

The Austrian Theory of Efficiency and the Role of Government

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Introduction

Orthodox public goods theory and its corollary—the standard economic justification for government intervention—have both been based on particular definitions of efficiency and optimality. According to the orthodox approach, if a market is not operating “efficiently,” some sort of government intervention to correct the inefficiency may be warranted. But this view of efficiency is derived directly from a neoclassical view of market structures and in particular from the notion of perfect competition.

The point to be emphasized in this paper is that if one starts with a different view of efficiency and market optimality, an entirely different set of conclusions relative to government intervention can be reached. In particular we will examine the approach to economics taken by the Austrian School and detail how that approach is applied to arrive at the Austrian theory of efficiency. In addition, we will examine how Austrians view government interventions into the market and their ultimate conclusions on the role of government in society.

The Neoclassical Approach to Efficiency: An Overview¹

Before beginning a discussion of the Austrian model, a brief examination of the orthodox, neoclassical perspective is necessary. This examination will help sharpen our understanding of the major differences in both methodology and final policy conclusions that separate the two points of view.

There are two cornerstones that provide the foundation for the traditional discussion of efficiency. These are the concepts of Pareto optimality and perfect competition.

When viewed in its most basic form, a Pareto optimum represents a static state of affairs within which no possible change can be made that would result in one person being made better off without another person being made worse off. This notion is important to our discussion because it has been adopted by most economists as the state of perfect “efficiency” in

economic affairs. In other words, to achieve a perfectly efficient market, all economic transactions in society should be such that no one is made better off at the expense of another. In addition, the final equilibrium should represent a situation where no further transactions can be made without violating the Paretian rule.

It is at this point that the neoclassical notion of perfect competition comes into play. It can be demonstrated that the equality of marginal cost and price that is inherent in the perfectly competitive model is sufficient to insure Pareto optimality, and, therefore, "efficiency" in the market. When price equals marginal cost, the marginal benefit received by the consumer (reflected by the price) equals the marginal value of the alternate uses of the factors that went into the production of the output (given by marginal cost). Under these circumstances if output were increased, the value to the consumer of the added product would be less than the value given up from other uses. On the other hand, if output were reduced the value lost would be greater than the value to be gained in some alternative use. In both instances one sector is being made better off at the expense of another. Hence this state, where marginal cost equals price or marginal benefit, is Pareto optimal and efficient, and any deviation from this equality is always less efficient.

We have now reviewed the standard against which the relative efficiency of a market is measured and, consequently, by which the necessity of government intervention into the market (to correct "inefficiency") is determined. From a neoclassical perspective, market inefficiency is an indication of "market failure" and may call for government intervention to make the market succeed, i.e., be efficient. Certain classic situations exist where, by employing these neoclassical standards, markets inherently fail, and the orthodox view is that intervention *is* necessary. For illustrative purposes I will briefly examine two of these: pure public goods, and the externalities "problem."

Definitionally, a pure public good is one in which benefits to additional consumers can be provided without additional costs to the producer. The most commonly given example of a pure public good is national defense. Because the marginal cost of producing additional "defense" is assumed to be zero, price would have to equal zero for the market to work "efficiently" in a neoclassical sense. Since no one in the private market would provide this type of good at the "efficient" price, it is argued that the government's responsibility is to step in and provide such outputs.

The second situation is the "problem" of externalities. Here costs and benefits external to both the buyer and the seller are being produced, and these externalities are not being considered when price and quantity are determined. Therefore, the real marginal cost and marginal benefit are not being equated and the result is "market failure." The typical solution suggested here is subsidization, taxation, or direct regulation, in order to insure

the efficient price-output combination. The most common example of this problem is pollution, where the costs incurred by a community because of polluted air are not considered by the firm creating the pollution.

It should be emphasized at this point that this neoclassical notion of market externalities brings into play the idea of costs and benefits to society as a whole and the expanded concept of social efficiency. This concept is usually presented as being distinct from the efficient actions of individuals within the society. I note this for one reason—in the following discussion on the Austrian theory of efficiency we will see that from its perspective there can be no rational explanation of “efficiency” apart from the individual actors that make up society.

The Methodology of Austrian Economics

Individual valuation is the keystone of economic theory.²

M. N. Rothbard

The importance of the work of the Austrian School for the history of ideas finds perhaps its most suggestive expression in the fact that here, acting man stands in the center of economic events.³

Ludwig M. Lachmann

It is this consistent focus on the actions and subjective valuations of individuals that distinguishes the methodology of the Austrian School from all other approaches to economic theory. This approach, sometimes referred to as “methodological individualism” or “radical subjectivism,” stems from the fact that Austrians see economics as a branch of the more general science of human action or praxeology.⁴

To truly understand the Austrian point of view, it is necessary to understand the concept of human action as the Austrians define it. Simply stated, human action is viewed as “purposeful behavior.”⁵ In other words, it is the application of specific means to achieve desired ends. This concept of human action has been developed, with respect to economics, most thoroughly in the writings of economist Ludwig von Mises, and the notion might best be summed up and clarified in his words:

No sensible proposition concerning human action can be asserted without reference to what the acting individuals are aiming at and what they consider as success or failure, as profit or loss.⁶

Due to the nature of their existence all humans act and all economic activity is based on action. It therefore follows that Austrians see praxeology as the logical foundation for economic science. The question for Austrians then becomes, how does the purposive behavior of all individuals and the means they choose to accomplish those purposes interact in a market economy? As one observer put it in explaining the views of Ludwig Lachmann:⁷

Economic phenomena cannot be explained unless they are related, either directly or indirectly, to subjective states of valuation as manifested either in choice or in expectations about the market.⁸

This notion of subjective valuation and the purposes and choices of individuals permeates every aspect of Austrian economic analysis. For example, the concept of cost is defined completely in terms of privately perceived foregone opportunities,⁹ the market rate of interest is the expression of the individual time preferences of the members of society,¹⁰ and as we shall see in detail below, efficiency is expressed in light of the success or failure of individual plans.¹¹

The Austrian Theory of Efficiency¹²

A. Efficiency and the Individual. Consistent with their approach to all economic analysis, Austrians begin their discussion of efficiency by first focusing on the individual. The problem then becomes, what constitutes efficient activity for the individual actors in society? In answering this question the Austrians again turn to the praxeological roots of their analysis. From this they conclude that efficiency must be seen in terms of the purposeful behavior of individuals, and more specifically, whether that behavior is consistent with attaining the purposes and goals that are being sought. To the Austrian economist, then, an efficient course of action would be to apply means that are consistent with attaining the desired goal or program of goals. Inefficiency arises when means are chosen that are inconsistent with the desired goals.

It should be made clear that the particular nature of the goals being pursued has no bearing on the analysis. These are taken as given. They are derived from the subjective valuations and preferences of each individual. It is not the ends whose efficiency is under question, but the means used to attain them. I point this out, because, very often obtaining something for the smallest available monetary cost or for the smallest possible input of time is considered "efficient." But, if these aspects are considered as part of a program of goals by the individual, they need not be of concern to the economist. For example, suppose a person set out to spend an entire afternoon mowing a lawn that he could possibly finish in an hour. Because it was part of his goal, the fact that he took the extra time could not be seen as inefficient. In fact, if he finished mowing the lawn in an hour in spite of the fact that he had planned to spend the entire afternoon, it then could be said that he acted inefficiently. Assuming he did not change his mind during the process, his methods would be inconsistent with his goals.

To the Austrian, this notion of efficiency plays an important part in all economic analysis, for it is the crux of the economic problem facing the individual. The degree to which an individual acts efficiently will determine success and failure in his economic life. (The word "success" is used in its subjective sense; i.e., success stems from the achievement of individually

determined goals and not from what any observer sees as successful.)

B. Society and Efficiency. With the above analysis of efficiency for the individual in mind, we can now proceed to examine how Austrians view the concept of social efficiency. As with the individual, Austrians see the economic problem facing society to be that of securing efficiency. But, the important point to be made is that Austrians do not see societal efficiency apart from the efficiency of the individuals that comprise it. In other words, they recognize that society cannot have goals apart from those of the individuals within it. This notion might best be expressed in the words of Professor Israel Kirzner:

Society is made up of numerous individuals. Each individual can be viewed as independently selecting his goal program...and each individual adopts his own course of action to achieve his goals. It is therefore unrealistic to speak of society as a single unit seeking to allocate resources in order to faithfully reflect "its" given hierarchy of goals. Society has no single mind where the goals of different individuals can be ranked on a single scale.¹³

From this Kirzner goes on to conclude that:

Efficiency for a social system means the efficiency with which it permits its individual members to achieve their several goals.¹⁴

Given this concept of social efficiency it is easy to understand why Austrians generally agree that a free market is the most efficient system. With its emphasis on voluntary cooperation, the market economy ensures that each individual is allowed to pursue his goals in the most efficient manner available, given his knowledge of the situation.

C. Determinants of Efficiency: Knowledge and Coordination. The key to economic efficiency, for both the individual and society, is knowledge. The extent to which an individual acts efficiently will be determined by the amount of knowledge he possesses regarding the appropriate means for attaining his desired ends. A brief example can illustrate this point. Suppose Mr. Jones has established as a goal the purchase of a new car. But, because of extremely limited knowledge, he decides to go to a department store to make his purchase. It is obvious that because of ignorance, he has chosen a very inefficient course of action with respect to his desired goal. Through trial and error his knowledge will improve, and as it improves so will the efficiency of his actions. For example, someone in the department store may tell Mr. Jones that he needs to go to an automobile dealer, thus improving his knowledge of the situation and therefore the efficiency of his subsequent acts.

Efficiency for the market as a whole is also dependent on individual knowledge of market conditions. In a market economy it is the mutually beneficial nature of voluntary exchange that allows all individuals to simultaneously pursue their goals. The key to the efficient pursuit of goals in

society then becomes a question of coordination between buyers and sellers, and the extent to which this coordination exists will reflect the knowledge of opportunities within the market held by its participants. To have efficiency in an economy, there must be more than just the opportunity to exchange, there must be knowledge of these opportunities on the part of buyers and sellers.

To illustrate this notion of coordination, let's go back to Mr. Jones' shopping for an automobile. Suppose he has now gained the knowledge it takes to realize that, in order to find a car at an acceptable price, he must go to various automobile dealers and make comparisons. The problem Mr. Jones now faces is this: he is willing to pay a maximum of \$4,000 for a car and no dealer he knows of is willing to sell him one for that low a price. The fact is, though, that a dealer on the other side of town is willing to sell a new car for \$3,500. Without the two parties knowing about each other there is no coordination of plans, and inefficiency arises in the market.

For Austrians, then, it is only when all market participants have perfect knowledge and foresight of the availability of means, that market plans will be perfectly coordinated and "perfect" efficiency will exist. To the Austrian, this notion of perfect knowledge in a market is the distinguishing feature of equilibrium. According to Kirzner:

The state of equilibrium is the state in which all actions are perfectly coordinated, each market participant dovetailing his decisions with those which he (with complete accuracy) anticipates other participants will make. The perfection of knowledge which defines the state of equilibrium ensures complete coordination of individual plans.¹⁵

From this we can conclude that a market in equilibrium is a market working with perfect efficiency.

This concept of equilibrium should not be confused with the notion of a perfectly competitive equilibrium and the neoclassical state of "perfect efficiency." The Austrian notion of perfect efficiency and market equilibrium sets no restrictions on market structure, the heterogeneity of products, or the relationship between marginal cost of production and the price of the output. It is simply a situation where "all acts are coordinated," where there are no shortages or surpluses in the market.

D. Inefficiency and the Coordinating Process. Now that we have examined the concept of efficiency, we can take a closer look at inefficiencies in a market and the process that occurs to correct them.

It should be apparent that a state of perfect efficiency, i.e., perfect knowledge, cannot be achieved completely in an economy. At any given point in time the available information will be scattered throughout the market. Some plans will be uncoordinated, and inefficiencies will arise. But, it is the "natural forces" in the market itself which act to correct for these inefficiencies. It is the market concepts of price and entrepreneurial activity that ensure the diffusion of knowledge and the tendency toward efficient use

of resources, i.e., “means,” in a market economy. Simply stated, it is the price system that makes available the pertinent information, and the entrepreneur—motivated by potential profits—who takes the information and uses it in a manner that tends to improve efficiency.

The price system lets it be known that inefficiencies exist through discrepancies in the price for undifferentiated goods within the market. This is true because, everything else being equal, people will buy at the lowest prices available. With perfect knowledge of all prices, the movement toward the lower prices and away from the higher ones would, under conditions of perfect efficiency, result in a uniform market price for the good. Therefore, price discrepancies would represent the existence of imperfect knowledge, i.e., inefficiency in the market.

It should be made clear that this uniformity of price under conditions of perfect efficiency holds only for goods that are homogeneous in the mind of the consumer. For goods that are differentiated in the consumer’s mind, the price discrepancies may simply reflect the relative values placed on the goods that arise from perceived differences. The point to be emphasized is that, contrary to the implications of the neoclassical model of perfect competition, homogeneous products are not more efficient to society than relatively heterogeneous products. The degree to which products are differentiated in an economy reflects individual desires and preferences and, as stated previously, the Austrian model analyzes the efficiency of the means used and not the ends desired.

Under the given conditions, then, when inefficiencies (i.e., price discrepancies) occur, the opportunity for profit will present itself to the alert entrepreneur. As Kirzner puts it:

A profit opportunity exists wherever a given resource or a given product can be bought in the market at one price and sold again for a higher price. [Therefore,] a possibility for profit exists wherever there is a price discrepancy.¹⁶

It is these opportunities for profits and the entrepreneurial activity they stimulate that tend to promote coordination and therefore efficiency in the market.

Our previous example can be used to illustrate this point. As we recall, Mr. Jones is in a position where he is willing to spend \$4,000 on a car and no dealer he knows of is willing to sell for that low a price. Let’s say that the lowest price he’s been offered is \$5,000. At the same time a dealer Mr. Jones is not aware of is willing to sell the car for \$3,500. Now a price discrepancy exists and, along with it, a chance for entrepreneurial profit. Into the picture comes Mr. Smith, a profit-seeking entrepreneur, who’s always on the lookout for a “fast buck.” Seeing the opportunity for profit, Mr. Smith buys the car at the lower price and sells it to Mr. Jones for \$4,000. What Mr. Smith has effectively done is coordinate the plans of Mr. Jones and the dealer selling at the lower price, thus improving efficiency in the market.

We can conclude from this that, in a free market, inefficiencies promote their own corrective action. Again in the words of Israel Kirzner:

A price discrepancy means a chance to make profits. By definition entrepreneurs seek profits; thus the very situation that symptomizes the need for a correction creates the force capable of inducing such actions. Moreover . . . the entrepreneurial search for profits implies a search for situations where resources are misallocated.¹⁷

One might protest that we have no assurance that entrepreneurs will recognize every inefficiency in the market or correctly perceive the ones that do exist, and this is true. But the fact remains that the market will reward successful entrepreneurs and penalize unsuccessful ones. Therefore, "the market process itself . . . attracts only those most able and competent to direct the future course of the process."¹⁸ As Kirzner concludes: "If the best entrepreneurial talent is insufficient to remove all misallocations, even with the inducement of the profit motive, then the remaining misallocations must simply be undetectable."¹⁹ (Kirzner uses the term "misallocation" to refer to a situation caused by discoordination of plans and therefore inefficiency in the market.²⁰)

The Role of Government

From our discussion up till now, it is clear that the neoclassical notion of market failure, discussed in the first section of this paper, cannot be used to justify government intervention in order to correct inefficiencies as defined from an Austrian perspective. Even though a market can never attain perfect efficiency, the corrective forces which arise from the market's own mechanism will make it as efficient as possible. In fact, any notion of market failure from the Austrian perspective would have to arise, not from the free market, but from government interventions that would distort market prices and allocate resources toward ends other than those being pursued by market participants.

In his book *Market Theory and the Price System*, Kirzner makes his conclusions about interference in the market perfectly clear. He states:

Interference with the webs and forces that are woven through the market process limits the attempts of participants to coordinate their activities through an engine of remarkable efficiency—the market. The analysis of the market process can clarify the costs involved through such interference, making it possible for market participants to decide, through the political process, on the extent to which they are willing to lay aside their engine of efficiency for the sake of special purposes of possibly overriding importance.²¹

It is clear from the first part of this statement that Kirzner feels government intervention into a market can never be justified on the basis of improving efficiency. This is both consistent with the Austrian view of

efficiency and generally accepted by contemporary Austrian economists. The second part of Kirzner's statement implies that there may be a justification for government intervention on other than efficiency grounds; for "special purposes of possibly overriding importance." This leads us into the area of welfare economics and brings in considerations of utility and equity which are beyond the scope of this paper. But it should be noted that many Austrians feel that judgments on these concepts can never be made by society as a whole and can only be made by individuals. This leads to the conclusion that there is no justification for any form of government interference. This view might best be summed up in the words of the noted Austrian economist Murray N. Rothbard:

No government interference with exchanges can ever increase social utility. . . . whenever government forces anyone to make an exchange which he would not have made, this person loses in utility as a result of the coercion. But taxation is just such a coerced exchange. . . . Since some lose by the existence of taxes, therefore, and since all government actions rest on its taxing power, we deduce that: *no act of government whatever can increase social utility.*²²

This may appear to be an extreme position, but it is consistent with the radical subjectivist nature of Austrian methodology.

The question might now arise as to how the problems in society that have been traditionally taken care of by government would be handled. What about the externalities "problem" and all the "public goods" that governments have traditionally provided? A full explanation of how the free market would take over all of the functions of government would, again, be beyond the scope of this paper. This subject has been covered in quite some detail in a number of volumes.²³ But briefly, "public goods" such as roads, education, parks, and, in a Rothbardian system, courts and defense, would be services provided by the market as demand conditions warranted. The fact that these services could not be priced where marginal cost equals marginal benefit would have no bearing on efficiency from an Austrian point of view. It also must be realized that a completely free-market economy implies a clearly defined system of property rights to all resources in society. It is this system of property rights that would act as the general regulator of all social and economic acts. To be more specific, the problem of spillovers and externalities would be nothing more than a problem of property rights violation, and would be handled through the courts just as for any other act of aggression.

It should be noted here that most neoclassical economists also view externalities, such as pollution, as a problem of unenforced property rights. The crucial difference is that the neoclassicist sees property rights as variable and to be granted, presumably by the state, on the basis of who stands to benefit most or to lose least from the particular rights assignment.²⁴ This is consistent with the neoclassical notion of social efficiency mentioned in the

first section of this paper, the logic being that if property rights are assigned to the party with the most to gain or least to lose as a result of the externality, the net benefit to society will be increased, and social efficiency will be improved.²⁵

The Austrian approach is quite different. Along with the objection to interpersonal cost-benefit analysis and social efficiency implied by the subjectivist nature of Austrian methodology,²⁶ there is a major difference in the Austrian view of property rights in general. It should be clear that in order to pursue goals and make plans it is necessary to have a system of property rights that is clearly defined and that each individual can count on into his foreseeable future. Any involuntary alteration of a given property rights structure will necessarily interfere with plans being made by some owners of property with respect to the pursuit of their goals. Because of this, Austrians take the particular property rights system as given and examine the efficiency of actions within the confines of the rights arrangement. As one Austrian economist has put it:

A property rights system lays down the rules, it defines the freedoms and restrictions according to which we evaluate alternatives and make choices, but as such it is conceptually distinct from alternatives among which we choose.²⁷

On what basis, then, do Austrians believe property rights should be assigned? The answer to this might best be expressed by Prof. Rothbard. He states that:

We cannot decide on . . . rights or liabilities on the basis of efficiencies or minimizing of costs. But if not costs or efficiency, then what? The answer is that only *ethical principles* can serve as criteria for our decisions. Efficiency can never serve as the basis for ethics; on the contrary, ethics must be the guide and touchstone for any consideration of efficiency.²⁸

In other words, it is felt that the choice of a particular property rights structure is beyond the realm of economic science, and has no place in positive discussions of efficiency. Dr. Rothbard goes on to conclude that:

Economists will have to get used to the idea that not all of life can be encompassed by our own discipline. A painful lesson no doubt, but compensated by the knowledge that it may be good for our souls to realize our own limits—and, just perhaps, to learn about ethics and about justice.²⁹

Concluding Remarks

This paper has brought to light the fact that there is more than one approach to the concept of efficiency in the economic literature. Furthermore, depending on which theory of efficiency is adopted, one can arrive at far

different conclusions concerning the role of the state both in the economy and in society in general.

It should be apparent that all methodologies within economics deserve full consideration by scholars and analysts. It is only after the alternatives have been considered that intelligent decisions can be made concerning the role economics should play in policy analysis.

NOTES

1. The discussion in this section has been generalized entirely from H. T. Kolin, *Micro-economic Analysis: Welfare and Efficiency in Private and Public Sectors* (New York: Harper and Row, 1971), pp. 10-14, 245-60.
2. Murray N. Rothbard, "Toward a Reconstruction of Utility and Welfare Economics," *Occasional Papers Series, #3* (New York: Center for Libertarian Studies, 1977), p. 1.
3. Lawrence H. White, "Methodology of the Austrian School," *Occasional Papers Series, #1*, (New York: Center for Libertarian Studies, 1977), p. 1.
4. *Ibid.*, p. 9.
5. Rothbard, *Man, Economy, and State* (Los Angeles: Nash Publishing, 1972), p. 1.
6. Ludwig von Mises, *The Ultimate Foundations of Economic Science*, with a Foreword by Israel Kirzner, 2nd ed. (Kansas City: Sheed, Andrews, and McMeel, 1978), p. 80.
7. Ludwig M. Lachmann, along with F. A. Hayek, is one of the elder statesmen of currently active Austrian economists. He is presently Visiting Professor at New York University.
8. Walter E. Grinder, "In Pursuit of the Subjective Paradigm," Introduction to Ludwig M. Lachmann's *Capital, Expectations, and the Market Process: Essays on the Theory of the Market Process* (Kansas City: Sheed, Andrews, and McMeel, 1977), p. 3.
9. Israel Kirzner, *Market Theory and the Price System* (Princeton, N.J.: D. Van Nostrand Co., 1963), p. 184.
10. Grinder, "In Pursuit of the Subjective Paradigm," p. 4.
11. Kirzner, *Market Theory*, p. 34, 35.
12. The major points in this section (A-D) have been extrapolated from Kirzner's *Market Theory*, pp. 33-44, 297-310; and also his *Competition and Entrepreneurship* (Chicago and London: University of Chicago Press, 1973), pp. 13-17, 212-31. All examples used are my own.
13. Kirzner, *Market Theory*, p. 35.
14. *Ibid.*
15. Kirzner, *Competition*, p. 218.
16. Kirzner, *Market Theory*, pp. 302-303.
17. *Ibid.*, p. 303.
18. *Ibid.*, p. 304.
19. *Ibid.*
20. *Ibid.*, p. 301.
21. *Ibid.*, p. 309.
22. Rothbard, "Toward a Reconstruction," p. 29.
23. See Rothbard, *For a New Liberty* (New York: Collier MacMillan, 1978); David Friedman, *Machinery of Freedom: Guide to a Radical Capitalism* (New Rochelle, N.Y.: Arlington House, 1973); and Jarret B. Wollstein, "Public Services Under Laissez-Faire," (publisher not given).
24. Harold Demsetz, "Ethics and Efficiency in Property Rights Systems," in Mario J. Rizzo, ed., *Time, Uncertainty, and Disequilibrium: Exploration of Austrian Themes*, (Lexington, Mass.: Lexington Books, D.C. Heath and Co., 1979), pp. 102-104.
25. *Ibid.*, p. 101.
26. John B. Egger, "Comment: Efficiency is Not a Substitute for Ethics," in Rizzo, *Time, Uncertainty*, p. 121.
27. *Ibid.*, p. 120.
28. Rothbard, "Comment: The Myth of Efficiency," in Rizzo, *Time, Uncertainty*, p. 95.
29. *Ibid.*