necessarily correspond

to the public welfare. That is, “Hayek’s argument is an application of comparative advantage to the selection of leaders within the system (Boettke 2001, 52).” It would appear that no controversial claim has been made.

Yet, CF challenge the hypothesis put forth by Hayek and Boettke on empirical grounds. They claim that

If Boettke’s account were correct, we should expect the historical record to be replete with cases where benevolent agents institute economic planning but are soon supplanted by those with a comparative advantage in the use of force when planning begins to fail. Instead, in the cases where socialist planning was implemented in consequence of socialist revolution, those leading the revolution were rarely benevolent (unless one posits Lenin, Mao, Pol Pot or Ho Chi Min to be benevolent). In those cases where democratic governments embarked upon the road towards economic planning, as was seen in much of Western Europe in the middle part of the last century, the planners largely retreated from planning. Agent-type seems to have been set prior to the initiation of planning, rather than as a result of it

Although Lenin, Mao, Pol Pot, and Ho Chi Min acted in their self-interest, this does not negate the Austrian argument. Nor does the shift from planning to markets in the Western democracies invalidate the hypothesis. Public officials have always acted in the self-interest.<sup>2</sup> Agent-type has always been set prior to planning and the agent acts in a self-interested manner. The argument lacks empirical support not because it contradicts the empirical record but rather that the conditions necessary to empirically examine the hypothesis have not, nor will they ever, exist!

CF, to their credit, do hint at a significant problem that plagues the Austrian theory. Problems arise because the theory does not state a clear hypothesis that, in principle, could be tested. Although Austrians do not fully embrace the methodology of econometric testing of hypotheses this does not excuse them from formulating ideas in a format that could be judged against the observed outcomes. Mises-Hayek-Boettke’s conjecture is no such thing. It represents an instance of rhetoric. We do not mean to suggest that rhetoric has no place in economics nor do we wish to endorse a view of strict empirical testing of all propositions. Some propositions we know to be true for theoretical reasons. Our position is much more modest. We do believe the success of the Austrian approach to political economy depends on its ability to generate new and empirically supported hypotheses that explain historical behavior. The Mises-Hayek-Boettke argument, we believe, can and will be developed into a form that does lend itself to empirical testing.

### Austrian welfare economics?

Next, CF move from the realm of positive to normative economics. They illustrate their normative critique by examining the welfare effects of a monopolist in the presence of perfect and imperfect information. As is well-known, a perfectly price discriminating monopolist achieves the efficient outcome whereas the monopolist without perfect information does not. The latter outcome exhibits deadweight losses whereas the former does not. The normative evaluation by CF of the calculation argument proceeds in three parts, two of which we examine here. They write that

<sup>2</sup> This may reflect a sample-selection problem inherent to political markets that low-quality individuals (i.e. dishonest and incompetent) enter political markets more often than high-quality individuals. See Caselli and Morelli (2004).

First, and most obviously, diminishing marginal utility of income suggests that the massive wealth transfer from citizens to planner will markedly reduce total utility in the system even though the economy operates efficiently. While GDP is unaffected, utility drops significantly.

Although intuitively appealing, one cannot simply assert that income exhibits diminishing marginal utility. If we assume that income exhibits diminishing marginal utility, then we have assumed that which we need to prove. Milton Friedman and Leonard Savage (1948), in a classic paper, argued that the willingness to gamble implies that marginal utility rises with income over some range. But the level at which income exhibits diminishing marginal utility remains undefined. Is it at one million dollars or a trillion dollars? Does it depend on relative income levels? Although, criticisms have arisen (Bailey, Olson, and Wonnocott 1980), one cannot assert that income exhibits diminishing marginal utility. One must explicitly state at the level which this occurs.

The second aspect of their normative declarations pertains to whether the mean as a welfare standard adequately serves as a welfare standard. CF write that

even if we deem output the relevant norm rather than utility per se, we have reason to question the use of a mean output norm in this context.

And thus we have arrived at the basis for the thesis of the paper. Rather than focus on the mean, as does traditional welfare economics and most econometric research, the authors have shifted to the median. The median, of course, does exhibit several properties that the mean lacks. Its most important attribute is that it minimizes the problem of outliers in the tails of a distribution. Use of the mean as a welfare standard in the case of a first-degree price discriminating monopolist provides a vivid example of this. The median citizen receives no consumer surplus and the monopolist captures it all in the presence of perfect information.

But all is not well with the median standard. A well-known problem with the median is that it is not computed by incorporating all sample observations. All information not contained in the median value does not appear in a median based welfare approach. Suppose that we had 1001 observations. Then, when using the median, we throw out information contained in 1000 observations. Furthermore, the median does not offer additional insight in the event that the distribution is either normal or bimodal.<sup>3</sup> It suffers significant problems in cases where the central part of the distribution exhibits significant variation.<sup>4</sup>

Finally, CF move back into the realm of positive analysis in order to use the median as a welfare standard to evaluate the welfare implications of the Mises-Hayek-Boettke argument. They argue that the welfare of the median citizen improves when the self-interested despot does not have perfect information. CF write that

We argue that, at the margin, the calculation argument makes socialism *more* rather than less desirable when planners are not benevolent—when they are chosen from among members of the human race rather than simply given to us from the heavens. That is to say, anyone who worries about the potential harm that can be caused by a self-interested planner has less cause to worry when he knows that said planner is constrained by the calculation problem.

The perfectly informed, self-interested despot engages in the behavior described by a perfectly price discriminating monopolist. When we relax the assumption of perfect information, the welfare of the median citizen improves. Thus, the inability to engage in economic calculation improves social welfare. Unfortunately, this highly stylized example obfuscates more than it illuminates. It does not adequately examine the problems of imperfect information and

<sup>3</sup> Recall that the mean, median, and mode are identical in the normal distribution.

<sup>4</sup> When we move from the median to least median squares, we have further reasons to question the median as a useful welfare standard. See Hettmansperger and Sheather (1992) and Rousseeuw (1993) for a rejoinder.

self-interest for social welfare comparisons. The ranking of social welfare states requires more information than the simple monopolistic example.

Following Olson (2000), suppose that we have a roaming and a stationary bandit that engages in predation. The bandits act in their self-interest and have complete information. The self-interested behavior of the stationary bandit leads to the development of institutions that raise the welfare of all, including the median citizen. However, if we adopt the approach of the roaming bandit, we have the situation of the perfectly price discriminating monopolist. Thus, the welfare comparisons across the states of the world cannot be resolved so simply as comparing a world with self-interested behavior in a world with and without perfect information. In both of Olson's scenarios, the social planner has perfect information and acts in her self-interest. Yet, two outcomes emerge because of (1) the different time horizons that the social planner faces and (2) the extent of the encompassing interest on the part of the social planner.

If we move to a world where the dictator does not have perfect information and closer to the Austrian argument, then what occurs? CF write that

It is difficult to imagine a case in which the welfare of a representative individual living under a non-benevolent planner is made better off by granting the planner the ability to engage in economic calculation. If the planner is wealth-maximizing, he will switch from Olsonian permanent banditry to perfect extraction, transferring surplus from the citizenry to himself. If the planner seeks to maximize personal power, he will obtain another tool to that end; if famines serve the political ends of the despot, he will be able to implement them even more effectively, and with fewer repercussions on other parts of the economy, when he has greater calculative efficacy.

Imagining such as a case with Victorian economic man is indeed difficult. But what if we move to the realm where people engage in production, exchange, and predation, that is, what if we examine the world of planning that includes the dark side of the force (Hirshleifer 2001)! Then we move to the realm of robust political economy.

Allowing the citizenry to potentially engage in violence against the social planner changes the welfare results yet, once again, the answer remains ambiguous.<sup>5</sup> The decision of a self-interested social planner to engage in predation depends on the expected effects of such a policy. For example, if the social planner, like Olson's stationary bandit, believes that that wealth maximization will improve their length of tenure, then they will invest in institutions that develop the rule of law and the welfare of the median citizen rises. But if the social planner believes that the pursuit of societal wealth-maximization will encourage rebellion by the citizenry (through improved income of the mean and median citizen), then they revert back to the pillaging and plundering of the citizenry. Thus, self-interest and imperfect information do not determine unambiguous welfare evaluations; the effects depend on the expectations of the dictator.

Once again, CF have hinted at a basic problem that underlies traditional Austrian economics: they lack of explicit institutional foundations for their analysis. Mises's arguments regarding economic calculation implicitly assume a specific institutional form (Subrick 2004). The development of Austrian political economy requires explicit statements about the underlying institutional framework. If it does not, then statement regarding the effects of planning cannot be made. Nor can the debate regarding the proper role of government be addressed.

CF make three important points regarding the developing field of robust political economy. First, they implicitly suggest the need for researchers within the Austrian tradition to explicitly state their hypotheses in a format that, in principle, could be evaluated against historical data. Second, they rightly stress the limitations of using the mean as the sole welfare standard to

<sup>5</sup> The following example is loosely based on Barzel (2000).

compare states of the world. The median, in some cases, offers additional information that the mean does not. Third, they highlight the importance of identifying the mechanism by which imperfect information exacerbates or inhibits the self-interest of public officials.

Finally, the project of robust political economy remains in its infancy. Attempts to develop an approach to evaluate the proper mix of markets and states (rather than markets or states!) represents a potentially useful theory to better understand the comparative economic performance of various countries as well as provide a sounder foundations for the science of policy-making. In essence, robust political economy aspires to be a new form of welfare economics. Although the earlier attempts to build a science of policy-making have failed, the questions raised in CF offer a useful continuation of the process.

**Acknowledgements** We thank Christopher Coyne, Eric Crampton, and Peter Leeson for helpful comments

## References

- Baily, M., Olson M. and Wonnacott P. (1980) "The Marginal Utility of Income Does Not Increase: Borrowing, Lending, and Friedman-Savage Gambles," *American Economic Review*, 70(3): 372–379.
- Barzel, Y. (2000) "Property Rights and the Evolution of the State," *Economics of Governance*, 1(1): 26–51.
- Boettke, P. (2001) *Calculation and Coordination: Essays on Socialism and Transitional Political Economy*. New York: Routledge.
- Caselli, F. and Morelli M. (2004) "Bad Politicians," *Journal of Public Economics*, 88(3–4): 759–782.
- Crampton, E. and Farrant A. (2006) "Relaxing Benevolence: Public Choice, Socialist Calculation, and Planner Self-interest," *Review of Austrian Economics*, 19(1): 81–93.
- Friedman, M. and Savage L. (1948) "The Utility Analysis of Choices Involving Risk," *Journal of Political Economy*, 56(4): 279–304.
- Hettmansperger, T. and Sheather S. (1992) "A Cautionary Note on the Method of Least Median Squares," *American Statistician*, 46(2): 79–83.
- Hirshleifer, J. (2001) *The Dark Side of the Force: Economics Foundation of Conflict Theory*. New York: Cambridge University Press.
- Lavoie, D. (1985) *Rivalry and Central Planning: The Socialist Calculation Debate Revisited*. Cambridge: Cambridge University Press.
- Levy, D. (1990) "The Bias in Centrally Planned Prices," *Public Choice*, 67(3): 213–226.
- Levy, D. (2002) "Robust Institutions," *Review of Austrian Economics*, 15(2–3): pp. 131–142.
- Olson, M. (2000) *Power and Prosperity: Outgrowing Capitalist and Communist Dictatorships*. New York: Basic Books.
- Rousseeuw, P. J. (1993) "A Comment on Hettmansperger and Sheather," *American Statistician*, 47(2): 162.
- Subrick, J. R. (2004) "After Shleifer, Who Needs Mises?" Working Paper, Center for Institutional Reform and the Informal Sector, University of Maryland.