The Fallacy of the Mixed Economy

An 'Austrian' Critique of Recent Economic Thinking and Policy

SECOND EDITION

S. C. LITTLECHILD

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I should like to express my indebtedness to the following, without whom this *Paper* could never have been written: the editor of the *City Press*, whose pages alone in 1961 carried the banner of Mises and Hayek; Professor Jack Wiseman, who convinced me that cost is subjective; Professors Israel Kirzner and Ludwig Lachmann, who patiently answered my questions on Austrian economics; the Earhart Foundation, which supported my visit to New York University to write a first draft of the *Paper*; Professor Terence Hutchison and Glyn Picton who, in addition to those named by the Editor in the Preface, contributed helpful written comments on the final draft (almost all of which have been incorporated, but responsibility for remaining errors and omissions unfortunately rests with me); Arthur Seldon, who provided patient editorial guidance; Kathy Major, who cheerfully typed so beautifully what must have seemed an endless series of drafts; and my wife Kate, who throughout had to bear the consequences, if not the costs, of my writing this *Paper*.

April 1978 S.C.L.

I am grateful to Professors Michael Beesley, Israel Kirzner and Jack Wiseman, and to the IEA, for comments on earlier drafts of the Postscript. This second edition gives me an opportunity to thank Michael Solly for helpful suggestions and advice on the first edition. The views in my Postscript are expressed in a personal capacity and not as a member of the Monopolies and Mergers Commission.

October 1985 S.C.L.

PREFACE

The *Hobart Papers* are intended to contribute a stream of authoritative, independent and lucid analyses to the understanding and application of economics to private and government activity. Their characteristic theme has been the optimum use of scarce resources and the extent to which it can best be achieved in markets within an appropriate framework of laws and institutions or, where markets cannot work or have disproportionate defects, by better methods with relative advantages or less decisive defects. Since the alternative to the market is in practice the state, and both are imperfect, the choice between them is effectively made on the judgement of the comparative consequences of 'market failure' and 'government failure'.

This theme provides the apposite setting for Hobart Paper 80, a concise study of a century of Austrian economics and its relevance for British economic policy in our day.

British economic thinking and policy has been dominated by what Professor S. C. Littlechild calls the neo-classical 'mainstream' and its associated welfare economics. He argues we have largely overlooked the importance of the contribution to thinking on policy in Britain that we could have drawn from the Austrian economists. In his *Paper* Professor Littlechild covers a wide range of topics from the origins of the Austrians in the mid-19th century to the recent revival in their thinking, especially in the USA and more recently in Britain, and to its very direct relevance to government policy in Britain in the last quarter of the 20th century. Austrian thinking is described as based on the individual, who provides both the method of the reasoning ('methodological individualism') and the source of the valuations ('subjectivism') on which policy must rest.

Professor Littlechild is led to the roots of the reasons for the 'market failure' that is said to be a major fault of a system of de-centralised private ownership, especially in its neglect of private contracts on the 'external' effects and the resulting despoliation of the environment. He turns this criticism into a counter-criticism of welfare economics, which he says has ignored the central importance of imperfect knowledge, the pervasive uncertainty which overshadows all decisions, whether taken in the market or by government. He describes as a 'myth' the view that government will necessarily have access to more or surer information than is available to men in the market. And he rejects the conclusion that 'market failure' is a sufficient justification for the replacement of the market by government.

This approach leads Professor Littlechild to his critique of the mixed economy, the case for which has been most persuasively argued by Professor J. E. Meade in devising economic policy for 'the intelligent radical'. The *Hobart Paper* argues that 'market failure' has derived not from the defects of the market as a method of organisation but from the imperfection of the framework of laws and institutions within which it has had to work. The intellectually more convincing solution for market failure is therefore not replacement of the market by government but refinement of the legal framework to make property rights easier to identify as the best incentive to the efficient use of resources.

The closely reasoned and scholarly analysis leads to strong implications not only for policy on competition but for the treatment of 'externalities', national planning (the National Enterprise Board), and nationalised industry.

To direct the reader to the central idea and insights of Austrian economics, Professor Littlechild has had to compress a large amount of material into a relatively short space, and a judicious use of italics has been employed to indicate the main propositions.

The Institute's constitution requires it to dissociate its Trustees, Directors and Advisers from the analysis and recommendations of its authors. It wishes to thank Professor Israel Kirzner of New York University, Miss Sudha Shenoy of Newcastle University, New South Wales, and Professor Jack Wiseman of the University of York for reading drafts and offering comments and suggestions that the author has borne in mind in his final revisions. His *Paper* should mark a renewed interest by British academies, government and industry in a school of thought that might provide solutions to the problems of British industry that have hitherto proved elusive.

April 1978 ARTHUR SELDON

PREFACE TO THE SECOND EDITION

Many students and teachers will have enjoyed their first glimpse of Austrian economic thought through the first edition of Professor Littlechild's *The Fallacy of the Mixed Economy*. In it he provided a brief account of the origins and resurgence of interest in the Austrian school. He then analysed the 'mixed economy' as it had developed up to 1978, in the light of insights typically derived from the Austrian rather than the neo-classical tradition of economics.

Since 1979 the Thatcher Government has dramatically switched the thrust of British economic policy towards greater reliance on markets, a change which should prove congenial to Austrian commentators, since it alters the 'mix' of the mixed economy. It is therefore all the more fascinating to learn from Professor Littlechild's new Postscript how far policy since 1979 is still vulnerable to the Austrian critique. Many aspects of the Government's policy and performance are examined, including central planning, privatisation, and, importantly, competition and merger policy, which embraces patents and price controls.

These developments are studied within an Austrian context, which in contrast to neo-classical or mainstream economics accepts competition not as a state but as a process, in which the entrepreneur has a special role to play in discovering the as yet unrevealed preferences of consumers.

The first Preface and original *Paper* have been left largely unrevised except for minor emendations and corrections.

As always the Directors and Trustees must dissociate themselves from the conclusions of the author but are pleased to offer this Postscript as a different and illuminating assessment of recent public policy.

November 1985 JOHN B. WOOD

THE AUTHOR

STEPHEN CHARLES LITTLECHILD was born in 1943 and educated at Wisbech Grammar School and the University of Birmingham, graduating with a Bachelor of Commerce degree in 1964; he obtained his PhD at the University of Texas at Austin in 1969. His post-graduate and post-doctoral studies included operations research and economics at Stanford and Northwestern Universities and at the University of California, Los Angeles.

Professor Littlechild was formerly Assistant Lecturer in Industrial Economics at the University of Birmingham, 1964-65, Senior Research Lecturer in Economics at the Graduate Centre for Management Studies, 1970-73, and Professor of Applied Economics at the University of Aston, 1973-75. Since 1975 he has been Professor of Commerce at the University of Birmingham. During 1979-80 he was Visiting Professor at the Universities of New York, Stanford, Chicago and Virginia Polytechnic. He has been a consultant to the Ministry of Transport, the Treasury, the World Bank, the Electricity Council, and American Telephone & Telegraph Co. He has also advised the Dept. of Industry and the Dept. of the Environment on the privatisation of British Telecom and water supply. He has been a member of the Monopolies and Mergers Commission since 1983, and a member of the IEA's Advisory Council since 1982.

Author of *Elements of Telecommunications Economics* (1979), editor and co-author of an introductory textbook, *Operational Research for Managers* (1977), and author of numerous articles on public utility economics, telecommunications, and game theory. For the IEA he contributed an essay, 'What Should Government Do?', in *The Taming of Government* (Readings 21, 1979).

I. INTRODUCTION

This *Paper* attempts to answer two questions:

- What is 'Austrian economics'?
- What does Austrian economics have to say about government policy on industry in Britain today?

The Austrian tradition provides an approach to economic theory quite distinct from that of what might be called the 'neo-classical mainstream', i.e. economics as it has developed since 1870 at the hands of such leading European figures as Jevons and Walras, Marshall and Pigou, and more recently Americans such as Professors Paul Samuelson and Kenneth Arrow. It is this approach which is embodied in almost all introductory and intermediate textbooks, not least Samuelson's *Economics*, and which constitutes common ground to a wide section of the economics profession. It is, however, an approach which is increasingly proving embarrassing, mainly because it is unable to analyse many phenomena in the real world which are associated with incomplete knowledge and uncertainty.

Almost all the advice which British governments have received from economists during the past half-century has naturally come from this neo-classical 'mainstream'. Policy recommendations have differed, but the general consensus seems to have been that Britain needs a 'mixed' economy of government and private activity in the market. There has been considerable experimenting in the 'mix' of the mixture, but the government component has risen more or less steadily. According to provisional findings by government statisticians, the 'public' sector's share of national wealth (i.e. that controlled *directly* by government), appears to have roughly trebled in the decade to 1975, from some 8 per cent in 1966 to an estimated 26 per cent in 1975.[1] In addition, a considerable proportion of the private sector's activities is subject to government regulation, influence or scrutiny.

Economic theory cannot prescribe what government policy

[1] *The Times*, 8 February 1978.

ought to be. It can only hope to ascertain what kinds of means *are or are not* suitable for attaining chosen ends. Since Austrian economic theory is so distinct from 'mainstream' theory, we shall not be surprised to find that the implications for policy are quite different. It becomes apparent that, when imperfections of knowledge are taken into account, many institutions of the mixed economy, some novel and some familiar, are by no means well suited to the purposes which most economists, politicians and laymen still fondly imagine them to be.

A brief summary

Neo-classical 'mainstream' economics tends to see the economic problem facing society as one of efficiently allocating resources in the light of preferences, techniques and resource availabilities, knowledge of which is supposed somehow to be 'given'. Austrian economics, by contrast, sees the problem as including the *discovery* of those preferences, techniques and resource availabilities. Neo-classical economics finds it appropriate to view the economy as if it were in or near a *state* of equilibrium. Austrian economics sees the economy as involved in a continual *process* of discovery, co-ordination and change.

These contrasting viewpoints lead to different interpretations of the role of government. Neo-classical 'welfare' economists (i.e. those concerned with devising policies to optimise the use of resources) ask whether the market provides the right incentives to allocate resources efficiently. Where it does not—where they therefore say there is 'market failure'—they see the case for government either to correct the incentives of the market or to replace the market entirely. Austrian economists, on the other hand, ask whether the market provides the right incentives to discover where there is scope for increased co-ordination leading to *improvements* in the allocation of resources. They are aware that the market frequently, indeed *always,* makes mistakes, but on the whole they conclude that the government cannot hope to acquire sufficient information to do a better job. They therefore ask what kind of government policies provide the most encouragement for the co-ordinating process of the market.

In concrete terms, neo-classical welfare economists have seen a requirement for institutions such as the Monopolies and Mergers Commission, cost-benefit analyses, the nationalised industries and the National Enterprise Board, as devices to correct 'market failure' and improve resource allocation. Austrian economists have generally seen these institutions as more likely to *impede* the process of co-ordination. They have emphasised instead the importance of freedom of entry and the development of private property rights as means to encourage the smooth functioning of markets and the competitive process and thereby to protect the public from exploitation and inefficiency, not only from monopoly but also from unnecessary government.

A comparison of textbooks

It may be helpful briefly to compare 'neo-classical mainstream' and 'Austrian' textbooks. A typical neo-classical textbook[1] emphasises two central concepts: *maximisation* of the utility of individuals or the profits of firms, and *equilibrium* between individuals and firms in markets and the economy as a whole. The analysis is conducted almost entirely on the assumption of perfect knowledge.

Austrian textbooks reject this latter assumption.[2] It follows that the concepts of maximisation and equilibrium must be supplemented by the concept of individual *alertness to new knowledge* leading to adjustment processes in the market. From this new point of view, familiar notions such as 'perfect' and 'imperfect' competition no longer appear very helpful. It might be argued, therefore, that Austrian economics provides a *generalisation* and *re-direction of neo-classical thought,* rather than a 'root-and-branch' replacement for it.

[1] For example, C. E. Ferguson and J. P. Gould, *Micro-economic Theory,* Irwin, Homewood, Illinois, 4th Edn., 1975, which is described by the authors as 'a textbook on neo-classical price theory'.

[2] M. N. Rothbard, *Man, Economy and State,* Van Nostrand, New York, 1962; I. M. Kirzner, *Market Theory and the Prices System,* Van Nostrand, Princeton, NJ, 1963. A textbook at the forefront of economic analysis, which combines elements of neo-classical and Austrian thinking, is A. A. Alchian and W. R. Allen, *Exchange and Production: Competition, Co-ordination and Control,* Wadsworth Publishing Co., Belmont, Ca., 3rd Edn., 1983.

II. WHO ARE THE AUSTRIANS?

The growing awareness

In 1974, Professor Friedrich Hayek was (jointly) awarded the Nobel Prize in Economics.[1] Hayek is nowadays accepted as the leader of the so-called 'Austrian School of Economics'. Over the last three years there has been an increasing number of references, in the press and the economics literature, to this school of thought. The influential American magazine *Business Week*, for example, has run two feature articles on the implications of Austrian ideas for macro-economic policy. There have been several sessions on leading Austrians at professional economics meetings in the USA and, more recently, in Britain. A series of introductory weekend seminars in London and major American cities has attracted over a thousand participants. Exponents of the Austrian approach have themselves been on lecture tours to many universities, and a series of reprints and original papers in Austrian economics is now under way, sponsored by the Institute for Humane Studies.

The British economist in his 30's or 40's now in industry, in the civil service, or indeed in academia itself, must find all this puzzling. Austrian economics did not form part of his university syllabus, even as a postgraduate student—unless he was at the London School of Economics where Hayek taught from 1931 to 1950. From his browsing in the literature he may associate with the Austrian School the work of Menger on marginal utility or Böhm-Bawerk on capital and interest or Schumpeter on the 'perennial gale of creative destruction' in the modern economy. But surely, he may feel, all these ideas have already been embodied into 'mainstream' theory?

To a large extent these ideas have indeed been accepted, but they by no means exhaust the Austrian tradition, nor indeed are they fully representative of it. Marginal utility played only one part in Menger's scheme of things and the notion of marginal equalities was by no means as central as in later

[1] His Nobel Memorial Lecture entitled 'The Pretence of Knowledge' was included with other essays in *Full Employment at Any Price?*, Occasional Paper 45, IEA, 1975.

mathematical writers. We also now know that Menger considered Böhm-Bawerk's theory of capital and interest 'one of the greatest errors ever committed'.[1] As for Schumpeter, although an Austrian by origin, he espoused too many Walrasian beliefs[2] that were anathema to subsequent Austrians such as Mises to be accepted uncritically as one of the school.

What, then, *is* Austrian economics? What are the consequences for our understanding of the economy and for economic policy? Who are the Austrians anyway? The rest of this Section will establish who the Austrians are. Section III gives a general outline of the Austrian position, and Section IV a more detailed exposition of the Austrian theory of competition and the market process. The remaining Sections apply these Austrian insights to a broad range of topics where the question at issue is the appropriate role of government in industry.

To deal with all aspects of Austrian economics would require a very large book—or several books. Other IEA studies deal with aspects of Austrian thought which by and large have been accepted into 'mainstream' theory (the contribution of Austrian economics or economists to the history of economic thought) and with Austrian thinking on capital theory, money, credit, the trade cycle, unemployment, etc.[3] Austrian contributions here have been quite distinctive. On the economics of capital, for example, it has been argued that it is impossible to measure the size of the capital stock and, on the economics of money, that the *mode* by which money is injected into the economy, and not merely the total *quantity* of money, has a crucial effect on prices and production. Certainly, the three-pronged debate between Friedman, Hayek and the neo-Keynesians on macro-economic policy is still in full swing,[4] as illustrated in Hayek's recent and perhaps most radical *Denationalisation of Money*.

[1] J. A. Schumpeter, *History of Economic Analysis*, Oxford University Press, New York, 1954, p. 847, fn. 8.

[2] Such as general equilibrium and mathematical economics.

[3] E.g. such IEA publications as L. M. Lachmann, *Macro-economic Thinking and the Market Economy*, Hobart Paper 56, 1973; F. A. Hayek, *A Tiger by the Tail*, Hobart Paperback 4, 1972 (2nd Edn., 1978); *Full Employment at Any Price?*, *op. cit.*; *Choice in Currency*, Occasional Paper 48, 1976; *Denationalisation of Money*, Hobart Paper 70, 1976 (2nd Edn., 1978).

[4] E.g. Hayek, *Full Employment at Any Price?*, Occasional Paper 45, IEA, 1975, and *Choice in Currency: A Way to Stop Inflation*, Occasional Paper 48, IEA, 1976; Friedman, *Unemployment versus Inflation?*, Occasional Paper 44, IEA, 1975, and *Inflation and Unemployment: The New Dimension of Politics*, Occasional Paper 51, IEA, 1977.

The origin of the Austrian School

The 'Austrian School of Economics' may be said to date from the publication in 1871 of Carl Menger's *Principles of Economics (Grundsätze der Volkswirtschaftslehre)*. It was not immediately acclaimed. 'Until the end of the Seventies', remarked Mises, 'there was no "Austrian School". There was only Carl Menger'.[1] Subsequently, Menger (1840-1921) attracted a small but devoted band of disciples, notably Wieser (1851-1926) and Böhm-Bawerk (1851-1914), to expound and extend his thinking.

Menger's second book, *Investigations into the Method of Sociology and Political Economy*, appeared in 1883. It was intended as a defence of economics as a theoretical discipline, and represented a full-scale attack on the aims and methods of historical economics as they had been developing in Germany. Gustav Schmoller, the leading member of the German historical school, reacted with a rather contemptuous review. The various publications engendered over the next two decades by this controversy are known as the *methodenstreit* or 'clash over methods'. It was during this clash that the term 'Austrian School' was first used, in a derogatory sense, by members of the German historical school to refer to Menger and his disciples.

The Austrian School generated a rich crop of students, the best known of the second generation being Ludwig von Mises (1881-1973) and Joseph Schumpeter (1883-1950). The third generation, born around the turn of this century and taught by Mises, includes Haberler (b. 1901), Hayek (b. 1899), Machlup (b. 1902), Morgenstern (1902-1977) and Rosenstein-Rodan (b. 1902). All these economists eventually emigrated to the United States, and in one sense the Austrian School thereby came to an end.

It may be argued that the school had ended long before. By the turn of the century, the *methodenstreit* had petered out for lack of substantial disagreement, and Mises was later able to write that

> 'after some years all the essential ideas of the Austrian School were by and large accepted as an integral part of economic theory. About the time of Menger's demise (1921), one no longer

[1] *The Historical Setting of the Austrian School of Economics*, Arlington House, New Rochelle, New York, 1969, p. 10.

> distinguished between an Austrian School and other economics. The appellation "Austrian School" became the name given to an important chapter of the history of economic thought; it was no longer the name of a specific sect with doctrines different from those held by other economists.'[1]

The continuation of the Austrian School

How, then, did the concept of an Austrian School survive? Mises gave as the one exception to his generalisation his own work on the course and causes of the trade cycle. In retrospect, we can see that subsequent 'mainstream' economic theory developed along lines which differed in several crucial respects from those envisaged by Menger. Consequently, 'mainstream' economics failed to incorporate the bulk of the ideas of Mises and Hayek, who of all the Austrians worked most closely in the tradition of Menger.

It is possible, then, to speak of a distinct Austrian tradition even after 1920 in the sense of the ideas and methods initially proposed by Carl Menger and developed by Mises and Hayek. Several economists, regardless of their place of birth or education, have consciously worked in this tradition. It is in this sense that Ludwig Lachmann, a Berliner who studied under Hayek at the LSE in the 1930s, and Israel Kirzner and Murray Rothbard, who both attended Mises's seminar in New York in the 1950s and 1960s, are now considered current members of the historically-recognised Austrian School.

The last few years have seen a resurgence of interest in the Austrian approach. Younger scholars teaching in universities around the USA include W. Block, J. B. Egger, R. W. Garrison, W. Grinder, G. P. O'Driscoll, Jr., M. J. Rizzo and a further half-dozen graduate students at New York University. Indeed, New York is effectively the headquarters of the Austrian School today! It should be mentioned, however, that the Carl Menger Society in London runs a regular seminar programme on Austrian ideas; that Erich Streissler, the current holder of Menger's chair in Vienna, appears to have sympathy with the traditional Austrian approach; and that there is emerging interest in Australia, encouraged by Sudha Shenoy, a British 'Austrian' of Indian origin.

[1] *Ibid.*, p. 41.

Related writers

Our account would not be complete without some reference to other writers who have been particularly influenced, directly or indirectly, by the ideas of the Austrian School. Early followers included Smart and Wicksteed in Britain, Irving Fisher and Frank Fetter in the USA, Cossa and Pantaleoni in Italy and Wicksell in Sweden.[1] Later, Lord Robbins, Sir John Hicks and others at the LSE were influential in spreading Austrian ideas within Britain.[2]

Professor G. L. S. Shackle was a student of Hayek's at the LSE, and it has been remarked that to a striking extent Mises and Shackle share a common outlook on the foundations of economics.[3] Professor Brian Loasby (Stirling University) and Dr Alan Coddington (Queen Mary College, London) have in their turn been influenced by Shackle.[4] G. F. Thirlby (LSE retired) and Professor Jack Wiseman (LSE, now at York) reflect a distinctive LSE tradition which can ultimately be traced *via* Robbins and Hayek to Mises and the earlier Austrians.[5] G. B. Richardson, a student of Hicks at Oxford in the 1940s, has also acknowledged the important influence of Hayek's writings.[6] Nevertheless, these British writers have not worked consciously in the Austrian tradition, and in some respects they have gone further than the Austrians in emphasising the unpredictability of economic events and the limited role of general equilibrium.

Since Hayek taught for nearly two decades at the University

[1] I am indebted to Professor Machlup for these suggestions.

[2] L. C. Robbins, *An Essay on The Nature and Significance of Economic Science,* Macmillan, 1932, and *Autobiography of an Economist,* Macmillan, 1971, especially pp. 106-8; J. R. Hicks, *Capital and Time: A Neo-Austrian Theory,* Clarendon Press, Oxford, 1973. It may be noted, however, that Kirzner has taken issue with Robbins's emphasis on 'economising' to the exclusion of 'alertness' (below, p. 30), and that even Hicks's 'neo-Austrian' approach is associated rather narrowly with the Böhm-Bawerkian theory of capital.

[3] L. M. Lachmann, 'From Mises to Shackle: An Essay', *Journal of Economic Literature,* March 1976, pp. 54-62. An example of Shackle's work is *Epistemics and Economics,* Cambridge University Press, 1972.

[4] B. J. Loasby, *Choice, Complexity and Ignorance,* Cambridge University Press, 1976; Alan Coddington, 'The Rationale of General Equilibrium Theories', *Economic Inquiry,* December 1975, pp. 539-58.

[5] Cf. J. M. Buchanan, *Cost and Choice,* Markham Publishing Co., Chicago, 1969, and J. M. Buchanan and G. F. Thirlby, *LSE Essays on Cost,* Weidenfeld & Nicolson, 1973. Also Jack Wiseman, 'Costs and Decisions', Lecture to AUTE Meeting, York, March 1978.

[6] G. B. Richardson, *Information and Investment,* Oxford University Press, 1960.

of Chicago, albeit not in the economics department, one would expect to find there traces of his influence. Members of the so-called 'Chicago School' generally share a similar philosophic outlook but differ sharply on methodology from the Austrians. I shall argue later, nevertheless, that the work of Professors Armen Alchian and Harold Demsetz, both formerly of Chicago but now at the University of California at Los Angeles (UCLA), in many respects runs parallel to that of the Austrians. So too, in a different way, does that of the 'Virginia School' writers on public choice, notably Professors J. M. Buchanan and Gordon Tullock, both of whom also studied at Chicago.[1]

[1] A. A. Alchian and W. R. Allen, *op. cit.*; H. Demsetz, 'Information and Efficiency: Another Viewpoint', *Journal of Law & Economics*, April 1969, pp. 1-22; J. M. Buchanan and G. Tullock, *The Calculus of Consent*, University of Michigan Press, Ann Arbor, 1962, and several other works.

III. AUSTRIAN IDEAS

The views of Carl Menger

Menger is probably best known as one of the co-initiators (with Jevons and Walras) of the 'marginal' or 'subjective' revolution of the 1870s. This revolution, as Lachmann has remarked, amounted to a recognition that 'value is not a property inherent in goods, but constitutes a relationship between an appraising mind and the object appraised'.[1] Hence, there arose the need systematically to introduce *subjective* utility into economics. Some would argue that, for Menger, subjectivism meant essentially that different men have different tastes; recent work by Kirzner and others has emphasised the degree to which Menger's work contained at least the seeds of recognition of the role of knowledge and expectations.

Menger also emphasised what he called the 'atomistic' method. The nation as a whole is not equivalent to *one* large decision-maker, but is rather composed of a complex *collection* of individual decision-makers.

> 'Whoever wants to understand theoretically the phenomena of a national economy . . . must for this reason attempt to go back to their *true* elements, *to the individual economies in the nation* [i.e. to the individual decision-makers], and to investigate the laws by which the former are built up from the latter.'[2]

The classical economists, Menger felt, had failed to do this.

To explain some of these phenomena was for Menger one of the major tasks of economics.

> 'Language, religion, law, even the state itself, and, to mention a few economic and social phenomena, the phenomena of markets, of competition, of money, and numerous other social structures are already met within epochs of history *where we cannot properly speak of a purposeful activity of the community*, as such, directed at establishing them.

[1] L. M. Lachmann, 'Methodological Individualism and the Market Economy', in Erich Streissler *et al.* (eds.), *Roads to Freedom: Essays in Honour of Friedrich A. Von Hayek,* Routledge and Kegan Paul, 1969, p. 95.

[2] C. Menger, *Problems of Economics and Sociology* [1883], University of Illinois Press, 1960, p. 93.

> 'We are confronted here with the appearance of social institutions which to a high degree serve the welfare of society. Indeed, they are not infrequently of vital significance for the latter and yet are *not the result of communal activity.* It is here that we meet a noteworthy, perhaps the most noteworthy, problem of the social sciences: How can it be that institutions which serve the common welfare and are extremely significant for its development come into being *without a common will directed towards establishing them?*'[1] (My italics.)

Menger used the term 'organic' to refer to phenomena generated by such processes, as opposed to 'pragmatic' phenomena which are the result of legislation or agreement to that conscious end. Here, too, he felt that the classical economists had failed to appreciate this distinction.

> 'What Adam Smith and even those of his followers who have most successfully developed political economy can actually be charged with is . . . their defective understanding of the *unintentionally created social institutions* and their significance for economy. It is the opinion appearing chiefly in their writings that the institutions of economy are always the *intended* product of the common will of society as such, results of expressed agreement of members of society or of positive legislation. . . . The result is that the broad realm of unintentionally created social structures remains closed to their theoretical comprehension.'[2] (My italics.)

These three concepts emphasised by Menger—subjective utility, the atomistic method and organic phenomena—form the basis for the distinctive Austrian tradition which continued after 1920.

Developments of later generations

Modern Austrian economics is sometimes described as 'thoroughgoing subjectivism'. In Hayek's opinion, 'it is probably no exaggeration to say that every important advance in economic theory during the last hundred years was a further step in the consistent application of subjectivism'.[3] This was a development, he suggested, which had most consistently been carried out by Mises.

Neo-classical economics embodies individual tastes described

[1] *Ibid.,* p. 146.

[2] *Ibid.,* p. 172.

[3] *The Counter-Revolution of Science,* The Free Press of Glencoe, New York, 1952, p. 33.

in the form of charts called 'indifference curves' but, for the most part, has not gone further in characterising personalities. In Pareto's words: 'The individual can disappear, providing he leaves us this photograph of his tastes'.[1] If the purpose is to analyse the properties of general equilibrium in a state of perfect knowledge, this may suffice. But Austrian economics, in sharp contrast to neo-classical economics, has always attempted to explain behaviour in a world characterised by lack or dispersion of knowledge. It has consequently been necessary to emphasise the importance of incorporating many other aspects of the individual personality, notably

(i) *knowledge* about one's own tastes and the opportunities available;

(ii) *interpretations* of current events and the actions of others;

(iii) *expectations* about further events and behaviour;

(iv) *alertness* to new opportunities previously unperceived.

What is important here, of course, is that people *differ* with respect to their knowledge, interpretations, expectations and alertness. Subjectivism thus takes on a wider meaning than merely tastes, and Austrian economists have thereby been led to examine

> '... the new problems which these developments [in subjectivism] make appear more and more central, such as the problem of the compatibility of intentions and expectations of different people, of the division of knowledge between them, and the process by which the relevant knowledge is acquired and expectations formed'.[2]

Methodological individualism

Menger's 'atomistic method' would nowadays be referred to as 'methodological individualism'. This is the consistent use of the intelligible conduct of individuals as building blocks from which to construct 'models' of complex phenomena. It might be thought that 'mainstream' economics, based as it is upon the decisions of individual producers and consumers, already fully embodies the principle of methodological individualism. It is not difficult to find important exceptions.

(1) Despite much discussion of equilibrium prices, leading to a

[1] V. Pareto, *Manual of Political Economy* [1906], A. M. Kelley, New York, 1971, p. 120.

[2] Hayek, *The Counter-Revolution of Science*, *op. cit.*, p. 33.

presumption that they occur, neo-classical economics does not explain *how*, in practice, they come about.

(2) If the 'firm' is not just a single entrepreneur, but a collection of co-operating individuals, neo-classical economics does not explain how, or to what extent, the members of the firm, each with their own tasks and objectives, combine to design and carry out the firm's policy.

(3) Economists often invoke a 'social welfare function' which purports to embody the preferences of society, but welfare economics does not explain how the possibly conflicting beliefs and preferences of the individual members of society are aggregated to form this function.

(4) Welfare economics tacitly assumes that a government policy, once decided upon, is correctly and efficiently carried out. It does not refer at all to the problems of designing a suitable organisational framework within which to co-ordinate and monitor the politicians and bureaucrats selected for the task.

In other words, 'mainstream' economics has failed to relate the actions taken by these organisations to the preferences, knowledge, interpretations, expectations and plans of their constituent members. The result has been that traditional theory has failed adequately to explain the behaviour of such organisations. As we shall see, its 'normative' prescriptions on what governments *should* do, especially concerning optimal policy for industry or government, have turned out to be naïve or impracticable.

Unintended consequences and the passage of time

It is a common view, which Mises shared, that the task of economics is to look beyond the immediate and obvious consequences of any action to the more distant and obscure consequences, which can only be appreciated by an understanding of economic theory. Hayek went further: he said the major task of economics (indeed, of the social sciences generally) is to explain 'the unintended consequences of human action'. Many social institutions, as Menger had realised, are 'the results of human action but not of human design'. This insight, as we shall see, has important implications for the appropriate role of government in society.

One further aspect of Austrian economics is especially important. Organic phenomena such as money and markets can be developed only by a process which takes place over time. The individuals who comprise an organisation can form a common plan only by negotiations over time. Changes in knowledge and plans have significance only when earlier periods are compared with later ones. We thus see that an appreciation of the role of time—more precisely, the *passage* of time—is the fourth vital element of the Austrian approach, in addition to the concepts of subjectivism, methodological individualism and organic phenomena.

It may be felt that the concept 'Austrian' is still rather indistinct around the edges. This is no doubt true. It certainly cannot be claimed, for example, that Austrians alone saw the importance of introducing imperfect knowledge, expectations, learning and time into economics. In the period up to 1929, F. H. Knight, J. M. Keynes and the Scandinavian writers Wicksell, Myrdal and Lindahl certainly emphasised one or more of these aspects.[1] In the last decade many eminent mathematical economists have attempted to develop theories of general equilibrium under uncertainty.[2] What can be claimed, perhaps, is that Austrian writers have pursued the implications of subjectivism with a significantly greater consciousness and consistency than other writers.

Austrian methodology: reservations about empirical testing

It is safe to say that no two Austrians have ever completely agreed on methodology, any more than have any two other economists. Nevertheless, there has been broad agreement on a general position, which Kirzner has summarised:

> 'Austrian economists are subjectivists; they emphasise the purposefulness of human action; they are unhappy with constructions that emphasise equilibrium to the exclusion of market processes; they are deeply suspicious of attempts to apply measurement procedures to economics; they are sceptical of empirical "proofs" of economic theorems and consequently have serious reservations about the validity and importance of a good deal of the empirical work being carried on in the economics profession today.'[3]

[1] Cf. T. W. Hutchison, *A Review of Economic Doctrines 1870-1929*, Clarendon Press, Oxford, 1953, especially Ch. 20.

[2] Below, Section IV, sub-section entitled 'Temporary equilibrium models', pp. 36-7.

[3] 'On the Method of Austrian Economics', in E. G. Dolan (ed.), *The Foundations of Modern Austrian Economics*, Sheed and Ward Inc., Kansas City, 1976, p. 40.

This position is evidently quite different from that taken by 'mainstream' economists. It is therefore necessary to provide a brief explanation.

It is nowadays widely held, and most emphatically taught at the University of Chicago, that economic laws and theories can be established only by adopting the methods of the natural sciences, such as physics. These proceed by inventing, testing and revising hypotheses about the nature of, say, the atoms which are presumed to comprise familiar objects such as tables and chairs. Consequently, it is suggested, economists should make hypotheses about the ways in which 'atoms' such as consumers, firms, governments and economies make decisions, then test the predictions of these hypotheses against observed behaviour. The adequacy of a theory should then be judged by how well it *predicts* behaviour, rather than by how realistic its assumptions are. Indeed, it would be argued that the only test of realism *is* the test of prediction. It is this behaviouristic approach which has come to be known as 'positive economics', and which is reflected in the title of one of the most respected introductory textbooks today.[1] The implication is that approaches to economics which do not follow this methodology are unscientific.

As the quotation from Kirzner (p. 24) suggests, Austrians do not subscribe to this view. At least four reasons can be identified.

First, Austrians from Menger onwards (and indeed other economists such as Frank Knight) have always maintained that in observing the actions of other persons we are assisted by a capacity of *understanding* the meaning of such actions in a way in which we cannot understand physical events. Being human ourselves, we have insights into the behaviour of other human beings which it is, in part, the task of the social sciences to explain.[2] We know, for example, that men are *purposeful* and that they are *alert to new possibilities* for increasing their satisfaction. They take *initiatives*: they do not merely *respond* passively to external stimuli in the way that biological organisms do. Thus, if we see the British government pass a series of measures controlling prices and incomes, we may be led to correlate

[1] Milton Friedman, 'The Methodology of Positive Economics' in *Essays in Positive Economics*, University of Chicago Press, Chicago, 1953. Also R. G. Lipsey, *An Introduction to Positive Economics*, Weidenfeld and Nicolson, 1st Edn., 1963.

[2] Hayek, *The Counter-Revolution of Science, op. cit.*, p. 25. Mises used the term 'praxeology' to describe the sciences of human action, of which economics was the most developed.

the actions taken with, say, the levels of inflation and unemployment precisely because of our suspicion that members of the government are actively trying to find a solution to what they perceive as a serious problem. The existence of such a sense of purpose we know, and do not need to *deduce* from observed behaviour. Indeed, it might be argued that we *cannot* deduce it merely from observed behaviour, and furthermore that any explanation or theory of observed behaviour is ultimately unsatisfactory unless it is consistent with such knowledge.

The second Austrian reservation is based on the truth that it is difficult to make precise testable predictions in situations where there is a large number of elements ('variables') about which it will never be possible to obtain the necessary full information. This is, of course, the usual case in the social sciences. The economist will typically be able to predict only general *patterns* of behaviour and not the behaviour of each *individual* element. He can predict, for example, that a rise in price will lead to a fall in demand, but he cannot usually predict the exact extent of this change in demand, simply because he never has sufficient information about the preferences and opportunities of the individuals in question. He is limited, as Professor Hayek put it, to 'prediction in principle' rather than 'prediction in detail'.[1] To insist that the only theories which are acceptable are those referring to measurable and testable magnitudes may cause the true theory to be disregarded and may lead to policies which make matters worse, as Hayek believes to be true of the present very serious problem of inflation and unemployment.[2]

Third, it is not even clear that economic theory *can* be empirically tested. Consider the 'law of demand' just referred to: that a rise in price will lead to a fall in demand. How is this law established? Many economists argue that we believe the law because it is continually being tested and has never been found false. If a rise in the price of, say, apples is occasionally followed by a *rise* in the demand for apples, they explain that consumers must have thought the higher-priced apples were of

[1] F. A. Hayek, 'The Theory of Complex Phenomena' in *Studies in Philosophy, Politics and Economics,* Routledge & Kegan Paul and the University of Chicago Press, 1967. Cf. also Aristotle: 'For it is the mark of an educated mind to expect that amount of exactness in each kind which the nature of the particular subject admits'. (*Nichomachean Ethics,* Book 1, Ch. 3.)

[2] 'The Pretence of Knowledge', *op. cit.,* p. 36.

better quality, whereas the law applies only to apples perceived as identical. In this case, however, it seems that empirical testing established not the truth or falsity of the law of demand, *but whether the observer has correctly identified identical commodities.* How, then, is it ever possible to establish empirically the law of demand?

The fourth reservation about empirical work is based upon the Austrian insight that *there is an indeterminacy and unpredictability inherent in human preferences, human expectations and human knowledge.* Shackle and Lachmann, in particular, have stressed the spontaneity and creativity of the act of choice. If this is true, one cannot hope to find *permanent* empirical regularities in economics which may be safely extrapolated beyond the existing data at hand to yield scientific theorems of universal validity. 'Elasticities' of demand (the degree to which demand changes in response to changes in price) and substitution will remain constant only until such time as people discover new tastes or opportunities. There can be no unchanging 'parameters' in the social sciences of the kind existing in the natural sciences.[1]

For these four reasons, Austrians argue that the nature of the social sciences is fundamentally different from that of the natural sciences. Economics as a social science requires a different methodology from physics. This is not at all 'unscientific'. Indeed, it is the uncritical application to economics of the methods of the natural sciences which is itself the unscientific procedure.

It is not surprising, therefore, to find that Austrians have for the most part eschewed empirical and statistical work. They have concentrated on deriving propositions of a *qualitative* rather than a *quantitative* nature. These propositions follow from the basic insights into human nature referred to earlier, rather than from assumptions about the real-life content of preferences, knowledge or expectations. For this reason, it is envisaged that such propositions will be true for *all* times and places rather than only for specific times and places.

The appropriate role of empirical work

In the light of the Austrian reservations against empirical testing of economic theories, it seems appropriate to indicate two im-

[1] Kirzner, *op. cit.*, p. 43.

portant roles which empirical work can and does play.

The first role concerns the status of the insights about human nature which Austrians use as basic assumptions. Mises liked to refer to them as *a priori* knowledge. But he did not suppose that such knowledge is completely and immediately made known to us merely by introspection. At any time we undoubtedly fail to appreciate the nature and significance of certain features of the human personality, and interpret other features incorrectly. Moreover, yet other insights depend not only upon introspection but upon observation: the insight that man's preferences are unpredictable depends upon our *experience* that men *are* unpredictable in their actions. Similarly, the Austrian belief in a co-ordinating market process depends upon empirical assertions about how men learn from *experience.*

If this argument is correct, there is also an important role for empirical testing in the process of developing, modifying and correcting economic theory itself. Empirical measurement and testing may suggest hitherto unnoticed flaws or omissions or undeveloped propositions in economic theory, and may help to resolve differences of opinion about such matters.

Mises, as we have remarked, thought of economic theory as limited to qualitative propositions that are true for all times and places. But the term 'economic theory' is frequently used in a looser sense, to explain behaviour in a particular country over a particular period of time. It has recently been observed, for example, that the analysis and prescriptions of Keynesian economics may have been appropriate in the time of Keynes but no longer are so, and similarly for the Phillips Curve.[1] The reason is that people learn from experience and react differently henceforth.

If economic theory is used in this more general sense, it clearly embodies assumptions about the beliefs held by people, and about the ways in which they respond to events. Whether these assumptions are correct is eminently a matter for empirical testing.

[1] Jack Wiseman, 'A Model of Inflation and the Government Deficit', in *The Dilemmas of Government Expenditure,* IEA Readings No. 15, IEA, 1976, pp. 39-49; Milton Friedman, *Inflation and Unemployment: The New Dimension of Politics,* Occasional Paper 51, IEA, 1977.

IV. COMPETITION AND THE MARKET PROCESS

Difficulties of 'perfect' competition

If one had to identify a single concept at the heart of Austrian economics, it would undoubtedly be that of the market process. 'Mainstream' economics is centred upon the notion of competitive equilibrium at a point in time characterised by perfect knowledge and co-ordinated plans on the part of the participants in the market. Austrians supplement (or even replace) this notion with that of a process taking place over time which is characterised not only by *lack* of knowledge and consequent *lack* of co-ordination, but also by *learning* and *increasing* co-ordination.[1]

Consider the conventional textbook analysis of perfect competition. Each consumer with given income chooses a basket of commodities at known prices to maximise his utility. Each producer chooses the bundle of inputs and outputs and the set of techniques which will maximise his profit, again at given prices. These prices are determined by aggregating the decisions of individual consumers and producers to generate total demand and supply curves for each industry. The intersection points of these curves determine equilibrium prices and quantities for all commodities. Everything happens very smoothly.

Can such an analysis be reconciled with the real world, characterised as it is by lack of knowledge and mistakes? To some extent it can. The conventional analyses of consumer and producer must be interpreted as referring to the *plans* of these individuals. The goods and techniques from which they choose are those of which they have knowledge at the time: the prices are those they expect to prevail when the time comes to buy or sell. The plans of these individuals are optimal for them in the light of their current views of the market.

These plans must now be put into effect. To the extent that

[1] Of course, the notion of competition as a process did not originate with the Austrians. It is to be found in Adam Smith and other classical writers. P. J. McNulty argues that only in this century has it been superseded by the static concept of perfect competition. ('A Note on the History of Perfect Competition', *Journal of Political Economy*, August 1967.)

they embody correct predictions about the environment and the actions of others, it will be possible to carry them out. But sooner or later a revision of plans will be desirable, either because of *errors* in forecasting or because *new opportunities* are noticed which had previously been missed. The decision-makers must, therefore, be represented as alert to their environment, in order that they may revise their plans when it seems to them advantageous to do so.

The concept of 'economising', or maximising subject to *given* tastes and prices, is not adequate to encompass the search for *new* opportunities, whether new products or better terms for existing ones. Many Austrians reserve the term 'entrepreneurship' to describe this latter power of alertness. The term 'acting man' was coined by Mises to refer to the typical decision-maker equipped with the power not only to economise but also to exercise such entrepreneurship. Professor Kirzner emphasises that:

> 'It is this entrepreneurial element that is responsible for our understanding of human action as active, creative, and human rather than as passive, automatic and mechanical.'[1]

Competition and the market process

According to the Austrian view, the key insight into competition is that different people know different things; the market process gathers and transmits these discrete and often contradictory bits of information, thereby co-ordinating people's actions.[2] The importance of this idea is seen when examined in a little more detail.

In the context of the market, the term *entrepreneurship* refers to the alertness to profit opportunities not so far grasped by other market participants. In the simplest case, this response will consist of arbitrage: where a commodity is unwittingly sold at different prices in different places or at different times, it is possible to profit by buying at the lowest prices and selling at the highest. In the more complex case, production may be seen as an opportunity to put together a bundle of inputs

[1] *Competition and Entrepreneurship,* University of Chicago Press, 1973, p. 35.

[2] Mises, *Human Action,* Henry Regnery Co., Chicago, 1st Edn., 1949, 3rd Rev. Edn., 1963; Hayek, 'The Meaning of Competition' and other studies in *Individualism and Economic Order,* University of Chicago Press, Chicago, 1948; more recently 'Competition as a Discovery Procedure', in *New Studies in Philosophy, Politics, Economics and the History of Ideas,* Routledge and Kegan Paul, 1978.

(labour, capital, etc.) costing less than the value of the output, or even yielding a different product which other firms have not yet noticed.[1]

Thus profit is not necessarily (or even usually) the result of monopoly power: it is the result of successful entrepreneurial activity, the reward for noticing some lack of co-ordination in the market. Thus Professor Kirzner:

> 'The essence of the "profit incentive" (and in particular its significance for normative economics) is thus not to be seen as motivation to work harder or to allocate resources more efficiently. The profit incentive (including, of course, the disincentive of loss) operates most significantly by sparking the alertness of entrepreneurs—by encouraging them to keep their eyes open for new information that will lead to new plans.'[2]

Especially in the British context, mention should be made of the subtle but pervasive and harmful effect which high marginal income taxes cannot fail to have on *entrepreneurial incentives.* There can be little incentive to be alert to opportunities the gain from which will accrue to unknown others decided by government. Something of a vicious cycle may indeed be noticed. That over one-quarter of British GNP is channelled *directly* through government is responsible for the high income-tax rates which sap the incentive to notice new opportunities—providing in turn fuel for the critics who point to the failure of the market to achieve prosperity, etc.

The very activity of exploiting opportunities brings them to the notice of other market participants, and they in turn respond by new alertness. Profits which previously existed because of unnoticed opportunities are now competed away. Whereas a variety of prices used to exist in the market, because sellers at one price were unaware that there were buyers at a higher price, over time a single price comes to rule as information is dispersed through the market. Thus, as Professor Kirzner explains:

[1] *Sunday Times* (16 October 1977) contains the following amusing example of entrepreneurship. Mr Gerry Crown realised that since horse-chestnut trees do not grow in Australia, the Pommies would miss their conkers, so he collected and shipped out 300,000 from England. Another example chosen at random is Sir Fred Pontin's 'early awareness of holiday-makers' growing preference for self-catering villages rather than the regimented image of the traditional holiday camp', which yielded pre-tax profits of £6·7 million in 1977. (*The Times,* 5 January 1978.)

[2] Kirzner, *op. cit.,* p. 223.

> '. . . even without changes in the basic data of the market (i.e. in consumer tastes, technological possibilities, and resource availabilities), the decisions made in one period of time generate systematic alterations in the corresponding decisions for the succeeding period. Taken over time, this series of systematic changes in the interconnected network of market decisions constitutes the market process'.[1]

The situation depicted in the perfect competition model represents the situation when the competitive process has run its course. There are no further profit opportunities to be exploited; the market participants are fully co-ordinated. In such a situation there is no role for entrepreneurship. Mises saw the perfectly competitive model (or a variant of it, which he called the 'evenly rotating economy') as serving a useful, albeit limited, function.

> 'In order to grasp the function of entrepreneurship and the meaning of profit and loss, we construct a system from which they are absent. . . . In eliminating the entrepreneur one eliminates the driving force of the whole system.'[2]

Since, however, all action in the real world takes place in the face of more or less uncertainty, all action *ipso facto* contains an element of entrepreneurship.

Competition is thus seen as a device for *co-ordinating* the plans of market participants. To be sure, a piece of new information, or the intervention of a competitor, will disrupt someone's existing plan and force him to revise it. Many economists, including perhaps Schumpeter, see only this aspect of competition and thereby label it 'disruptive' of equilibrium. But the very existence of unexploited profit opportunities which are seized by competitors is an indication that previous plans were somewhere not co-ordinated. By drawing attention to and remedying this lack of co-ordination, competition acts as an equilibrium force.

'Monopolistic' competition

There have been several attempts to replace or supplement the notion of perfect competition. Most notable were the concepts of monopolistic and imperfect competition developed during the 1930s by, respectively, Professor E. H. Chamberlin of

[1] *Ibid.*, p. 10.

[2] *Human Action, op. cit.*, pp. 248-9.

Harvard and Professor Joan Robinson of Cambridge, England.[1] According to Professor Kirzner, these attempts were completely on the wrong track:

> 'The authors of the new theory failed entirely to correctly identify the source of [the existing theory's] unrealistic character. Instead of attacking the equilibrium emphasis in the theory of pure competition, these authors introduced *different* equilibrium theories . . . In the course of attempting to account for such market phenomena as product differentiation, advertising or markets in which few producers are to be found, the new theories were led to conclusions which grossly misinterpret the significance of these phenomena.'[2]

Let us briefly examine the basis for this claim. The theory of monopolistic competition is generally believed to be more realistic than the previous theories of perfect competition and monopoly, because it allowed for product differentiation, advertising and inter-dependent demand curves. Chamberlin's explanation of product differentiation, nevertheless, suffers from two deficiencies. First, like the previous theories of perfect competition and monopoly, it assumes the demand curves to be somehow 'given'. There is no recognition of the need for manufacturers and consumers to *experiment* in order to find those products and variations which are most appropriate. Consequently, the theory of monopolistic competition rules out the possibility that a significant part of the product differentiation existing in the world today is not the result of a *final informed equilibrium choice* by consumers, but rather a reflection of a *continuing process of exploration*. Second, as others besides Austrians have pointed out,[3] the theory of monopolistic competition does not explain how product differentiation can persist in equilibrium—that is, why other firms cannot duplicate those varieties of product which turn out to be successful.

The role of advertising

Advertising represented something of an embarrassment to traditional economic theory. If consumers had perfect informa-

[1] E. H. Chamberlin, *The Theory of Monopolistic Competition*, Harvard University Press, Cambridge, Mass., 7th Edn., 1956; Joan Robinson, *The Economics of Imperfect Competition*, Macmillan, 1933.

[2] *Competition and Entrepreneurship*, *op. cit.*, p. 29.

[3] H. Demsetz, 'The Notion of Equilibrium in Monopolistic Competition', *Journal of Political Economy*, February 1959, pp. 21-30.

tion about the products available, it was not clear what the role of advertising could be. It seemed to represent a waste of resources. But if consumers did not have perfect information, there would obviously be a need for its provision, and resources thus spent would not necessarily be wasted.

To Chamberlin and others, advertising was one way of conveying information to consumers about a product they knew existed. But to mix information with persuasion seemed undesirable, and the amount of resources devoted to advertising seemed excessive. Perhaps a more efficient and unbiased method of spreading the necessary information might be reports by independent consumer advisory units. Professor J. E. Meade put this view:

> 'Of course, much advertisement of an informative nature is necessary and desirable. But much advertisement is not of this kind. A tax on advertisement would increase the incentive for firms to seek markets by cutting prices rather than by persuasive bamboozlement. . . .
> Measures might be taken to replace much interested persuasive advertisement with impartial information through the promotion by the State of bodies for consumers' research and education.'[1]

Austrian thinking provides a new insight into advertising. Consumers do *not* always know what products are available, and even if they know of their existence they are not always aware of their properties. And consumers cannot, of course, seek further information about a product or property of whose existence they are unaware. Consequently, there is an important role for the manufacturer in bringing these new products to their notice. In effect, he has to help the consumer to act entrepreneurially. For this purpose, advertising may well have to be persuasive, even accompanied by a catchy jingle, because it is necessary to attract the consumer's attention, and persuade him that it will be worth while to take an interest.[2] Thus it is that Charles Atlas proclaims 'You too can have a body like mine' because his potential customers are seven-stone weaklings who have given up hope.

[1] J. E. Meade, *The Intelligent Radical's Guide to Economic Policy,* George Allen & Unwin, 1975, pp. 49-50.

[2] [Early IEA studies of advertising reached broadly similar conclusions: Ralph Harris and Arthur Seldon, *Advertising in a Free Society,* 1959, and *Advertising and the Public,* 1962.—ED.]

Austrian views on markets with few producers—oligopoly—are somewhat ambiguous and not treated at much length. It will therefore be more fruitful to outline the Austrian position on markets with a single producer—the case of monopoly.

It is traditionally assumed that a single producer will be able to raise his price and thereby earn a monopoly profit, depending upon the shape of his demand curve. It is not always explained how he comes to know this demand curve, why he is a single producer, and why entry (or the threat of it) from other firms does not prevent him from acting as he does. For Austrians, these questions are crucial.

Demand curves are not somehow 'given': they have to be discovered by experimenting, by trial and error. (Alchian and Allen use the term 'price searcher'.)[1] Even if a firm is a monopolist, it has to discover what its customers want and what they will pay for it. In other words, the presence of monopoly in no way obviates the need for the market process of discovery. In this sense the competitive character of the market process has not been affected. As Professor Kirzner puts it:

> 'The final equilibrium position toward which the market is tending may be drastically affected by monopoly resource ownership, but the process of bringing the decisions of market participants into more closely dovetailing patterns remains unchanged.'[2]

Schumpeter always emphasised that the real source of competition, that which threatened a producer's very livelihood, arose not from other producers of the *same* product but from *new* and *better* products and techniques. Monopoly of the original product availed little against such attacks; hence the market was characterised by a 'perennial gale of creative destruction'.[3]

This approach leads in turn to the question of *why* a firm is a single seller of a given product. There are several possibilities. Other firms may not find it worthwhile to compete. I believe, for example, there is only one firm in Britain supplying academic gowns on loan for degree congregations, although others easily could. Such cases are no cause for concern.

[1] *Exchange and Production . . ., op. cit.*

[2] *Competition and Entrepreneurship, op. cit.*, p. 21.

[3] J. A. Schumpeter, *Capitalism, Socialism and Democracy*, Harper and Row, New York, 1st Edn., 1942, 3rd Edn., 1950.

Some firms may be protected from entry by the government. The Post Office has a statutory monopoly of letters, telegraphs and telephones, though other firms would like to compete in various areas. Laker airlines was for many years prevented by British and American governments from operating its cheap 'Skytrain' to New York. Austrians have always condemned such special privileges.

Some firms may be producing products or varieties thereof which other firms have not seen as profitable, or whose potential profitability they have recognised only belatedly. Providing competitors can enter, the monopoly position is then only temporary, and 'monopoly profits' are more accurately described as 'entrepreneurial profits', for they result from the successful exploitation of an opportunity which others have not yet seen. A pertinent example is provided by Xerox, which was bought by Rank Corporation after 40 other organisations had turned down the opportunity; yet in 1975 Rank Xerox achieved pre-tax profits of £184 million.[1]

Finally, a firm may be a monopolist because it owns the entire stock of some resource required to produce the products. Other firms would like to enter the market and are prevented from doing so not by the government but by the company itself. The monopolist is therefore able to restrict his output, increase his prices and earn true monopoly profits deriving from his monopoly ownership of the resource. Only in this last case does the market mechanism not ensure that resources are distributed according to the wishes of the consumers.[2]

The implications of monopoly for public policy are discussed in Section VI. It suffices here to establish the emphasis which Austrians place upon freedom of entry as a necessary and sufficient condition for competition in the sense of a market process.

Temporary equilibrium models

There has recently been a good deal of interest in mathematical models of temporary equilibrium, designed to incorporate un-

[1] Monopolies and Mergers Commission, *Indirect Electrostatic Reprographic Equipment*, HC 47, HMSO, December 1976.

[2] Mises, *Human Action, op. cit.* However, other Austrians would disagree, taking the line that in practice a monopoly price can never be identified, or that the monopolist is himself a consumer: Murray N. Rothbard, *Man, Economy and State*, Van Nostrand, New York, 1962, Ch. 10; W. Block, 'Austrian Monopoly Theory: A Critique', *Journal of Libertarian Studies*, Vol. 1, No. 4, 1977.

certainty, information and time into the static general equilibrium models of the last two decades.[1] It might appear that these models are consistent with the Austrian approach. I would maintain that a closer examination reveals a significant difference: they contain no element of alertness or entrepreneurship. Essentially, the agents are programmed with 'expectation functions' and 'decision functions' which enable them to operate in an environment of uncertainty and change. But though the specific forecasts made by the agents may change over time in response to changes in inputs, the 'functions' themselves remain the same. Nothing will ever occur for which the agents are not prepared; nor can they ever initiate anything which was not pre-ordained for them.[2]

The 'concentration doctrine'

It is often suggested (usually in informal discussion between academics) that although the notion of a competitive process is helpful as an explanation of how competitive equilibrium is attained, nonetheless it is the theory of equilibrium which is more important. For all practical purposes the economy is 'near enough' in equilibrium. In particular, it is said, this assumption is the most useful basis for empirical work.

It is therefore of interest to examine a group of studies which show that a theory of market process, in which the economy is explicitly assumed *not* to be in equilibrium but rather in *transition*, provides a quite different, and apparently superior, explanation of certain empirical data. Moreover, this alternative explanation based on a continuing market process has implications for government policy which are radically different from the implications of the theory based upon equilibrium.

The so-called 'concentration doctrine' is the belief that collusion between firms is easier in industries where total output is concentrated in relatively few firms, and that collusion will, in turn, lead to higher prices and profits and lower output. This doctrine is frequently put forward to justify policies of merger control and even forcible de-concentration.[3]

[1] F. H. Hahn, *On the Notion of Equilibrium in Economics*, Cambridge University Press, 1973; J. M. Grandmont, 'Temporary General Equilibrium Theory', *Econometrica*, April 1977, pp. 535-72.

[2] S. C. Littlechild, *Change Rules, O.K.?*, Inaugural Lecture delivered at the University of Birmingham, 28 May 1977, and published by the University.

[3] Harold Demsetz, *The Market Concentration Doctrine*, AEI-Hoover Domestic Policy Studies, Washington DC, 1973.

If this theory is correct, we should observe higher profit ratios in highly concentrated industries. The evidence is not entirely convincing. An important pioneering study, by Professor J. S. Bain, was based on data for 42 US industries over the period 1936-40.[1] He found that in the group of highly concentrated industries, where the eight largest firms accounted for 70 per cent or more of value added, the average profit rate was significantly higher than in the less concentrated industries.

This study has been examined by Professor Yale Brozen of Chicago University. He showed that even if concentration had facilitated collusion in 1940, it had not been possible to keep out new entry for a long period: 15 years later the high and low profit rates in Bain's industries had moved back towards the average.[2]

Professor Harold Demsetz analysed the same problem from a different point of view.[3] If concentration facilitates collusion, not only the large firms but also the small firms in a concentrated industry would benefit from higher prices and show higher profit rates. Yet the evidence he adduced did *not* show that profit rates of small firms increased with concentration. Demsetz also suggested that those firms tended to grow fastest which noticed and exploited profitable opportunities before others. An industry would be more highly concentrated the wider the difference in ability between its constituent firms. Higher concentration should therefore imply a wider difference in profit rates between small and large firms. The evidence collected by Demsetz supported this hypothesis.

These results seem to reject the theory that concentration allows collusion which, in turn, leads to higher profit rates. Rather, variations in profit rates are to be explained by differences in the perception of, and speed of reaction to, *changes* in the underlying market phenomena. These changes set in motion a market process which takes time to work out: indeed, firms are *always* in transition. Some have learned and

[1] Bain, 'Relation of Profit Rate to Industry Concentration: American Manufacturing 1936-40', *Quarterly Journal of Economics*, Vol. 65, 1951.

[2] Brozen, 'The Antitrust-Task Force Deconcentration Recommendation', *Journal of Law and Economics*, October 1970. His later work showed that Bain's results were biased by a statistical error resulting from the incorrect assumption that industries were in long-run equilibrium: Y. Brozen, 'Bain's Concentration and Rates of Return Revisited', *Journal of Law and Economics*, October 1971.

[3] Demsetz, 'Industry Structure, Market Rivalry and Public Policy', *Journal of Law and Economics*, April 1973.

grown, some are learning and growing, others have misjudged the situation and are shrinking. The profits achieved by these firms reflect their success in adapting themselves to the changing conditions of the market. In short, we have here an apposite illustration of the Austrian approach to competition as a process. This theory, which implies the ever-changing structure of industry, seems more successful than the 'concentration doctrine' in explaining the relationship between profit, size of firm and concentration.

The competitive process theory has quite different policy implications from those of the concentration doctrine. To break up firms or to prohibit mergers in order to deconcentrate the industry is not likely to decrease profit rates. On the contrary, it is more likely in the short run to force firms to operate at inefficient sizes with the result that prices will be higher than they otherwise would be, and in the long run to discourage firms from noticing and exploiting opportunities to reduce costs or introduce new products. These and related issues will be further developed in Section VI.

V. THE ROLE OF GOVERNMENT

The mixed economy

The appropriate role of government is the subject matter of 'welfare economics'. In essence, it is argued that, under specified 'ideal' conditions, a competitive economy will bring about an allocation of resources which is 'efficient'. But these conditions may not be met in the real world: so there may be cases of 'market failure'. The job of the welfare economist is to identify such failures, and to prescribe appropriate government policy for dealing with them.

This kind of thinking is frequently used to explain and defend the 'mixed economy' which characterises almost all non-Communist countries today. A distinguished proponent of this view is Professor James Meade of Cambridge University, the latest (joint) Nobel Prizewinner in Economics. His book, *The Intelligent Radical's Guide to Economic Policy: The Mixed Economy*, develops his argument, from which it will be convenient to quote at some length.

The 'intelligent radical' is concerned to encourage efficiency, security and participation, but above all dislikes large concentrations of power, which threaten independence, and large concentrations of wealth, which perpetuate class distinctions. From these value-judgements the following conclusions for policy are derived:

> 'The intelligent radical . . . starts by advocating the removal of all unnecessary restrictions on the operation of free competitive markets. But he recognises that on the foundation of this market mechanism there must be built a super-structure of governmental interventions and controls. Some of these interventions are needed simply to set a background of conditions in which free competition can work effectively; others are needed to replace entirely the mechanism of competitive markets, where that mechanism cannot be expected to operate effectively; others have an intermediate purpose, namely to modify without replacing the operation of a market price mechanism . . .
>
> First, the intelligent radical . . . will realise how essential . . . it is to his purpose to control inflations and deflations . . .

> Second, . . . governmental intervention is needed to submit to appropriate social controls the use of the monopolistic powers of large corporate concerns, whether these can be huge conglomerate industrial concerns or powerful labour monopolies.
>
> Third, in some cases economies of large scale are so important that monopoly is inevitable, as in the case of railway transport, the generation and distribution of electricity and such like services. In these cases, the intelligent radical will advocate outright state ownership and control.
>
> Fourth, there are many goods and services—such as the administration of justice and maintenance of law and order—which in the nature of things cannot be purchased separately by each individual for his own separate enjoyment, but which must be purchased and enjoyed in common by all members of the community. The intelligent radical will recognise the fact that in modern conditions the central and local governments must play a large role in the provision of such public goods.
>
> Fifth, the intelligent radical . . . advocates State action to promote equality of opportunity [and] . . . far-reaching direct fiscal measures should be taken by budgetary taxes and expenditures to moderate the high, and to supplement the low, incomes and properties.
>
> Sixth, the intelligent radical realises that the market mechanism cannot be expected to deal adequately with planning for the uncertainties of the future, and that its operation may well be aided by some measure of governmental indicative planning.
>
> Seventh, he also recognises the need for the central planning of large structural changes in the economy.
>
> Finally, he recognises the need for controls and interventions in order to cope with important cases in which the market mechanism will otherwise neglect to take into account important items of social, as opposed to private, costs and benefits. Problems of environmental control, of the use of exhaustible resources, and of population growth will on these grounds be recognised as raising issues which call for governmental action.'[1]

Professor Meade is here expressing a view which is held by many, if not most, economists and, indeed, perhaps intuitively, by members of the general public. His argument is clear and concise, and his initial value-judgements will surely command widespread sympathy. In his vigorous defence of competition, he will certainly have the support of Austrians. Nevertheless there are many other aspects of his proposals which raise serious doubts about the desirability of the mixed economy.

[1] Meade, *op. cit.*, pp. 13-16.

Austrian scepticism about 'welfare economics'

To begin with, it is clear, in the light of the principles sketched out in Sections III and IV, that an Austrian is necessarily sceptical about the 'welfare economics' lying behind these policies. He has reservations in three major respects.

First, he cannot accept the implied description of how the market mechanism operates. He sees hardly any reference in welfare economics to uncertainty and mistakes. He finds competition presented as a state of equilibrium with *given* commodities and techniques, rather than as a dynamic process of *searching* for *new* commodities and *better* techniques. He finds more concern with achieving the 'efficient' set of prices and outputs than with ensuring a steady reduction in prices and increase in outputs. (This proposition has been discussed at some length in the preceding section.)

Second, the Austrian finds no detailed explanation in welfare economics of how government is supposed to obtain the information necessary to carry out its assigned tasks. The knowledge required for a general assessment is not to be found collected in one place, but rather dispersed throughout the many members of the economy. Moreover, the relevant knowledge does not for the most part refer to 'facts' about the past but to preferences and opportunities in the future, which exist only in people's heads and are therefore highly subjective. This proposition will become clear in the succeeding sections.[1]

Third, as Menger and Hayek have pointed out, institutions for solving social problems may in principle be of two kinds: pragmatic (reflecting conscious design) or organic (arising unintentionally). It is necessary to choose an appropriate balance between the two kinds of institutions, to choose an appropriate pragmatic framework of regulations and government policies within which organic processes can operate. To Austrians, welfare economics fails sufficiently to appreciate the nature, resilience and power of organic processes, and hence tends to see the solution as necessarily pragmatic, requiring a government organisation to exert conscious control.

Austrians have not been alone in this conclusion. In par-

[1] Mises, 'Economic Calculation in a Socialist Community', in Hayek (ed.), *Collectivist Economic Planning*, George Routledge & Sons, 1935; Hayek, 'The Use of Knowledge in Society', and 'Socialist Calculation I, II, III', in *Individualism and Economic Order, op. cit.;* Rothbard, 'Toward a Reconstruction of Utility and Welfare Economics', in M. Sennholz (ed.), *On Freedom and Free Enterprise,* Van Nostrand, Princeton, NJ, 1956.

ticular, the authors mentioned in Section II (pp. 18-19), especially Professor Demsetz, have emphasised that our interpretation and evaluation of the market and government depend crucially upon the availability (or otherwise) of information.[1]

In recent years there has also been considerable important work on the economics of government behaviour. I have in mind here the theories of property rights, public choice (or economics of politics), and economic regulation.[2] These three somewhat different approaches have in common that they focus on the nature of the choices facing individuals, whether as producers, consumers, employees, taxpayers, voters, councillors, civil servants, politicians, etc. They explore the kinds of opportunities open to these individuals, and the ways in which pressures of various kinds affect their evaluation of the outcomes of choices. Considerable insights have thereby been obtained into the reasons for, and working of, government policies and organisations, ranging from the National Health Service to the regulation of the professions.

This work is an example of the further application of the principle of methodological individualism. As such, it seems to me nicely to complement the Austrian approach. Indeed, it seems to lead to similar implications for public policy. Nonetheless, though it runs in parallel with the Austrian approach, it is not the approach which Austrians themselves have used.[3] For this reason, since the theme of this *Paper* is the Austrians, I shall occasionally refer to public choice and property rights but will not emphasise their significance as much as their importance otherwise warrants.

Is there an Austrian view on the role of government?

While it is true that, for the reasons just given, Austrians

[1] *Op. cit.* (above, p. 19, footnote).

[2] Alchian and R. A. Kessel, 'Competition, Monopoly and the Pursuit of Money', in Universities—National Bureau of Economic Research, *Aspects of Labor Economics*, New York, 1962; Alchian and Allen, *Exchange and Production . . ., op. cit.*; Buchanan and Tullock, *The Calculus of Consent, op. cit.;* Buchanan, *The Inconsistencies of the National Health Service,* Occasional Paper 7, IEA, 1965; Tullock, *The Vote Motive,* Hobart Paperback 9, IEA, 1976; W. A. Niskanen, *Bureaucracy: Servant or Master?,* Hobart Paperback 5, IEA, 1973; G. J. Stigler, 'The Theory of Economic Regulation', *Bell Journal of Economics and Management Science,* Spring 1971, pp. 3-21; L. de Alessi, 'An Economic Analysis of Government Ownership and Regulation', *Public Choice,* Fall 1974.

[3] But cf. Hayek, *Economic Freedom and Representative Government,* Occasional Paper 39, IEA, 1973, reprinted in *New Studies . . ., op. cit.*

would not accept most of the arguments of welfare economics, it is by no means clear that they share a common view about the policy implications of economic theory.

Austrians are nowadays associated with the free market, and Lachmann has indeed described the Austrians as 'defenders of the market economy'. To some extent, this position reflects the influence of Mises and Hayek, who were both strong liberals (in the 19th-century sense), though Menger and Böhm-Bawerk probably held similar views. Yet this was not always so. Wieser and Schumpeter envisaged a relatively extensive role for government. At the other extreme, there is nowadays a libertarian/anarchist element in the Austrian camp, headed by Rothbard, which agrees that economic theory does not necessarily imply any particular role for government and advocates a form of 'private government'.

The writers listed as apparently sympathetic to the Austrian approach seem to fall into two groups. Some are clearly identified with a free-market position. For others, it is quite impossible to tell from their writings (or indeed from casual personal acquaintance) where their political sympathies lie.

The contribution of Austrian economic theory to the understanding of how economies work is independent of the philosophical positions of Austrian economists. At present, it is true that most Austrians place a high value on individual freedom and would probably support the market economy for that reason alone. However, if an economist held certain value-judgements—for example, that private property is immoral, or that (economic) power tends to corrupt, or that working for profit is degrading—it seems he could perfectly well advocate a very substantial role for government, or at least severe limitations on private enterprise, while fully accepting Austrian economic theory.

The important question for policy remains: How far would the 'intelligent radical' who starts with the kind of value-judgements Professor Meade has assumed, and who accepts the superiority of Austrian economic theory over conventional welfare economics, still favour the kind of 'mixed economy' Professor Meade has proposed?

It may be helpful to indicate in advance the view held by Mises, as interpreted by Kirzner:

> '. . . when one examines Mises's many statements about economic policy, whether they be about price controls, tariffs, antitrust

> policy, or anything else, one invariably discovers that his conclusions do not at all reflect his own personal valuations. They reflect only his opinions concerning the degree of success with which others are pursuing *their* purposes . . .
>
> This was made very clear indeed in Mises's oral presentations. He would emphasise again and again that interventionist policies are "wrong", not from the point of view of the economist himself, but from the point of view of those initiating these policies (or at least from the point of view of those whose well-being the policies are supposed to enhance).'[1]

Mises would not deny that the various measures of a mixed economy benefit particular interest-groups in the short run. But in the long run he thought all would be made worse off.

[1] Kirzner, 'Philosophical and Ethical Implications of Austrian Economics', in Dolan (ed.), *op. cit.*, p. 82.

VI. POLICY ON COMPETITION

The 'mainstream' view

A small country like Britain inevitably faces the dilemma that if firms are allowed to exploit the advantages of economies of scale, they may grow so large that there is a danger of monopoly, or at least collusion amongst the few firms in the industry. The 'man in the street' has probably been most concerned about monopoly insofar as there is a presumed transfer of wealth from consumers to producers in the form of high profits. Economists have traditionally eschewed this distributive aspect, and objected to monopoly on the ground that it prevents the efficient allocation of resources associated with perfect competition. But everyone seems to agree that, since monopolists will restrict output to raise prices and profits, it is necessary to prevent

(a) the exploitation of monopoly power;

(b) the creation of monopoly power in the first place; and

(c) collusive practices amongst otherwise competitive firms.[1]

Policy on competition in Britain today seems to reflect these views. It has three major elements:

(1) The Monopolies and Mergers Commission may be asked to investigate whether the 'things done' by large firms, and proposed mergers, may be expected to operate against the public interest. If so, government has power to prohibit such activities or mergers.

(2) A broad range of agreements between firms must be publicly registered and may be brought before the Restrictive Trade Practices Court, where they will be held illegal unless the firms can satisfy the Court that the agreements are in the 'public interest'.

[1] Cf. the recent statement by Mr Roy Hattersley, the Prices Secretary, to a meeting of West Midlands businessmen:

> 'When Government is inactive monopolies develop, mergers are made, agreements in restraint of trade are signed. So I hope you will agree that the achievement of your aim of greater competition involves Government action.' (*Birmingham Post,* 11 March 1978.)

(3) 'Emergency' measures of price control have been in force over the past few years, whereby price increases for all but the smallest firms are vetted by the Price Commission and are allowed only on specific grounds.

Some economists have doubted whether the distortion caused by monopoly is very severe. In 1954, Professor Arnold C. Harberger of Chicago University made rough calculations which suggested that the net value of output lost due to monopoly in US industry amounted at most to 0·1 per cent of GNP.[1] Subsequent authors, on different assumptions, have argued for percentages as high as 5 per cent, but these calculations still leave some doubt whether monopoly (excluding 'natural monopoly') is worth bothering about.

On the other hand, it has recently been noted that, in order to attain a monopoly position, firms will find it worthwhile to incur expenditure up to the level of prospective monopoly profit. This has led Professors Keith Cowling and Dennis C. Mueller, of the Universities of Warwick and Maryland respectively, to argue that

> ' "the monopoly problem" is broader than traditionally suggested. A large part of this problem lies not in the height of monopoly prices and profits *per se*, but in the resources wasted in their creation and protection'.[2]

They calculate that, in the year 1968-69, losses due to monopoly power of the top 102 UK firms amounted to between £970 million and £1,400 million (depending upon the method of calculation). This represents 9 to 14 per cent of gross corporate profits. The authors therefore call for intensified enforcement of anti-trust policy, beginning with the largest firms such as BP and Shell, which (according to their estimates) together accounted for a monopoly cost of up to £285 million in the same year.

An alternative interpretation of profit

Austrians, as we have seen, have not viewed monopoly in the same light as welfare economists. Neither the number of firms in an industry nor the rate of profits earned are, in themselves, a cause for alarm. On the contrary, insofar as profits reflect

[1] 'Monopoly and Resource Allocation', *American Economic Review,* May 1954, pp. 73-87.

[2] 'The Social Costs of Monopoly Power', *Economic Journal,* December 1978, p. 744.

successful entrepreneurial awareness, they are a measure of consumer satisfaction, an indication that some co-ordination has been achieved where none existed before. It was in this light that we interpreted the £184 million profits earned by Rank Xerox (p. 36).

Now these profits were no doubt achieved by setting such a high price that the volume of photo-copying was restricted below its 'competitive' size. On the other hand, had it not been for the lure of this temporary monopoly profit, the arrival of photo-copying in Britain might have been delayed for several years, presumably at very considerable loss to both producers and the general public.

In other words, the appropriate comparison is not between an existing product supplied at a high price and that same product supplied at a low price. It is between a product supplied at a high price and *no product at all!* It is this insight which provides a counter to the argument of Professors Cowling and Mueller. Even if resources *are* used up in an attempt to achieve a monopoly position, nonetheless that may be a price worth paying if the result is to make a product available sooner than it otherwise would be.

The distinctive Austrian approach is further illustrated by the Monopolies and Mergers Commission's condemnation of Hoffman-La Roche for making excessive profits from the sale of the tranquillisers Librium and Valium.[1] The company agreed to repay a not inconsiderable sum to the National Health Service, and to lower the prices of the two drugs henceforth. The utilisation of these drugs will thereby increase, to the benefit of existing patients and those within whose price range these drugs now fall for the first time. Seen from a short-run point of view, this action by the government has improved the allocation of resources by relaxing the monopoly restriction on output.

From a longer-run point of view, the issue is not so clear-cut. If it becomes common practice to control drug prices, will pharmaceutical companies risk the heavy expense of basic research necessary to produce new drugs? Allegedly, fewer than one in every 200 compounds proves successful. The danger is

[1] Monopolies and Mergers Commission, *Report on Supply of Chlordiazepoxide and Diazepam*, HC 197, HMSO, April 1973. A critical study of this and other Monopolies Commission reports is in George Polanyi, *Which Way Monopoly Policy?*, Research Monograph 30, IEA, 1973.

that limiting monopoly profits may remove the incentives to exploit opportunities of mutual benefit to producers and consumers, or at least delay the date at which new ideas come to light.

The role of patents in monopoly

Rank Xerox and Hoffman-La Roche do, however, highlight a different cause of concern to Austrians. Presumably one of the reasons for the high level of profits, and for the lack of actively competing firms, is the existence of patents. Other firms would like to compete but are not allowed to do so. It is here that Austrians would probably see the solution to such 'monopoly problem' as exists.

The purpose of a patent is to encourage innovation in pursuit of monopoly profit. The danger lies in the restriction of entry consequent upon conferring this special property right. It may be true that, without the protection of a patent, less money would be spent on research and development in hitherto protected areas, and innovation there might be reduced. On the other hand, resources used there have an opportunity cost: they would otherwise be used in other directions. Research and innovation would by no means cease altogether, for there is still a gain (a temporary monopoly profit) to be made from being first in the field. Moreover, abolishing patent protection would encourage the early exploitation and improvement by competitors of those innovations made by others.

The above case for the abolition of patents has been argued by (the late) Professor Sir Arnold Plant, and most Austrians would probably subscribe to it.[1] Austrians must therefore view with concern the recent extension in Britain of the duration of patents from 16 to 20 years and the proposed introduction of licensing for photo-copying.[2] The experience of Italy, which has only a very limited patent system, deserves further study.

Since Austrians place their faith in entrepreneurial profits resulting from such temporary monopoly positions, they must be even more concerned about a recent legal judgement in New York. It was held that Kodak had violated the antitrust

[1] 'The Economic Theory Concerning Patents for Inventions', *Economica*, February 1934; Rothbard, *Man, Economy and State, op. cit.*, Ch.10.7. Mises, however, did not commit himself: *Human Action, op. cit.*, pp. 661-2.

[2] The extension of patent protection was enacted by the Patents Act, 1977; the correspondence on the photo-copying proposals in *The Times* culminated in an editorial ('The Flood of Facsimiles') on 24 January 1978.

laws and monopolised the market in amateur cameras, colour print paper and film. The reason was that Kodak had failed to give its competitors early warning of its decision to introduce new films and cameras with enough information that its competitors could be in a position to offer alternative products![1]

Mergers and restrictive practices

Policy on mergers follows naturally from policy on monopoly. If a single firm in an industry is not undesirable *per se,* nor is a merger to create one. Indeed, merging is one obvious way of competing. To prevent mergers is to protect other firms from competition, perhaps to prevent the adoption of some new technique or mode of organisation and thereby to impede the competitive process.

Many economists have argued that the potential advantages of mergers resulting from economies of scale should be estimated and compared to the potential disadvantages from higher prices. At present, the Monopolies and Mergers Commission is required to do this only if the likely disadvantages seem serious. In the light of recent studies on the (lack of) profitability of mergers, however, the Secretary of State for Prices and Consumer Protection is currently being urged to adopt a 'stiffer' policy on competition involving the prohibition of mergers 'where real benefits cannot be proved'.[2]

The difficulty with this new proposal (indeed, with the present arrangement also) is that information about the past is difficult to obtain and predictions about the future are notoriously unreliable. This difficulty had led to suggestions that merger appraisals by the Commission might usefully be replaced by prohibitions on undesirable conduct after the event. Such prohibitions would be enforceable through the Courts.[3] Moreover, future competition will often come, as Schumpeter stressed, from quite unexpected sources. It is not surprising, therefore, that the Monopolies and Mergers Commission has been criticised for underestimating the strength of competition,

[1] *New York Times,* 26 February 1978 (article by K. I. Clearwaters).

[2] *The Times,* Business Diary, 4 January 1978. The studies referred to presumably include G. Meeks, *Disappointing Marriage: A Study of the Gains from Merger,* University of Cambridge, Department of Applied Economics, Occasional Paper 51, Cambridge University Press, 1977.

[3] M. E. Beesley, 'Mergers and Economic Welfare', in *Mergers, Takeovers and the Structure of Industry,* IEA Readings No. 10, 1973.

and, therefore, biasing its judgements against mergers.[1]

Restrictive practices: a dilemma for Austrians

Restrictive practices pose a dilemma. On the one hand, many practices such as exclusive dealing between manufacturers and suppliers or distributors are undoubtedly intended to prevent new entry. They thereby impede the competitive process, and it would seem that current laws against them might be strengthened. On the other hand, it may be argued that this is their very merit. Protection from competition provides an inducement to make large and risky investments which otherwise would not be made.[2] On balance, most Austrians would probably not favour laws against restrictive practices, relying for protection once again on the possibility that new entry would overcome such barriers.

In this connection, it may be observed that restrictive practices in several industries seem to stem from a government-granted monopoly position, notably the professions such as accounting, law, medicine and architecture. Austrians would therefore be unwilling to grant such a privileged status to those occupations like hairdressing and insurance broking which are currently applying for official recognition.[3]

The Monopolies and Mergers Commission and the Price Commission suffer a further disadvantage to which the principle of methodological individualism should alert us. Since the government is involved in initiating and/or implementing the work of these commissions, a *political* element will inevitably emerge. Takeovers are occasionally referred to the Commission in response to pressure from people likely to lose jobs, and investigations which might prove embarrassing are not always authorised. Nor has government always found it convenient to implement the recommendations of the Commission. Such behaviour by government must be expected: a government must be expected to respond to political pressures as it perceives them and whatever instrument is most convenient will inevitably be used.

The Restrictive Trade Practices Court, being part of the legal system, is essentially immune from this disadvantage

[1] C. K. Rowley, 'Mergers and Public Policy in Great Britain', *Journal of Law and Economics,* April 1968, pp. 75-132.

[2] Schumpeter, *op. cit.*; Richardson, *op. cit.*

[3] *The Times,* 3 November 1976, and 25 January 1978, respectively.

(though of course the scope of the legislation is a matter of government policy and presumably it is not thought politically expedient to bring unions and nationalised industries within it). It is arguable, however, that if this Court is continued, the opportunity to prosecute should be extended to those adversely affected by restrictive practices, who have most incentive to discover the practices and provide the necessary information.[1]

[1] Beesley, *op. cit.*

VII. CONTROLLING THE NATIONALISED INDUSTRIES

The situation today

In various industries, it is alleged, the economies of large-scale production are so large that it would be inefficient to have more than one producer. It would be impractical and undesirable, Professor Meade argued, to impose a permanent system of price control on such 'natural monopolies'.

> 'The second and final solution is the social ownership and management of the activities concerned. Railways, roads, gas, electricity, sewage, water supply, telephones are all examples where price competition in a free market is out of the question.'[1]

In 1975, the nationalised industries accounted for more than a tenth of Britain's national product and nearly a fifth of total fixed investment. These proportions have subsequently increased with the nationalisation of the aircraft and shipbuilding industries, and the acquisition of British Leyland and other companies.

On what principles should the nationalised industries be operated? Professor Meade argues that

> 'a socialised concern should take into account all the social costs involved' and that 'prices should be set equal to marginal costs, even though this may mean running the nationalised concern at an abnormally high profit or running it at a loss'.

These ideas reflect traditional welfare economics. Under competition there is a tendency for price to be forced down to the level of marginal cost (the cost of a small addition to output), and for investments to be undertaken if and only if they promise to earn a return in excess of the cost of capital. In this way, the welfare economist argues, perfect competition leads to an efficient allocation of resources. Consequently, where competition is non-existent, the nationalised industry should act *as if* it were in a perfectly competitive situation. Unlike many proponents of nationalisation, however, Professor Meade urges that 'nationalised concerns should not be protected from direct or indirect competition from outside sources'.

[1] Meade, *op. cit.* (above, p. 34, footnote 1), p. 51.

The first British nationalised industries were typically required only to produce efficiently, to meet demand and to break even. The more precise instructions in the 1967 White Paper[1] represented a modest victory for the advocates of welfare economics. 'In addition to recovering accounting costs', it said, 'prices need to be reasonably related to costs at the margin'. The White Paper also required investment proposals to be expressed in present values by the use of a specified test rate of discount (8 per cent, later raised to 10 per cent), urged the nationalised industries to look for ways of economising on manpower, and laid down for each industry a financial objective to act as an incentive to management and as a standard of performance.

It cannot be claimed that the 1967 White Paper has been an outstanding success. On the contrary, the recent report by the National Economic Development Office was extremely critical of the current framework of control.

> '. . . there are certain features of the relationship between government and nationalised industries which came through so clearly in our inquiry that we believe they can be stated without risk of contradiction:
>
> - there is a lack of trust and mutual understanding between those who run the nationalised industries and those in government (politicians and civil servants) who are concerned with their affairs;
> - there is confusion about the respective roles of the boards of nationalised industries, Ministers and Parliament, with the result that accountability is seriously blurred;
> - there is no systematic framework for reaching agreement on long-term objectives and strategy, and no assurance of continuity when decisions are reached;
> - there is no effective system for measuring the performance of nationalised industries and assessing managerial competence'.[2]

Why has the framework proposed by the 1967 White Paper been so unsuccessful? The explanation is twofold. In the first place, the *intellectual* task facing the nationalised industries was misunderstood, and the rules derived from static welfare economics were inappropriate to the real world of uncertainty in which the industries operate. In the second place, the White

[1] *Nationalised Industries: A Review of Financial and Economic Objectives*, Cmnd. 3437, HMSO, 1967.

[2] *A Study of UK Nationalised Industries*, HMSO, 1976, p. 8.

Paper failed to take account of the *political* context of the nationalised industries, the reasons for their initial nationalisation and the political pressures bearing on them.

The first of these aspects was analysed by Mises and Hayek in the course of the debate on socialist planning.[1] Their ideas were developed by the British subjectivists G. F. Thirlby and Professor Jack Wiseman.[2] The second aspect has been dealt with most recently, mainly in the US context, by the writers on public choice, property rights and economic regulation, to whom we referred earlier.[3]

Inappropriate rules

The pricing and investment rules prescribed by the White Paper are derived from the familiar model of static general equilibrium. They presume that the relevant products, demands, resources, resource prices and techniques are 'given', so that the task of the manager in a nationalised industry is merely to calculate the cheapest way of supplying demand and to price accordingly. In such an environment, cost is 'objective' because it is merely the sum of the known prices of known inputs, and it may easily be verified whether or not the industry is setting price equal to marginal cost.

In practice, these data are not 'given'. The task of the manager is precisely *to find out what they are*: to discover what products consumers want, what resources and techniques are available, and what prices are likely to have to be paid. The market mechanism, as we have seen, is a process of conjecture and experiment. It continously re-allocates resources to new uses which seem preferable to previous uses, and which earlier had perhaps not even been imagined.

It follows that the relevant cost of production, whether marginal, average or total, is not objective but *subjective*: it is not the money outlay but the value of output in some alternative foregone use, and this alternative use is not 'given' but exists only in the mind of the manager(s). Two managers with

[1] *Op. cit.* (above, p. 42, footnote). Also Rothbard, *Man, Economy and State, op. cit.,* p. 824.

[2] E.g. G. F. Thirlby, 'Economists' Cost Rules and Equilibrium Theory', *Economica,* May 1960; Jack Wiseman, 'The Theory of Public Utility Price—An Empty Box', *Oxford Economic Papers,* Vol. 9, 1957, pp. 56-74. These papers are reprinted with others in Buchanan and Thirlby, *op. cit.* (above, p. 18, footnote 5).

[3] Above, p. 43, footnote 2.

different knowledge about available alternatives, or different views about the future, will associate different costs with the very same output. Since the correctness of beliefs about the future cannot be established objectively (at the time), neither manager can be said to be wrong—each is right given his beliefs.

Two conclusions follow. First, since it is impossible to check a manager's beliefs, it is impossible to check whether prices are being 'reasonably related to costs at the margin', i.e. whether the prescribed policy is being carried out. Second, even if a manager were correctly following his instructions, it does not necessarily mean that he will be successful in discovering new consumer demands and the best ways of meeting them.

Exactly analogous difficulties apply to the test rate of discount which is prescribed for assessing investment proposals. It is impossible to tell whether a manager really believes the estimates of revenue which support his case, and even if he does he is not necessarily correct, nor does this preclude him from overlooking yet more favourable opportunities.

Private firms have similar difficulties in monitoring the performance of their employees and subsidiaries, but the important difference is that the market provides an essential 'feedback'. Entrepreneurs who are successful in discovering and meeting the wishes of consumers are rewarded by profits; those who are unsuccessful are penalised by losses. The 'feedback' provides an incentive to good performance, and at the same time redistributes resources to people who appear most competent in using them. Finally, the possibility of competition means that a failure to exploit an opportunity by one firm is likely to be remedied by another. In this way, competition facilitates the task of owners of resources and safeguards the interests of consumers.

Neither of these benefits—'feedback' and competition—is available in the nationalised industries. They are almost always statutory monopolies, so that new entry by firms with superior ideas is precluded. Cross-subsidisation of loss-making activities by monopoly profits is quite normal, the pattern of prices and products is subject to political pressures, and quite frequently losses are borne out of general taxation. Thus the suppression of competition makes it exceedingly difficult to know which activities ought to be encouraged, which industries ought to be expanded, and which managers ought to be promoted.

In sum, it is impossible to tell whether the prescribed rules for pricing and investment by nationalised industries are being followed, and if they are it does not guarantee that the best pattern of resource allocation is being achieved. The task is to find this best pattern, which moreover is constantly changing over time. Nationalisation invariably removes a vital part of the information 'feedback' and protection generated by the free-market mechanism.

Motivation and political pressures

It is commonly believed that industries are nationalised in order to protect consumers from exploitation by a natural monopoly. An examination of the history of these industries soon reveals this belief to be a myth. Telegraphs were nationalised in order to protect Crown revenues deriving from the postal monopoly, and telephones in turn were nationalised to protect Crown revenues deriving from the telegraph monopoly. Municipal water companies were set up to provide service where private companies had not yet found it profitable to do so, and private companies were later regulated and nationalised in order to facilitate the cross-subsidisation of consumers. Competing steel companies were nationalised in order to control the 'commanding heights' of the economy. The recent nationalisation of the aircraft and shipbuilding industries has clearly been provoked by the desire to protect existing jobs.

It is equally fallacious to believe that industries, once nationalised, are operated with the prime aim of securing the efficient allocation of resources. Nationalisation has protected coal miners and postal workers from faster rates of closure, as it has protected suppliers to the electricity industry and the Post Office from falling demand.

Furthermore, in the last few years, government instructions to the nationalised industries have alternated between 'standstills' on prices and investment so as to combat inflation and exhortations to raise prices so as to break even or to accelerate investment so as to avoid unemployment. These instructions have made it clear that the micro-economic principles of the White Paper designed to promote long-run efficient resource allocation are clearly subordinate to the day-to-day requirements of macro-economic policy and demand management. The principles set out in the 1967 White Paper are at best an irrelevance, and at worst a hindrance, to the attempts of both government and nationalised industries to create or protect jobs, redistribute income, fight inflation or stimulate the economy.

An alternative framework

We can now see why the framework provided by the 1967 White Paper was bound to fail. In the first place, it constructed a set of rules derived from the inadequate theoretical basis of static equilibrium, which was useless in the real world of imperfect knowledge. In the second place, the framework erroneously assumed a widespread and overwhelming desire to seek efficient resource allocation, which in practice was not the relevant assumption to make. In short, the White Paper foundered because it neglected the implications of the twin principles of methodological individualism and subjectivism.

Let us assume for the moment that a government has inherited a set of nationalised industries and wishes to promote the efficient allocation of resources. What kind of framework is indicated? Four principles suggest themselves.

1. The managers of the industries must be given incentives to seek out and meet the demands of consumers, they must be rewarded for doing so, and the selection of top managers and the allocation of funds should reflect this success. In practice, net revenue (possibly in relation to a target) is the most effective criterion of serving the market. Stronger incentives to managers could be provided by bonuses linked to the industry's financial performance.[1] A higher proportion of self-finance, which offers the industry the attraction of wider latitude in using its profits, is also an incentive to earn the profits in the first place. At the same time, if the borrowing rate for capital from the National Loans Fund were raised to the market rate, or indeed if capital had to be raised on the market, excessive or frivolous investment would be discouraged.

2. Freedom of entry should be allowed in order to minimise the chance of favourable opportunities being overlooked and to limit the ability of nationalised industries to meet profit targets merely by raising prices in protected markets. Professor Meade notwithstanding, the economies-of-scale argument is intellectually suspect. Abolishing the statutory monopoly enjoyed by the public utilities would allow new entry into profitable lines

[1] Cf. *The Economist*, 24 December 1977, p. 72.

of business, such as telephone subscriber equipment, intra-city postal deliveries, gas and electricity supply. Current restrictions on entry into road and air transport could usefully be relaxed or abolished. Where competition *within* the market is not feasible, competition *for* the market may be possible, for example, by auctioning limited-term franchises for local telephone, gas and electricity distribution networks, as with local radio and television stations.[1] In many cases, the mere threat of entry might suffice to promote the competitive process.

3. Instructions to the nationalised industries should be couched in objective rather than subjective terms, i.e. they should be operational. Injunctions to set price equal to marginal cost and to appraise investment according to a test discount rate are unenforceable, and should therefore be abandoned. In contrast, instructions to break even, or to meet a target rate of net revenue or self-finance, may easily be monitored, as may instructions to provide specified products at specified prices (e.g. a railway service of specified frequency between specified points at a specified maximum rate per mile).

4. It is therefore essential that the government should state explicitly what are the 'social obligations' of each nationalised industry, and how these are to be met, e.g. by government subsidy, by cross-subsidy from other consumers, by protection from competition, by cash grants or vouchers to consumers, etc. The government will then be held accountable in Parliament for giving these instructions, and ensuring that the industry meets them. Beyond these instructions, the framework within which the industries operate should be designed to make *ad hoc* government intervention as difficult as possible. Competition has an important role here; another possibility is to allow industries access to the private capital market. This would provide the necessary funds for those expanding industries, notably telecommunications, which have been severely deprived of capital, while providing some additional pressure to repay on industries like British Steel which have tended to fall by the wayside.

Political realities

At this point, one might ask whether any government would be willing to contemplate such a framework for its nationalised

[1] Cf. Demsetz, 'Why Regulate Utilities?', *Journal of Law and Economics,* April 1968, pp. 55-66.

industries and, if so, whether there is any point in maintaining their nationalised status. The answer to both questions is probably 'no'. It must be accepted that, in practice, the real purpose and effect of nationalisation is not to promote the efficient allocation of resources but precisely the reverse—to prevent it. If this is true, then monopoly is essential and competition is anathema.

This is not by any means to imply that the various motives for nationalisation are reprehensible, or that nationalisation itself is undesirable—though it may not be the most effective way to achieve the desired ends. Serious conflicts will, however, be generated by failure to acknowledge the *political* considerations and by a framework for control which focuses almost entirely on the issue of efficiency—as indeed events of the past decade have demonstrated.

But even if these political considerations can in some way be resolved, there remain the questions to which the Austrian economists and their followers have addressed themselves: namely, the appropriate role of nationalised industries and the principles upon which they should be operated. Traditional concern about 'monopolistic exploitation' in a static framework has diverted attention from the role of competition as a social process of discovering new and better products and techniques. Austrian economists have not been convinced that nationalisation is likely to protect consumers from monopoly, much less replace the co-ordinating process of the competitive market.

New policy on nationalised industries: Austrians unenthusiastic

A new White Paper, *The Nationalised Industries,*[1] was published after the above section was written. It appears from press accounts (*The Times,* 6 April 1978) that Ministers are to have powers to issue 'specific' directives. This will improve accountability and in that sense is preferable to 'arm-twisting', but presumably is intended to facilitate detailed government intervention. State industry boards are to be widened to include representatives of government and trade unions, management and consumers. This reform recognises but again increases the power of special interest-groups. Financial targets are retained, 'tailored to allow for the circumstances of the particular industry', which means they are unlikely to be demanding. The

[1] Cmnd. 7131, HMSO, March 1978.

test discount rate is to be replaced by a 'required rate of return', but the press account does not succeed in explaining how this differs from the test discount rate, and therefore how, if at all, the latter's deficiencies will be avoided. Marginal cost pricing has apparently been allowed to die a quiet death, but 'the Government must satisfy itself that the main elements of an industry's pricing structure are sensibly related to costs of supply and market situation'. If this is all there is on pricing it means, in effect, that the Government does not know what relationship between price and cost *is* sensible, or is not prepared to say, but nonetheless wishes to preserve the right to intervene. All told, it does not appear to be a document that Austrians will find satisfactory.

VIII. DEALING WITH EXTERNALITIES

The prevalence of externalities

Most decisions concerning location, investment, production and employment are taken upon agreement of acceptable terms by the parties directly concerned. But economists and the general public have always been aware that one man's action may impose costs and disadvantages on third parties without his having to pay for the damage he does. Such divergences between 'private' and 'social' consequences are known as 'externalities'. Increasingly, governments are intervening in an attempt to ensure that these externalities are taken into account.

A glance at a newspaper will suggest the wide range of externalities, leading to situations where government has apparently to resolve a potential dispute.

(i) Should a reduction in aircraft noise be secured by improved engine design or by moving airports away from people? (*The Times,* 17 January 1977.)

(ii) Do the benefits of mining coal in the Vale of Belvoir offset the undesirable effects on the local communities and on the environment? (*The Observer,* 21 November 1976.)

(iii) Should the site of the Battle of Hastings be sold for property development? (*The Times,* 12 March 1976.)

(iv) Should an ugly and polluting oil refinery be built at Nigg Point in Scotland where jobs are desired to combat unemployment? (*The Times,* 3 March 1976.)

(v) Should betting shops be set up in working-class areas where they are a temptation to the people who live there? (*Wisbech Standard,* 9 January 1976.)

(vi) Should farmers be allowed to spray crops by aircraft in view of the danger to beehives and disturbance to householders? (*The Times,* 5 July 1976.)

Alternative policies

Often no government intervention takes place, either because there is no formal means by which the party disadvantaged may exert influence, or because the effects of some acts are so dispersed or obscure that the detriments are not fully recognised. Where externalities are of lively public concern (as with Windscale) a public inquiry may be held and where they are likely to occur repeatedly, provision for control is often embodied in local or national planning regulations.

(i) *Cost-benefit analysis*

Economists have developed three main concepts to help in analysing and treating externalities. The first is social cost-benefit analysis, the aim of which is to identify, evaluate and aggregate the consequences of any action and thereby to choose the solution which maximises the net benefit to society. To do this, it is necessary to measure the values which people appear to place on commodities such as time, comfort, noise and pollution which are seldom traded directly on the market. Notable examples of cost-benefit analysis are the studies of the M-1 motorway, the Victoria underground line and the Third London Airport.[1]

(ii) *Externality taxes*

A second and somewhat older contribution by economists, dating back to Pigou, is much loved and taught by theorists but so far hardly used in practice. This is the notion of a tax (or subsidy) equal to the divergence between private and social costs or benefits. Such a tax imposed on the decision-maker would, it is argued, lead him to take the social interest fully into account.

Motorists experience delays in the rush-hour, for example, but do not consider the delay they impose upon others by their own contribution to congestion. It is therefore suggested that a rush-hour 'congestion tax' be imposed. The Greater London Council is reported to be considering such a tax on large office car parks in Central London, at a rate of, perhaps, £6 per week for each space, in order to reduce peak-period traffic by between 15 and 22 per cent.[2] In Singapore, drivers are now required to buy special licences costing about £15 per month in order to drive into the city between 7.30 a.m. and 10.15 a.m.

[1] Discussed at more length in G. H. Peters, *Cost-Benefit Analysis and Public Expenditure*, Eaton Paper 8, IEA, 1965 (3rd Edn., 1974).

[2] *The Times*, 21 February 1976.

The scheme is said to be an outstanding success with all concerned, since roads in the city centre are no longer congested, travel time on buses has been cut by 30 per cent, and the government has a steady stream of income.[1]

Economists have also proposed externality taxes on pollution and on noise.[2] Thus, the Civil Aviation Bill currently before Parliament would allow airport authorities to re-structure their landing charges so that they discriminate in favour of quieter aircraft.[3] Professor Meade's view, indeed, is that

> 'the authorities should make a grand tour round the whole economy taxing those activities which are socially costly according to the degree of social costs which they involve'.[4]

(iii) *Property rights*

The third main contribution by economists to the debate over externalities is based upon the insight that externalities are intimately related to property rights. Externalities exist because the facilities to make relevant transactions do *not* exist. Developing and enforcing an adequate system of property rights, so that people can capture the benefits of 'making a market' if it is worth doing so, may obviate the need for frequent and specific government intervention. This approach has been vigorously developed by Professors Coase and Demsetz.[5]

Consider Professor Meade's example of

> 'the use of nitrates as a fertiliser by farmers, the nitrates finding their way into the neighbourhood's water supply; unless special steps are taken, the farmers will not meet the cost of the damage done to the water supply'.[6]

Meade's recommendation is a tax per gallon of pollution or the auction of licences to pollute up to a given amount per month. But there is a better policy. If the farmers were held legally liable for damages caused by their nitrates, they would have to take these damages into account without any other government intervention.

[1] World Bank *Report*, May-June 1976, p. 6.

[2] W. Beckerman, *Pricing for Pollution*, Hobart Paper 66, IEA, 1975.

[3] *The Times*, 16 December 1977.

[4] *Op. cit.*, p. 113.

[5] R. H. Coase, 'The Problem of Social Cost', *Journal of Law and Economics*, Vol. III, 1960, pp. 1-44; Demsetz, 'Toward a Theory of Property Rights', *American Economic Review* (*Proceedings*), May 1967, pp. 347-359.

[6] *Op. cit.*, p. 110.

This solution may be applied to aircraft noise. In this country, unlike the United States, France and Germany, citizens no longer have the right to sue for damages.[1] Restoring this right would oblige the airlines and airports authorities to take into account the consequences of aircraft noise when deciding upon airport locations and flight schedules. The convenience of easy airport access in large cities would then have to be offset by the noise inconvenience to a dense population of householders.

The Austrian view

Austrian economists have mostly been preoccupied with economic problems which seemed of more significance than externalities. Nevertheless, one passage by Mises clearly indicates that he anticipated the property rights analysis:

> 'It is true that where a considerable part of the costs incurred are external costs from the point of view of the acting individuals or firms, the economic calculation established by them is manifestly defective and their results deceptive. But this is not the outcome of alleged deficiencies inherent in the system of private ownership of the means of production. It is on the contrary a consequence of loopholes left in this system. It could be removed by a reform of the laws concerning liability for damages inflicted and by rescinding the institutional barriers preventing the full operation of private ownership.'[2]

Why do Austrian ideas suggest the use of property rights rather than the use of cost-benefit analysis or externality taxes? In Austrian thinking, the task is not primarily one of computing the optimal solution to a well-defined 'problem', but rather one of discovering the 'problem' in the first place (and the possibility of making some improvement), then gathering and utilising the necessary information, and finally implementing an improved solution.

What kind of institutional framework is most likely to promote the discovery of activities with significant externalities? Will complaints from people affected by aircraft noise be sufficient to alert the appropriate department of national or local government? Or is the prospect of paying and receiving damages more likely to spur the parties to agreement?

How will the information necessary to reach an efficient solution be acquired? In the market, negotiations take place

[1] Letter from Mr Hugh Jenkins, MP, to *The Times*, 14 February 1978.

[2] *Human Action*, *op. cit.*, pp. 657-8.

between parties who act in accordance with their own preferences and the opportunities they believe open to them. For an agency carrying out a public inquiry or a cost-benefit analysis, or setting externality taxes, a major difficulty is that these preferences and opportunities must be estimated. If conservationists have to purchase the site of the Battle of Hastings from the property developers, or art lovers a Rembrandt from foreign buyers, these same actions reveal the values placed on these commodities.

Finally, what incentives do the individuals involved in each process have to implement the solution thought to be most efficient? In the market the incentive is private gain; in a bureaucracy other incentives and pressures take precedence. Experience so far suggests that for political reasons it is unlikely that the recommendation of a cost-benefit analysis will be unhesitatingly accepted, or that an externality tax will be imposed at the rate calculated as optimal. The M-1 and Victoria Line studies were completed after the crucial decisions had been made, but the recommendations of studies on the Cambrian Line and the Third London Airport were rejected. Presumably the government attached a *political* significance to the outcomes of the various alternatives which was different from that of the investigating Commission, and probably different again from the view which consumers would have expressed in the market. Specifically, it seems that the government was most concerned to retain popularity with small Welsh coastal towns and potential employers and employees in the neighbourhood of Foulness. If this is the fate of the recommendations of a formal public inquiry, it seems unlikely that recommendations about the location of new coal mines and oil refineries, which may be based upon informal analyses by government departments or local authorities, will be any less vulnerable to political pressures. Politicians are in office to respond to public pressures, not to override them.

All this is not to suggest that political pressures are undesirable, or that governments should not respond to them. The argument is, rather, that governments inevitably *will* respond to political pressures. It cannot be assumed that the use of cost-benefit analysis and externality taxes will ensure the remedy of externalities in the manner assumed by many welfare economists. Attempts to improve the framework of property rights within which the market operates may well be more fruitful.

The creation of property rights

Professor Demsetz has suggested that property rights have evolved over time precisely as an efficient social response to the emergence of new externalities.[1] The exact nature of this process is not yet well understood. However, this is precisely a topic on which Austrian economics ought to be capable of shedding light, since it is an outstanding example of an 'organic' phenomenon.

In Britain, property rights are not usually defined by statute, but by a succession of common law judgements on specific cases in the light of legal precedent. Not all decisions are as helpful in defining property rights as one might wish. It was recently held, for example, that the owners of salmon fishing rights in the River Spey do not have the right to prevent public use of the waters for canoeing and sailing.[2] This decision establishes a property right where the situation was not previously well-defined, but the resulting property right, being held by 'the public', is not transferable. Even if the value of (uninterrupted) salmon fishing were higher than the value of canoeing, it is difficult to see how potential fishermen could buy the right to fish from potential canoeists. Had the legal decision gone the other way, it would have been straightforward for potential canoeists to negotiate with the easily-identified owners of the fishing rights. Far from protecting the rights of the public at large, this legal decision may have prevented the use of resources in the way the public would prefer.

The creation of property rights is not a conscious act but rather the unintended consequence of a multitude of actions by people with control over property and by others trying to attain such control. Only gradually over time does the notion of a transferable property right emerge. This insight enables us to appreciate that the apparently chaotic state of affairs in the early days of radio, with transmitting stations in different locations interfering with one another's broadcasts, marked in reality an intermediate stage in the definition of property rights. Those rights, as Professor Coase has argued, were beginning to emerge and would have evolved into an efficient market in radio broadcasting (in the USA), had not the govern-

[1] *Op. cit.* (above, p. 64, footnote 5).

[2] Law Report, House of Lords, *The Times*, 3 March 1976.

ment intervened to prevent it.[1]

Similarly, we are seeing today the gradual creation of fishing rights in the North Sea, in response to conflicts between fishermen of different nations. There has always been an absence of property rights in the sea, as a result of which no-one has an incentive to economise stocks of fish through time. Recent developments in fishing technology, such as refrigerated holds, allow longer voyages to more distant waters. The scale of the problem is therefore magnified. What we are now seeing is a vast new enclosure of (private) property in the sea comparable to the British enclosure of land in the 18th century.

To establish national fishing quotas in areas nominally open to all EEC nations is one solution which has been advocated. An alternative is to extend the territory of individual countries. 'With a 200-mile limit, we could license outsiders to fish in our waters and back this up with a tough fishery protection system', suggested Mr James Johnson, Labour MP for Hull West and chairman of the House of Commons all-party fisheries committee. In other words, if fishing rights can be defined and policed, they can be bought and sold. Such an international market in North Sea fishing rights would provide an incentive to the owners to conserve stocks of fish and at the same time allow the fishing to be undertaken by those with the lowest costs.

[1] R. H. Coase, 'The Federal Communications Commission', *Journal of Law and Economics*, October 1959, especially pp. 30-31.

IX. NATIONAL ECONOMIC PLANNING

Britain's industrial strategy

'The task we face', wrote Mr Denis Healey, the Chancellor of the Exchequer, and Mr Eric Varley, the Secretary of State for Industry, 'is nothing less than to reverse the relative decline of British industry which has been continuous for many years.'[1]

To achieve this task, the 1975 Industry Act introduced two 'powerful new instruments': planning agreements with major firms in key sectors of industry, and the National Enterprise Board (NEB) to provide the means for 'direct public initiatives' (e.g. making investments or buying shareholdings) in key sectors.

Planning agreements

Advocates of the mixed economy frequently argue that the market price mechanism is inefficient because it lacks a complete system of contingent forward markets. Professor Meade has asked:

> 'In the absence of a futures market, how can the total plans of all the steel producers to supply steel in the future be co-ordinated with the total plans of all the steel users to use steel in the future?'[2]

The National Economic Development Council was created in 1961 to bring together various people in a 'process of consultation and forecasting with a view to better co-ordination of ideas and plans'. The idea was to develop some form of 'indicative planning', in 'an attempt to promote more stable, rapid and efficient growth via the exchange of forecasts, leading to a generally held set of consistent expectations'.[3] A process of repeated consultation, it was argued, would remove uncertainties associated with the actions of other market partici-

[1] *An Approach to Industrial Strategy,* Cmnd. 6315, HMSO, November 1975, p. 3 (Foreword). Also *The Regeneration of British Industry,* Cmnd. 5710, HMSO, August 1974.

[2] Meade, *op. cit.,* p. 104.

[3] J. Black, 'Theory of Indicative Planning', *Oxford Economic Papers,* November 1968.

pants. Firms can produce more efficiently knowing that their supplies and markets are secure, bottlenecks and other obstacles to growth can be identified and remedied, and all market participants may be induced to revise upwards their expectations and plans for economic growth.

Failure of planning in the 1960s

The attempts to put indicative planning into practice in the 1960s did not meet these expectations, and were abandoned within the decade.[1] What went wrong? Was the attempt doomed to failure? *'Mainstream' economic theory can shed little light on the problem.* A framework of general equilibrium which assumes perfect knowledge cannot hope to explain a situation whose very essence is *lack* of knowledge. In contrast, this is precisely the framework of uncertainty within which Austrian economics has developed. From this vantage point, two potential difficulties with indicative planning immediately appear.

First, it is assumed that each firm will 'play the game' by stating truthfully its own plans. A firm's incentive to comply with the Plan is that it incorporates the firm's own stated plans. But if the method of competition is to take competitors by surprise, any one firm has an incentive to mislead others, and to *conceal* its true plans. Since there is a cost to participating in the national planning process, a firm might wonder how much time and expense it is really worthwhile to invest in such an artificial exercise.

Second, firms cannot hope to commit themselves to plans for five years ahead. Even if the plans of suppliers and competitors are known, the uncertainties associated with external events cannot be removed. New technological developments will inevitably occur, and there is no convenient way of introducing the views of final consumers, even if they could be supposed to make consumption plans for five years ahead. Even the best-laid plans eventually have to be revised.

In proposing flexible planning agreements, the Government now appears to have recognised the necessity to cope with change.

> 'The likelihood is that any plan which erected a single complete and mutually consistent set of industrial forecasts would rapidly be falsified by events and have to be discarded.'[2]

[1] An incisive critique of Britain's first national plan is in John Brunner, *The National Plan,* Eaton Paper 4, IEA, 1965 (3rd Edn., 1969).

[2] *An Approach to Industrial Strategy, op. cit.,* p. 7.

Planning agreements are to be concluded individually between the Government and major firms in key industrial sectors. They will be drawn up for three years ahead, reviewed and rolled forward annually. It is envisaged that firms will supply past data, forecasts, long-term plans and changes in plans on investment, prices, productivity, employment, exports and import saving, 'interests of consumers and the community', etc. Since the Government does not wish to restrict firms' freedom to respond to market changes, the agreements will not be enforceable at law.

But how useful is a *flexible* plan? The advantage of a co-ordinated plan is precisely to *commit* each party to a specific line of action. If flexibility is introduced, this advantage will no longer hold: each party will have to makc its own estimates of how external events will turn out and how other parties will respond. What, then, do firms or the Government gain from planning agreements? In a world of uncertainty, national plans and planning agreements can achieve co-ordination only at the expense of freedom to initiate and respond to change. *Far from supplementing the market process, national planning precludes it.*

Lest there be any confusion here, it should be emphasised that the above argument is not directed against 'planning' *per se*. It is clearly necessary that private firms, nationalised industries and government departments all make 'plans', and flexible ones at that, *within their appropriate spheres*. 'National planning' is a horse of a different colour altogether. The real question is not whether planning should take place, but who is to do the planning.[1]

The National Enterprise Board

The NEB was set up with an initial capital of £500 million (subsequently doubled) to provide investment capital, promote reorganisation of industries by taking shareholdings, manage existing government shareholdings, assist ailing companies, create employment and provide a source of financial and managerial advice. Like its predecessor, the Industrial Reorganisation Corporation (IRC), the NEB was established in the belief that mergers needed to be arranged between many

[1] Cf. Hayek, 'The New Confusion about "Planning" ', *The Morgan Guarantee Survey*, New York, January 1976, reprinted in *New Studies . . .*, *op. cit.*

firms or factories too small to reap the benefits of economies of scale, and that new investments needed to be made in many firms using outdated techniques or equipment. 'There is no evidence', said the White Paper on the IRC in 1966,[1] 'that we can rely on market forces alone to provide the necessary structural changes at the pace required.' There were many financial institutions 'but there is no organisation whose special function is to search for opportunities to promote rationalisation schemes which could yield benefits to the whole economy'.

This assertion betrayed a naïve misunderstanding of the market mechanism. Every shareholder, every entrepreneur, every manager has direct financial incentive to identify activities where improvements might be made. If a bottleneck is not identified until too late, a firm loses money; by the same token, profits could have been made by anticipating the bottleneck. Firms go to whatever lengths they deem appropriate to secure their supplies: sometimes they buy ahead, sometimes they integrate back into the supply industry, at yet other times they find it more profitable to take a risk and modify their plans as the situation develops.

If the future were known, there would be little difficulty in identifying the optimal structure of each industry and the optimal set of techniques. But in that event, the problems would not arise in the first place. The question to be posed is whether the NEB can expect to make *better* predictions and decisions than the thousands of individuals in the market. It seems unlikely. Participants in the market have collectively not only more experience and knowledge but also the personal financial incentive to seek out relevant information and to make correct decisions. Over time the market encourages people who are successful and weeds out those who are not. By contrast, members of the NEB are not risking their own money and are under pressure to return an overall performance which is satisfactory to the Government. And for the Government, profit derived from efficiency and alertness is only one of many considerations: political considerations may count for more. Thus, it has been explicitly stated that the purpose of the NEB is 'to secure where necessary large-scale sustained investment to offset the effects of the short-term pull of market forces'.[2] This presumably means that the NEB should act to

[1] *Industrial Reorganisation Corporation,* Cmnd. 2889, HMSO, January 1966.

[2] *The Regeneration of British Industry, op. cit.*

promote employment or prevent unemployment, to increase exports or replace imports, to build up a large domestic concern or to prevent foreign control.

'Burning the furniture to heat the stove': the British approach?

The owners and employees of a firm which receives financial assistance or preferential treatment will usually benefit from it. But such actions have a cost in opportunities foregone: funds have to be withdrawn from some other use, or prices are maintained at a higher level than they otherwise would be. Now the economist *qua* economist cannot object to the redistribution of income from taxpayers and consumers to owners and employees of firms in actual or potential financial difficulties. For humanitarian reasons, he may support a programme designed to cushion the effects of change. He must object, however, to the *pretence* that this will reverse the decline in British industry, and he may even question whether those whom such a policy is intended to benefit will, in the long run, be better off. Here again the Austrian view, put by Mises, is relevant to our present day:

> 'There are certainly, both in the actions of individuals and in the conduct of public affairs, situations in which the actors may have good reasons to put up even with very undesirable long-run effects in order to avoid what they consider still more undesirable short-run conditions. It may sometimes be expedient for a man to heat the stove with his furniture. But if he does, he should know what the remoter effects will be. He should not delude himself by believing that he has discovered a wonderful new method of heating his premises.'[1]

The debate about national planning reveals in particularly stark form the fallacies that the Austrians have been most concerned to expose. The prime defence of national planning has not been the desirability of protecting any particular social group or promoting the consumption of any particular product, nor has it been the need to curb the activities of powerful firms or unions. The claim has been, instead, that national planning, in one or more of its variants, can 'reverse the decline of British industry' by increasing the efficiency with which the economy operates. Ultimately, the basis for this claim is that government,

[1] *Human Action, op. cit.*, p. 654.

or one of its agencies, has a better knowledge of what needs to be done, at least in general terms if not in detail, than do the many thousands of individual firms in the economy.

Now it is clear that firms in the market are continually making errors of omission and commission, which they could avoid if they had better knowledge, which would lead in turn to a much faster growth rate in the economy. What is not explained is how the government has or is able to acquire the superior knowledge which will make this possible. Does the government have a different source of knowledge from that of the firms? If so, what is it? Or is its knowledge merely a synthesis of what it learns from firms? If so, how does it reduce the total quantity of information to a manageable level, sort out the wheat from the chaff, and resolve the inevitable ambiguities and conflicts in the information received? No settled answers to these questions are forthcoming.

Austrians have long been clear about the issues involved. The practical impossibility of efficient central planning has been frequently dissected by Professor Hayek, most recently in 1976:

> '. . . the economic order of any large society rests on a utilisation of the knowledge of particular circumstances widely dispersed among thousands or millions of individuals.
>
> . . . the market and the competitive determination of prices have provided a procedure by which it is possible to convey to the individual managers of productive units as much information in condensed form as they need in order to fit their plans into the order of the rest of the system.
>
> The alternative of having all the individual managers of businesses convey to a central planning authority the knowledge of particular facts which they possess is clearly impossible—simply because they never can know beforehand which of the many concrete circumstances about which they have knowledge or could find out might be of importance to the central planning authority.'[1]

For similar reasons, planning agreements and the NEB cannot hope to improve upon the efficiency in the use of resources which the market makes possible.

[1] 'The New Confusion about "Planning" ', *op. cit.*

X. SUMMING UP

The distinctive Austrian approach

Mises believed that the ideas of the original Austrian School founded by Carl Menger in 1870 were substantially incorporated into 'mainstream' economic theory by 1920. The work of the second and third generation Austrians, notably Mises himself and Hayek, has not been so incorporated. Their ideas have been subsequently developed by Kirzner, Lachmann, Rothbard and others who, although not Austrian by birth, may be considered members of the Austrian school. In addition, I have argued that about a dozen other noted scholars, working independently, have been directly or indirectly influenced by Mises or Hayek and that their work is substantially in sympathy with that of the Austrian school.

Austrian economic theory is based upon the twin principles of methodological individualism and subjectivism. Economic phenomena must be related to the actions of the *individuals* involved, which in turn must be interpreted in terms of their purposes and perceived opportunities. These two principles both describe what Austrian economists do and define what Austrians believe good economics to be. These principles also provide a kind of guideline by which to evaluate a situation or theory.

Neo-classical 'mainstream' economics pays lip-service to these principles. The working of the competitive economy is supposedly 'explained' in terms of the choices of individual firms and consumers, determined by their preferences and resources. But these choices are made in the light of *perfect information*: there is no explanation of *how* all prices come to be known and consequently *how* a competitive equilibrium comes about.

Austrian economics takes as its starting point the behaviour of people with incomplete knowledge, who have not only to 'economise' in the situations in which they find themselves, but also to be on the alert for better opportunities 'just around the corner'. This alertness, missing from 'mainstream' economics, is called entrepreneurship. It leads to the revision of plans, and forms the basis of the competitive process, which in many ways epitomises the Austrian approach. For Austrians, the *changes* over time in prices, production, plans, knowledge and expectations are more important than prices and output at any one time. Similarly, from a 'normative' point of view (of what policy should be), the adequacy of an economic system is judged not by the efficiency with which it allocates given resources at a point in time, but by the speed with which it discovers and responds to new opportunities over time.

'Mainstream' economics has approached the role of government by identifying as 'market failures' situations in which 'perfect competition' is not possible. But very often the alleged failure is due to a *lack of information,* in which case government intervention cannot hope to perform any better. Moreover, the incentives for the members of government organisations are different from those of private organisations, in a way which is not likely to improve their performance.

The implications for government policy

These ideas have been illustrated in this *Paper* by examination of British government policies on competition, nationalised industries, externalities and national planning. The conclusions have been broadly that, in all these contexts, the present extent of government intervention cannot be justified if the aim is to encourage an efficient, responsive and increasingly wealthy economy. Even the 'intelligent radical' who places a high value on liberty and equality would not, we have argued, favour the 'mixed economy' advocated on his behalf by Professor Meade. We have found that the free-market economy is surprisingly resilient, that it has strengths in an environment of uncertainty and change which are not appreciated if perfect knowledge is assumed, and that government intervention has corresponding weaknesses. A more effective way of achieving the desired ends would be to promote the competitive process by removing government-imposed barriers to new entry and by strengthening the system of private property rights.

In more detail the implications of these policy changes are mainly four:

(i) It was suggested that the Monopolies and Mergers Commission should no longer be responsible for mergers. This would make it easier for efficient large firms to expand, and withdraw protection from firms whose assets are not being used as efficiently as they might be. Patent monopolies should be abolished. This would expose the established companies in industries such as, notably, pharmaceuticals and computers to active competition from new and smaller firms able to produce more efficiently or to make minor improvements on established products. Consumers would benefit from cheaper products, although more fundamental discoveries, at least in those industries, might possibly be introduced more slowly. Finally, relaxing the laws against restrictive practices might allow the continuation of collusions to raise prices by electrical and construction firms. On the other hand, removing the statutory monopoly power of the professions would put an end to the present scandal of conveyancing charges.

(ii) Allowing competition against the nationalised industries and enforcing financial discipline there would no doubt lead to more rapid closures of inefficient steelworks and pits by British Steel and the National Coal Board. It is possible, however, that some of this labour would be taken on by expanding private firms in those sectors. The postal side of the Post Office would certainly contract but the telecommunications side would expand. Consumers would benefit from lower prices for telephone calls and competition to provide more attractive and efficient telephone sets. British Rail and the aircraft and shipbuilding industries would contract more rapidly. Indeed, the size of the public sector generally would be reduced, but the shift in demand and resources to the private sector would lead to expansion there more or less across the board.

(iii) Abandoning government inquiries into controversies about planning permission does not necessarily mean that externalities would be ignored, leading to increased pollution, noise and scenic devastation. It was recommended that private property rights be better defined and enforced, so that these less tangible goods can be transacted in the market. If airlines have to compensate residents in the neighbourhood of airports for excessive noise levels, it is much more likely than now that the airlines will take notice. The same is true of water and air pollution. It does of course raise the question whether conservationists will be able to raise sufficient funds to protect the scenery, or persuade taxpayers to do so. If not, this would indicate that scenic delights are a minority interest. That the National Trust has been able steadily to increase its purchase of Britain's coastline suggests that all is by no means lost for conservationists and nature lovers.

(iv) Finally, to abandon the attempt to sign planning agreements would remove a potential hindrance from the larger firms, and to sell back the assets of the NEB to private industry would mean less help was available for firms in distress. Employees and shareholders in such industries would suffer, at least initially, but consumers and taxpayers would benefit.

The general effect of adopting these Austrian proposals is that resources would tend to be used as consumers, given their incomes, wished. The result would not necessarily be compatible with any particular person's idea of 'social justice', but a responsive and growing economy provides the best likelihood of satisfying the wishes of people in general.

The limitations of government

Adopting the recommendations of Austrian economists would not immediately solve Britain's economic problems. Though many people would benefit, others would initially experience serious and unpleasant changes in their lives. But this fate, of course, is precisely what successive governments of both political complexions have been predicting over the past decade. Without exception they have seen our salvation in a larger role for government. And without exception it has failed.

Why then do we still persevere with a mixed economy? There are basically two reasons. The first is intellectual: most people in politics and academia and the general public have been genuinely persuaded that a mixed economy is necessary and inevitable. Indeed, as the modern economy grows more complex, it is thought necessary to extend the role of government. One of the purposes of this *Paper* has been to show how Austrian ideas explode this myth. In Professor Hayek's words:

> '. . . the complexity of the structure required to produce the real income we are now able to provide for the masses of the Western world—which exceeds anything we can survey or picture in detail—could develop *only* because we did *not* attempt to plan it or subject it to any central direction, but left it to be guided by a

> spontaneous ordering mechanism, or a self-generating order, as modern cybernetics calls it.'[1]

This understanding of the vital role of organic, as opposed to pragmatic, institutions is characteristic of Austrians. Professor Hayek expresses the theme in more general terms:

> 'We flatter ourselves undeservedly if we represent human civilisation as entirely the product of conscious reason or as the product of human design, or when we assume that it is necessarily in our power deliberately to re-create or to maintain what we have built without knowing what we were doing.
>
> Though our civilisation is the result of a cumulation of individual knowledge, it is not by the explicit or conscious combination of all this knowledge in any individual brain, but by its embodiment in symbols which we use without understanding them, in habits and institutions, tools and concepts, that man in society is constantly able to profit from a body of knowledge neither he nor any other man completely possesses.
>
> Many of the greatest things man has achieved are not the result of consciously directed thought, and still less the product of a deliberately co-ordinated effort of many individuals, but of a process in which the individual plays a part which he can never fully understand. They are greater than any individual precisely because they result from the combination of knowledge more extensive than a single mind can master.'[2]

This appraisal leads to an appreciation of the necessarily modest role of government.

> 'If man is not to do more harm than good in his efforts to improve the social order, he will have to learn that . . . where essential complexity of an organised kind prevails, *he cannot acquire the full knowledge which would make mastery of the events possible.* He will therefore have to use what knowledge he can achieve, not to shape the results as the craftsman shapes his handiwork, but rather to cultivate a growth by providing the appropriate environment, as the gardener does for his plants.'[3] (My italics.)

The political problem of democracy

The second reason advanced for the continuation and extension of the mixed economy is political: as any Minister will

[1] 'The New Confusion about "Planning" ', *op. cit.*

[2] *The Counter-Revolution of Science, op. cit.*, p. 84.

[3] 'The Pretence of Knowledge', *op. cit.*, p. 42.

confirm, it would be political suicide to resist it. The explanation is not difficult to find. Although the various aspects of direct government intervention discussed above cannot be justified as in the interests of people as a whole, it is undoubtedly true that each measure, taken separately, benefits at least one group of people. Prohibitions on mergers protect competitors and employees likely to be made redundant as capacity is rationalised. Nationalisation slows down the rate at which resources are transferred out of declining industries, thereby benefiting their employees and sometimes their consumers. If the NEB invests in a firm when others are unwilling to do so, the benefits to its shareholders and employees are obvious. It may, indeed, be argued that the various devices of government involvement in industry are deliberately intended to serve the interests of powerful political groups. It is political pressures which provide the initial impetus for such measures and the support to carry them through.

By no means as obvious are the disadvantages imposed on others. If consumers of one product or employees in one industry are favoured, it is necessarily at the expense of consumers of other products, of employees in other industries or of taxpayers generally. Support and protection for one industry can only be given by reducing support for another, in effect diverting resources away from uses to which consumers would have preferred to direct them.

This diagnosis of the nature of knowledge poses ultimately the political problem of democracy. Even if all citizens as consumers stand to gain from a general policy of non-intervention, each citizen as employee or investor stands to gain from *particular* interventions. As long as government is responsible to electors, so long will organised pressure-groups be able to impose their will. This dilemma has recently led Professor Hayek to explore the possibilities of constitutions having two distinct representative assemblies with different tasks. One would be a true legislative body and the other concerned with government proper, i.e. everything except the making of laws. Both assemblies would be democratically elected, but whereas the government assembly would operate much as existing parliaments, the legislative assembly would need to represent not specific interest-groups but prevailing opinion on what kind of conduct was just. To achieve this, its members would have to be elected for long periods (say, 15 years) without reelection, but with a constant fraction replaced each year.[1]

The purpose of this separation of powers is, of course, to create a legislature which is not subservient to the momentary pressures of government, and hence which severely limits the response which governments may make to immediate political pressures, in order to protect the long-run interest of these same people.

This recent development of Austrian thought on the borders of economics and political science forms an appropriate conclusion to this *Paper*. The gradual and insidious encroachment of the mixed economy is an unintended consequence of our present constitution. The quite different government policy which the 'intelligent radical' would derive from an application of Austrian economics may seem unlikely to be widely acceptable today. Nor does it seem likely that an appropriate revision of the constitution will take place in the near future. But the Austrian contribution depends squarely upon the phenomenon of learning from experience. The Austrian must be confident that even ideas at present unthinkable will eventually be accepted, and sooner rather than later.

Having revealed the theoretical flaw and thus the root fallacy of the mixed economy, Austrian economics offers the prospect of government policy that would much more certainly achieve the aspirations of the 'intelligent radical'.

[1] *Economic Freedom and Representative Government, op. cit.*; *Law, Legislation and Liberty*, Routledge and Kegan Paul, Vol. 1, 1973, Vol. 2, 1976. Also J. M. Buchanan, *The Limits of Liberty: Between Anarchy and Leviathan,* University of Chicago Press, Chicago, 1975; and Lord Hailsham, *The Dilemma of Democracy: Diagnosis and Prescription,* Collins, 1978.

POSTSCRIPT, 1985

An Austrian Critique Revisited

INTRODUCTION

A year after *The Fallacy of the Mixed Economy* was published a new Conservative Government was elected under Margaret Thatcher. It was re-elected in 1983 with an increased majority. During the last seven years its policies have often been dramatically different from those pursued during the previous two decades by governments of either major Party. The re-issue of this *Hobart Paper* provides an appropriate opportunity to assess whether UK policy is less vulnerable to the 'Austrian critique' in 1985 than it was in 1978.

The original *Paper*, as its subtitle indicates, presented an Austrian critique of economic thinking as well as policy. It is therefore appropriate to begin by appraising the recent development of Austrian economics and its reception by the economics profession.

Part I

AUSTRIAN ECONOMICS AND ECONOMIC THINKING

Modern Austrian economics has built on the value and fruitfulness of certain insights basic to the earlier school of Austrian economics. These originated in the 1870s with Carl Menger in Vienna, and were subsequently developed by Wieser, Böhm-Bawerk, Schumpeter, Mises and Hayek.

Austrians are sometimes described as 'thoroughgoing subjectivists'. They emphasise that individuals as economic agents, far from possessing perfect information, inevitably differ in their knowledge, beliefs and expectations. The central analytic concept of Austrian economics is that of a market *process* taking place over time and involving the discovery and correction of error. Mainstream neo-classical economic theory, because of its excessive pre-occupation with the state of equilibrium and its failure to incorporate a concept of market process, misinterprets the nature of competition. From the Austrian perspective, mainstream economics is 'seriously deficient in any genuine understanding of the workings of market capitalism'.[1]

Mainstream economic theory defines the efficiency of an economy in terms of its allocation of available resources, taking as given production technologies and consumer tastes. From the Austrian perspective, this definition is too narrow. Resources, technologies and tastes cannot be assumed to be fixed and known. A crucial part of the economic problem is to ascertain what they are—and, indeed, to create new resources, technologies and tastes. An economy is therefore not be judged merely by whether the conditions for perfect competition or Pareto-optimality exist at a particular time. Discovery, innovation and speed of response to exogenous change can be measured only over a period of time. Whether prices of given

[1] I. M. Kirzner, 'The "Austrian" Perspective on the Crisis [in economic theory]', *The Public Interest*, Special Issue 1980, p. 111.

products are equal to marginal costs is less important than whether these costs are continually being reduced, and those products being replaced by better ones. It is in this more general and *dynamic* sense that Austrians claim the market system is more effective at serving customers than any alternative type of economy.

Just as within mainstream economics, and indeed in any developing discipline, there are several differences of emphasis within the Austrian school. Some writers see the market process as disequilibrating, others as equilibrating, yet others as neither. Some base economic theory purely on *a priori* assumptions; others concede a rôle for empirical evidence. Some place emphasis on a 'natural rights' theory (in the analysis of property rights, taxation and the rôle of the state, for example); others find no need for it. Some have buttressed their arguments for a market economy by an appeal to liberalism or libertarianism; others have been of conservative or even mildly socialist persuasion. But all stress the importance of subjectivism and time, with the implication that the market must be seen as a dynamic process, and public policy designed accordingly.

Increasing interest

In the seven years since the publication of the *Hobart Paper*, there have been useful developments in Austrian thinking. Israel Kirzner has traced the implications of entrepreneurship in a variety of contexts.[1] His analysis of regulation from a market-process perspective will be explored in some detail in the next section. Gerald O'Driscoll and Mario Rizzo have provided a comprehensive restatement of subjectivism entitled *The Economics of Time and Ignorance*[2] which examines, *inter alia*, the policy implications of Austrian economics. Ludwig Lachmann's forthcoming book on *The Market as a Process*[3] is a challenging exposition of subjectivist thought, reflecting the radical ideas of G. L. S. Shackle rather than the Mises-Hayek-Kirzner tradition.

[1] I. M. Kirzner, *Perception, Opportunity and Profit*, University of Chicago Press, Chicago, 1979.

[2] Blackwell, Oxford, 1985.

[3] To be published by Blackwell, Oxford, in 1986. Also his paper, 'The Salvage of Ideas', *Journal of Institutional and Theoretical Economics*, Vol. 138, 1982, pp. 629-45.

Murray Rothbard has examined the ethical basis of capitalism.[1] Lawrence White and Don Lavoie have written substantial books (developed from doctoral dissertations) on *Free Banking* and *Rivalry and Central Planning* respectively.[2] A series of Conference Proceedings includes papers by numerous younger Austrian scholars.[3] Increasing interaction with non-Austrian economists is reflected in conference papers by such established economists as Buchanan, Demsetz, Hicks, Leibenstein, Loasby and Yeager.

Professor F. A. Hayek, who was made a Companion of Honour in 1984, is still writing vigorously on a wide variety of subjects.[4] His work on macro-economic policy, the price mechanism, private money, methodology, and political philosophy is increasingly being examined by mainstream economists.[5] Kirzner's work on entrepreneurship has also attracted general attention.[6] There have been several expositions and critiques of Austrian positions on competition, methodology and other issues.[7]

[1] Murray Rothbard, *The Ethics of Liberty*, Institute for Humane Studies, Menlo Park, California, 1982.

[2] L. White, *Free Banking in Britain: Theory, Experience and Debate 1800-1845*, Cambridge University Press, Cambridge, 1984; D. Lavoie, *Rivalry and Central Planning: The Socialist Calculation Debate Reconsidered*, Cambridge University Press, Cambridge, 1985.

[3] L. M. Spadaro (ed.), *New Directions in Austrian Economics*, Sheed Andrews and McMeel, Kansas City, 1978; M. J. Rizzo (ed.), *Time, Uncertainty and Disequilibrium*, D. C. Heath, Lexington, 1979; I. M. Kirzner (ed.), *Method, Process and Austrian Economics*, D. C. Heath, Lexington, 1982.

[4] F. A. Hayek, *New Studies in Philosophy, Economics and the History of Ideas*, Routledge and Kegan Paul, London, 1978; *Law, Legislation and Liberty:* Vol. III: *The Political Order of a Free People*, Routledge and Kegan Paul, London, 1979; *Knowledge, Evolution and Society*, Adam Smith Institute, London, 1978. The first volume of a new trilogy entitled *The Total Conceit* is forthcoming.

[5] For example, books and papers by Brennan and Buchanan, Burton, Hahn, Hutchison, Klein, Sen and Sowell.

[6] A. Seldon (ed.), *The Prime Mover of Progress*, IEA Readings No. 23, Institute of Economic Affairs, London, 1980; M. Casson, *The Entrepreneur*, Martin Robertson, London, 1982.

[7] W. D. Reekie, *Industry, Prices and Markets*, Philip Allan, Oxford, 1979; W. D. Reekie, *Markets, Entrepreneurs and Liberty: An Austrian View of Capitalism*, Harvester Press, Brighton, 1984; A. Shand, *Subjectivist Economics: The New Austrian School*, Pica Press, Oxford, 1981, and *The Capitalist Alternative: An Introduction to Neo-Austrian Economics*, Harvester Press, 1984; A. Shenfield, *Myth and Reality in Anti-Trust*, 14th Wincott Memorial Lecture, Occasional Paper 66, IEA, 1983.

Also chapters in R. Backhouse, *A History of Modern Economic Analysis*, Blackwell,

[*Contd. on p. 87*]

There are now PhD programmes emphasising Austrian economics at New York University, Auburn University (Alabama) and George Mason University (Fairfax, Virginia). A Mises Institute has been founded at Auburn, concentrating, at present, on developing understanding of the free market. The Mises Institute plans to issue a *Journal of Austrian Economics*, edited by Murray Rothbard and Walter Block. George Mason University has a Center for the Study of Market Processes (in addition to the Center for Public Choice, which moved from Virginia Polytechnic Institute). It issues an informative biannual newsletter, *Market Process*, containing news of publications and reviews of books and conferences.

Admittedly there have been no major breakthroughs in Austrian thinking, nor has professional attention (either favourable or critical) been comparable to that accorded to certain other new ideas in economics, such as public choice or rational expectations. Nonetheless, worthwhile research is proceeding along Austrian lines, and the increasing worldwide awareness of, and interest in Austrian ideas, especially by younger scholars, is encouraging.

Regulation and the market process

Mainstream economic analyses of government regulation focus on the changed motivation of decision-makers as a result of a change in property rights. Regulated companies are less motivated than unregulated ones to maximise profits, minimise costs and meet consumer demands; they therefore make different choices between the alternatives available—for example, about techniques of production or levels of output and prices. Over a hundred such studies, both theoretical and empirical, are surveyed by De Alessi.[1]

[*Contd. from p. 86*]
Oxford, 1985; M. Blaug, *The Methodology of Economics*, Cambridge University Press, Cambridge, 1980; B. Caldwell, *Beyond Positivism: Economic Methodology in the Twentieth Century*, Allen and Unwin, London, 1982; T. W. Hutchison, *The Politics and Philosophy of Economics*, Basil Blackwell, Oxford, 1981. For further information, R. M. Ebeling, 'Austrian Economics—An Annotated Bibliography', *Humane Studies Review*, Vol. 2, No. 1, 1983.

[1] L. De Alessi, 'An Economic Analysis of Government Ownership and Regulation', *Public Choice*, Vol. XIX, Fall 1974, and 'The Economics of Property Rights: A Review of the Evidence', *Research in Law and Economics*, Vol. 2, 1980.

Kirzner's characteristically Austrian approach[1] argues that the demand for regulation has stemmed in part from a misunderstanding of the market process; that regulation, unlike the market, has no systematic error-correcting mechanism; and that regulation both stifles the discovery of hitherto-unperceived opportunities and diverts entrepreneurial activity into less desirable channels, such as evasion and bribery.

Kirzner's argument implies that the effects of regulation go even deeper than neo-classical economics recognises. A change in property rights affects not only the choice among a set of given alternatives, but also the *content* of the available choice-set itself. Regulation not merely influences the levels of costs, prices and salaries; it also discourages the regulated company from devising new techniques of production, new structures of tariffs, and new contractual arrangements with employees.

If the entrepreneurial discovery process is ignored, the adverse effects of regulation tend to be understated. A historical study of a regulated industry would identify various labour-saving technologies or other investments that were considered and rejected, but would necessarily fail to identify those technologies that were never even discovered, though they might well have been if the incentive to do so had been stronger.

By the same token, the future beneficial consequences of de-regulation are also likely to be understated. The recent history of the US airline industry provides an instructive example. It was predicted that de-regulation would lead to withdrawal of services and/or higher fares on light-traffic short-haul routes because cross-subsidisation from profitable transcontinental routes could no longer be sustained. In the event, new and smaller aircraft types better suited to these particular conditions were developed, which could provide the same service at much lower cost. Regional airlines flourished, and the predicted adverse consequences of de-regulation did not take place. Similar developments can be traced in UK airlines and coaches, which have been partially de-regulated in recent years.

The regulatory process

Can it be said that there is *no* discovery process within a regulatory authority? Kirzner argues that

[1] I. M. Kirzner, *The Perils of Regulation: A Market-Process Approach*, Law and Economics Center, Occasional Paper, University of Miami School of Law, Coral Gables, FL 33124, 1979.

> 'even if one could imagine an official so dedicated to the citizenry that he would ensure the adoption of all known possible measures for cutting costs, one cannot yet imagine him divining *as yet undiscovered* techniques for cutting costs'.[1]

But surely every decision-maker, whether market-trader or bureaucrat, continually discovers new opportunities for increasing his or her own satisfaction? To be sure, regulation affects the discovery process of the regulated industry; but it also institutes a further discovery process on the part of the regulatory authority itself. The two discovery processes are inextricably linked as one reacts to the other.

Examples are not hard to find. The British Treasury, ever-anxious to control nationalised industry spending, has invented and imposed test discount rates, required rates of return, financial targets, cash limits and external financial limits (EFLs). Tax legislation is well-known for diverting the entrepreneurial energies of accountants into designing ever-more ingenious schemes of tax avoidance; but, equally, is not Budget Day the annual occasion on which the Chancellor demonstrates the skill of his Inland Revenue officials at identifying and plugging these loopholes?

Political and market processes are not identical, however. The political context in which regulation is set not only influences the direction of the regulatory discovery and adjustment process; it also limits its strength and speed. These aspects deserve further investigation. So, too, do the discovery processes of nationalised industries, local authorities, building societies, charities, trade unions, and the wide variety of other organisations which constitute alternatives to the regulated or unregulated private market.

Austrians have made little headway in this direction. This limits the usefulness and applicability of their insights into current policy problems. The lack of focus on political processes means they have relatively little to say about the problem of transition from a mixed economy to a market economy, which is of particular relevance in Britain today.

Has the profession been convinced?

In one sense, many fundamental Austrian insights have already been accepted by the profession, albeit not labelled Austrian.

[1] *Ibid.*, p. 16.

Over the last couple of decades, economists have increasingly conceded the importance of uncertainty and expectations. They accept that different people know different things, and that there is an important rôle for the price mechanism in spreading information. In macro-economics, unemployment is increasingly seen as a co-ordination problem. The efficacy of various policy instruments, such as increased government spending, is now acknowledged to depend in large part on the degree of public awareness of their full consequences (e.g. for inflation). Large areas of industrial economics are pervaded by 'opportunism', 'bounded rationality' and 'information impactedness' (the artificiality of such terms for everyday concepts presumably stressing the contrast with the conventional assumption of perfect knowledge). Principal-agent relationships, moral hazard, search theory, transactions costs, firms as bundles of contracts, signalling devices—all these concepts reflect the subjectivism of knowledge and beliefs.

Closer investigation suggests, however, that the full implications of subjectivism have generally been resisted. This is particularly true of mathematical economics, which set itself first to incorporate uncertainty into the Arrow-Debreu model of Walrasian general equilibrium, and subsequently to develop other equilibrium notions that include information processes and costs, transactions and transactions costs, expectations and uncertainty in an explicit and essential way.[1] Questions typically posed within these models are: How should equilibrium be defined? Under what conditions does it exist? Is equilibrium efficient? If not, can public policies be identified which do lead to an efficient equilibrium?—and so on. The focus is always on equilibrium. Completely absent from these mainstream models, despite their incorporation of uncertainty, is any concept of market process.

Some economists have indeed recognised the possibility and relevance of a theory of process. Frank Hahn,[2] for example, has embodied subjectivist assumptions and insights in a mathematical model which, it has been argued,[3] is formally analogous

[1] F. H. Hahn, *On the Notion of Equilibrium in Economics*, Cambridge University Press, Cambridge, 1973. Also Hahn, 'General Equilibrium Theory', *The Public Interest*, Special Issue 1980, pp. 123-38.

[2] *On the Notion of Equilibrium in Economics*, *op. cit*.

[3] S. C. Littlechild, 'Equilibrium and the Market Process', in Kirzner (ed.), *Method, Process and Austrian Economics*, *op. cit*., Ch. 8; F. A. Hayek, 'Economics and Knowledge', *Economica*, Vol. IV, 1937, pp. 33-54.

to that proposed by Hayek in 1937. Yet Hahn explicitly rejects the study of process in favour of the study of equilibrium. His reasons are various: that equilibrium in the extended Hayek-Hahn sense is a realistic description of the world; that a model involving learning would necessitate a 'higher-level' theory of the learning process which is not presently available, hence equilibrium represents the limit of economic analysis; and that economists are better engaged studying equilibrium because no one else will. Austrians, of course, could not accept these arguments as grounds for not placing the study of market processes at the centre of economic theory. Nevertheless, Hahn's view still seems to be broadly accepted by mathematical economists.

The importance of equilibrium as an organising concept is virtually never questioned. Thus Professor Robert Solow, giving the Mitsui Lectures at the University of Birmingham in March 1985, was critical of rational expectations theorists for interpreting every position of the economy as a Walrasian equilibrium. Professor Solow's own proposal, however, was not a rejection of equilibrium but an analysis of the labour market based on a *different* (non-Walrasian) equilibrium concept.[1] To take another example, now that mathematical economists have invaded industrial economics, it is increasingly common to find sunk costs and predatory pricing analysed in terms of equilibrium solutions to a multi-stage game—what Michael Beesley has referred to as 'attempting to abolish time'!

The unspecified market process

There are a few exceptions to the above characterisation. Some economists, in their theoretical and empirical work, have implicitly used a notion of market process. Two related examples are discussed in the main text of this *Hobart Paper*, concerning 'the concentration doctrine' (pp. 37-39) and the 'social costs of monopoly' (p. 47). Briefly, if industries are assumed to be in equilibrium, differences in profit rates must reflect monopoly power. But if industries are assumed not to be in equilibrium, an alternative and more plausible explanation is available.

> '. . . variations in profit rates are to be explained by differences in the perception of, and speed of reaction to, changes in the

[1] R. M. Solow, *Towards a Theory of Unemployment*, Basil Blackwell, Oxford (forthcoming, October 1986).

> underlying market phenomena. These changes set in motion a market process which takes time to work out: indeed firms are always in transition. Some have learned and grown, some are learning and growing, others have misjudged the situation and are shrinking. The profits achieved by these firms reflect their success in adapting themselves to the changing conditions of the market.'[1]

The changing emphasis of US anti-trust policy perhaps reflects a growing acceptance of this explanation. Yet one may search in vain for any non-Austrian exposition of the market process. Even the textbook by Alchian and Allen, which emphasises throughout the problems and market implications of the dispersion of knowledge, and finds no useful rôle for traditional concepts such as perfect, imperfect and monopolistic competition or for general equilibrium, devotes no more than a dozen pages (out of 400) to the analysis of anything resembling Austrian market process.[2]

Austrians have yet to convince the profession that a systematic market process exists (apart from luck and survival) and that the insights it provides deserve more than subsidiary mention in the context of equilibrium.[3] But as mainstream economics progresses beyond the concept of perfect competition, with its untenable assumption of perfect knowledge, it becomes increasingly necessary to explain with some precision whether and how equilibrium is actually attained in any market and how market participants respond to changes in market conditions. (And, for that matter, what is the nature of profit?) If the market process envisaged is not that developed by Austrians, what is it?

[1] Above, pp. 36-37. Also S. C. Littlechild, 'Misleading Calculations of the Social Costs of Monopoly Power', *Economic Journal*, Vol. 91, June 1981, pp. 348-63.

[2] A. A. Alchian and W. R. Allen, *Exchange and Production*, Wadsworth, Belmont, California, 3rd edn., 1983. This is the revised 'micro-economic' half of their *University Economics*.

[3] For an explicit statement of the market process, cf. especially I. M. Kirzner, *Competition and Entrepreneurship*, University of Chicago Press, Chicago, 1973, and his earlier textbook, *Market Theory and the Price System*, Van Nostrand, New York, 1963.

Part II

AUSTRIAN ECONOMICS AND UK ECONOMIC POLICY

The title, *The Fallacy of the Mixed Economy*, was not intended to suggest that government has no rôle in the economy. Austrians are not anarchists. At a minimum, government is required to defend the country, maintain law and order, and provide certain other public goods, such as roads.

Austrians are critical of the thinking (or lack of it) behind the concept of the mixed economy as it came to be understood in the UK during the 1960s and 1970s. It led to an elaborate superstructure of governmental interventions and controls on the market mechanism, including nationalised industries; national and regional planning boards; environmental, health and consumer protection agencies; co-partnership between government, industry and unions; and so on. In the Austrian view, as the original *Hobart Paper* concluded, such extensive government intervention

> 'cannot be justified if the aim is to encourage an efficient, responsive and increasingly wealthy economy. . . . A more effective way of achieving the desired ends would be to promote the competitive process by removing government-imposed barriers to new entry and by strengthening the system of private property rights'. (p. 76)

It is relatively easy to state these principles, but to implement them requires both economic judgement and political sensitivity. The 'right answer' is seldom obvious or easily achievable. Compromises have continually to be made. There are some areas where the incoming 1979 Government moved swiftly and boldly, notably in the abolition of exchange controls. There are other areas where as yet virtually nothing has been done to promote market forces, notably in education, health and pensions.[1] Our focus in this review will be on developments in

[1] For example, the following recent IEA publications: S. R. Dennison, *Choice in Education*, Hobart Paperback 19, 1984; H. S. Ferns, *How Much Freedom for*

[*Contd. on p. 94*]

policy in the four areas examined in the original *Hobart Paper*—national planning, competition policy (including price control, mergers, restrictive practices and patents), nationalised industries (now including privatisation), and externalities.

National planning

Adapting well-known Austrian writings on centralised national planning, the *Hobart Paper* argued that planning agreements and the National Enterprise Board could not hope to improve upon the efficiency in use of resources which the market makes possible via the price mechanism. Planning agreements have indeed been abandoned. The National Enterprise Board (NEB) was required to dispose of the majority of its holdings, and its rôle was severely reduced. It was then merged with the National Research Development Council (NRDC) to form the British Technology Group (BTG), whose task is to foster the development and adoption of new technology. Austrians would question whether even this residual rôle can be justified on grounds of efficient resource allocation.

Other aspects of industrial policy survive, such as regional subsidies, though the expenditure has been reduced. It is slowly becoming accepted that the case for such policies has to be made on political or social, rather than on economic, grounds.

Price control

Arguments had been made for various forms of price and profit control, often invoking calculations of the social welfare loss due to monopoly. The *Hobart Paper* argued that these calculations were based on a static framework of analysis which failed to appreciate the disincentive to innovation. In the event, there has been no attempt to regulate companies on account of their size or profitability *per se*. Indeed, one of the first acts of the incoming Government was to abolish the Price

[*Contd. from p. 93*]

Universities?, Occasional Paper 65, 1982; D. G. Green, *Which Doctor?*, Research Monograph 40, 1985; B. Griffiths and H. Murray, *Whose Business?*, Hobart Paper 102, 1985; A. Lewis *et al.*, *Grants or Loans?*, Research Monograph 34, 1980; E. V. Morgan, *Choice in Pensions*, Hobart Paper 100, 1984; W. D. Reekie and H. Otzbrugger, *Competition and Home Medicines*, Research Monograph 39, 1985.

Commission. Price control has been adopted in only two rather special cases (contraceptive sheaths and telephone services) where there are single suppliers and little immediate prospect of new ones. The form of the control (prices not to increase faster than an index of input or retail prices, with no explicit constraint on profit) was deliberately designed to avoid discouraging innovation or improvements in productivity.[1]

Mergers

The *Hobart Paper* reviewed the argument that high concentration of output in the hands of a few firms increases monopoly power, and therefore necessitates a tough merger policy. There is indeed some evidence of a statistical correlation between concentration and profit rates. However, there is also evidence that, over time, abnormal profit rates tend back towards the mean. This suggests the presence of a competitive market process, with high profits due to superior efficiency and alertness rather than to concentration and monopoly.

These two contrasting views were well illustrated in the Monopolies and Mergers Commission's report on the proposed merger between Huntley and Palmer and Nabisco Brands.[2] The Commission concluded that the merger would probably have significant benefits to competition in the UK biscuits markets, where Huntley and Nabisco had stakes of 19 and 5 per cent respectively. Despite the increased concentration, the combined company would make a more effective competitor for United Biscuits, the leading company. Opinion was sharply divided, however, on the impact upon the snack-foods market, where the merged group would have a 43 per cent share and United Biscuits 27 per cent. Two members of the Commission concluded that the concentration of 70 per cent of the UK snack-food industry in the combined hands of two companies would be against the public interest. The majority view was that, whatever the concentration of output among manufacturers, the countervailing power of retailers would be sufficient to ensure strong price competition.

[1] Monopolies and Mergers Commission, *Report on the supply in the UK of contraceptive sheaths*, Cmnd. 8689, HMSO, November 1982; S. C. Littlechild, *Regulation of British Telecommunications' Profitability*, Department of Industry, London, February 1983.

[2] *Nabisco Brands and Huntley and Palmer Foods*, Cmnd. 8680, HMSO, October 1982.

There is another aspect of mergers on which economists are divided, and where opinion within the Commission has been sufficiently finely balanced to lead to several split verdicts.[1] The *Hobart Paper* referred to several empirical studies in the 1970s which found a lack of profitability following merger (p. 50). These studies had been used to support an alternative argument for restricting mergers: to prevent inefficiency. It was proposed that the onus be put on companies to prove that real benefits would flow from merger, or at least that a 'neutral' stance on mergers should replace the present presumption in their favour.[2]

The difficulties of evaluating balance-sheet data have more recently led economists to examine stock-market evidence instead. There is now considerable evidence from the USA[3] that the stock-market valuation of merging companies generally rises, indicating that the market expects merger to lead to higher profitability in future (and there is no subsequent fall in share prices such as would be implied by initially over-optimistic evaluations).

Recent developments in the economic theory of the firm are also more congenial to Austrians. Manne[4] argues that management inefficiency is prevented not by diligent monitoring by shareholders of a board's decisions, nor by statutory regulations concerning directors' responsibilities (nor, by implication, by requiring companies publicly to prove the future profitability of their plans), but rather by the threat of takeover. Mergers and takeovers are a form of competition for management control. Just as consumer interests are promoted by rivalry between alternative suppliers, so shareholder interests are promoted by rivalry between alternative management teams. The competitive market process thus encompasses capital markets as well as product markets. On this view, restricting mergers is more likely to *reduce* efficiency (by protecting incumbent managers from competition) than to increase it.

[1] *Lonrho and House of Fraser*, HC 73, HMSO, December 1981; *Charter Consolidated and Anderson Strathclyde*, Cmnd. 8771, HMSO, December 1982; *Dee Corporation and Booker McConnell*, Cmnd. 9429, HMSO, January 1985.

[2] *A Review of Monopolies and Mergers Policy*, Cmnd. 7198, HMSO, May 1978.

[3] M. C. Jensen and R. S. Ruback, 'The Market for Corporate Control', *Journal of Financial Economics*, Vol. 11, 1983, pp. 5-50.

[4] H. Manne, 'Mergers and the Market for Corporate Control', *Journal of Political Economy*, Vol. 73, 1965, pp. 110-20.

Policy implications

The Secretary of State and the Commission have continued to be criticised for the unpredictability of their merger references and recommendations. There have been renewed suggestions that the criteria for referring and assessing a merger should be formally restricted to the impact on competition instead of encompassing the wider and ambiguous 'public interest'. Previous ministers announced their satisfaction with the existing statutory framework, but indicated that competition would henceforth be the main consideration in making references.[1] How long such a policy will be affirmed and implemented remains to be seen.

Statements of government policy do not, of course, change the statutory criteria which the Commission has to apply. But even supposing that regional and balance-of-payments considerations were deleted from the Commission's criteria, thereby restricting it solely to considering the competition aspect, the above analysis suggests that unpredictability in merger recommendations cannot be avoided so long as different views exist about concentration and efficiency.

In recognition of the difficulty of predicting the full effects of mergers, there has been limited further support for switching the emphasis of competition policy from *ex ante* appraisal of mergers to *ex post* prohibition of abuse of a dominant position. Legislation concerning anti-competitive practices was introduced in the Competition Act of 1980. This could be used as an alternative to merger control, though there is no intention to abandon the latter. There have also been proposals to transfer the evaluation of anti-competitive practices from the Commission to the Courts. This would allow those parties adversely affected to sue on their own account, as in the USA. Such a development would surely be consistent with Austrian thinking: Why should there be a monopoly of access to the Courts?

Restrictive practices

Restrictive practices may be intended to limit competition, but in so doing may facilitate otherwise risky investment. Current legislation copes with the dilemma by examining each

[1] Alex Fletcher, DTI Press Release, 6 July 1983; Norman Tebbit, OFT Conference, 31 January 1984.

restrictive practice on its merits, though the establishment of precedent now leads to the presumption that nearly all such practices will be found to be against the public interest.

Legislation was extended from goods to services in 1973. The first few agreements have now been brought to court. The Stock Exchange was exempted from restrictive practices legislation at the last moment, but not before fixed commissions had been abandoned and other concessions secured. Travel agents were required to abandon several restrictions including collective resale price maintenance, though the latter has apparently been replaced by a series of bilateral agreements.

Austrians are more concerned about restrictive practices which stem from statutory monopolies. Following Schumpeter and Hayek, Arthur Shenfield refers to

> 'the powerful tendency of private restrictive agreements, when not bolstered by government blessing or enforcement, to fall apart, sometimes instantaneously'.[1]

By exhortation and legislation, the present Government has attempted to intensify competition in various professions. Accountants, solicitors and vets have been persuaded to allow a limited degree of advertising, though the Office of Fair Trading has recently been asked to make a further investigation of the more reluctant professions. The opticians' monopoly of dispensing glasses has been withdrawn. The solicitors' statutory monopoly of conveyancing is supposed to follow suit, though whether the proposed restrictions on entry into conveyancing are significantly more liberal than the ones they replace is debatable. The full effects of all these measures have yet to emerge, but experience to date in the UK and USA (and the volume of protest by some participants) tend to confirm the predictions of economic analysis. The sharpening of competition will indeed lead to improvements in efficiency and services and to reductions in prices.

There has been no attempt to bring labour practices and agreements within the scope of monopoly and restrictive practices legislation, even though their extent and significance cannot be doubted. For example, are 'no poaching' agreements between unions in the interest even of their members, let alone consumers? Here again, however, Austrians would argue that repeal of legal privileges is the most effective way of promoting

[1] A. Shenfield, *op. cit.* (above, p. 86, fn. 7), pp. 17-18.

competition in labour markets. The willingness of private employers to use the Courts, which recently became possible in certain respects (such as in secondary picketing), already seems to have had a salutary effect on the behaviour of union officials.

Patents

The traditional justification of the patent system, which grants monopoly rights in the use of new technologies for a limited period, is to encourage research and development and thereby accelerate technological progress. A more recent defence is that it disseminates information about research prospects and thereby improves the allocation of research resources between potential researchers.[1] The obvious cost of the patent system is that it temporarily restricts other firms from copying or improving upon the innovation.

Some economists have argued for abolition of the patent system for this latter reason. In some industries this might cause little difficulty—for instance, the fast-moving computer industry makes little use of patents. In other industries, innovation might be seriously restricted. It is frequently claimed that the time and expense required to copy a new pharmaceutical drug are so small, compared with the time and expense required to develop and test it in the first place, that without patent protection the rewards of being first in the field would be negligible, so that innovation in the supply of drugs would virtually cease.

Austrians have generally been sceptical of the patent system, without specifying what alternative would be preferable. One possibility would be simply to delimit more strictly the nature of the right conferred—for example, to reduce the period of exclusive protection, to make 'licences of right' more easily available, and to weight more heavily the restriction of competition in deciding whether to grant extensions. The Competition Act of 1980 amended the Patent Act of 1977 by making it clear that a refusal to grant licences under a patent might be an anti-competitive practice, and included powers to ensure that the patent licences were granted.

The desirability of extending this power to copyright was

[1] E. W. Kitch, 'The Nature and Function of the Patent System', *Journal of Law and Economics*, Vol. XX, No. 2, October 1977, pp. 265-90.

nicely illustrated by the Monopolies and Mergers Commission's recent report on the Ford Motor Company's policy of not granting licences to sell replacement body parts for Ford vehicles.[1] The Commission acknowledged the costs of innovation in design, but was also conscious of the benefits of competition. It compromised by recommending that the period of protection for body panels under the Registered Designs Act should be limited to five years (instead of 15), and that the Secretary of State should be empowered to grant licences of right wherever an anti-competitive practice had been established. Austrians would probably find this a move in the right direction.

The Commission's subsequent report on the BBC and ITV practice of not allowing others to publish advance programme information is another matter.[2] Three members believed that, if the present practice were abandoned, a different system would emerge, the shape of which could not be completely foreseen, and that it was impossible to say what the balance of advantage and disadvantage would be. Three other members believed that the present practice, by precluding the operation of competitive forces in the market-place, prevented viewers from demonstrating their preferences about the way in which they obtained programme information. (For instance, many viewers might well prefer a single, comprehensive publication.) The Chairman's casting vote went to the first group, and the Commission concluded that the practice was not against the public interest. Austrians have long appreciated that restrictions on one aspect of competition may be desirable in order to promote another aspect of competition (as in the Ford case), but the notion that competition should be restricted because its full consequences cannot be foreseen, and because competition cannot be presumed superior to monopoly from the consumer's point of view, would be quite alien to Austrian thought.

Nationalised industries

The *Hobart Paper* argued that the principles of welfare economics lying behind the 1967 and 1978 White Papers failed to

[1] *Ford Motor Company Limited,* Cmnd. 9437, HMSO, London, February 1985.

[2] *The British Broadcasting Corporation and Independent Television Publications Ltd.*, Cmnd. 9614, HMSO, London, September 1985.

embrace either the nature of market processes or the political context in which nationalised industries necessarily operated. Being sceptical of pricing and investment 'rules' as laid down in the 1967 and 1978 White Papers, the *Paper* recommended four other means of increasing the efficiency of resource allocation: improved incentives to meet market demands, explicit financial directives, explicit 'social' obligations and, most importantly, freedom of entry.

Explicit financial directives now form the basis of nationalised industry control, notably external financial limits (EFLs) in addition to target rates of return. The industries have been encouraged to operate as businesses serving a market rather than as government agencies providing a 'social' service. Witness the case of water authorities, which no longer have predominantly local authority directors nor hold their board meetings in public. Managements have been given a freer hand in cutting back on output and employment in loss-making industries. 'Social' obligations remain obscure, however, and experience has confirmed that the present Government is no different from its predecessors in its willingness to intervene in the nationalised industries when it is politically convenient to do so, regardless of stated policy.

Restrictions on entry have been reduced in domestic airlines and inter-city coaches; almost complete abolition of such controls is ultimately envisaged. The British Gas Corporation no longer has monopoly buying rights over domestic gas, and anyone may now generate electricity for resale as a main business. British Telecom's monopoly in supplying or maintaining customer equipment has been ended, and one competitor, Mercury, has been licensed to provide trunk telephone calls. Value-added network services, such as telephone answering services, radio paging and electronic mail boxes, are essentially open to competition. Two competing cellular radio companies have been licensed to provide car telephone services. The Post Office is subject to competition for personal delivery services and in electronic mail.

Notable exceptions to the relaxation of entry barriers have been posts (apart from the two specific services mentioned) and coal (where imports are still actively discouraged). Further relaxation of entry barriers would have been entirely possible, especially in telecommunications (for example, by allowing all private networks, not only Mercury, to interconnect with

BT networks and re-sell spare capacity) and in airlines (by more liberal issue of landing rights). Nonetheless, the record has been broadly consistent with the policy of stimulating competition. As with the professions, the results are gradually emerging in the form of higher efficiency, lower prices and better quality and range of goods and services.

Privatisation

Undoubtedly the most striking aspect of policy towards nationalised industry has been privatisation. This was a stroke of political entrepreneurship for which I, like other commentators, was quite unprepared. A dozen major companies and numerous smaller enterprises have now been sold to private shareholders, with British Telecom the star of the show. Another eight corporations, including the British Airports Authority, British Airways and British Gas, are scheduled for sale before the next general election. Completion of this programme would nearly halve the size of the nationalised sector.[1]

The major effect of privatisation is to increase the rôle of market forces (*vis à vis* political forces).[2] Most industries privatised to date already operate in competitive conditions, so the main effects have been increased efficiency and faster growth, rather than improved service to consumers. Increased flexibility of decision-making has also improved industrial relations.[3] Even where competition in the product market is limited, competition in the capital market will stimulate increased efficiency and responsiveness to consumer demands. Admittedly the latter competition is blunted where the size of the company, coupled with government shareholdings or 'golden shares', restricts or prevents the possibility of takeover.

There has been extensive criticism that not enough competition has been fostered in telecommunications, airlines, air-

[1] John Moore, speech at Hoare Govett, 17 July 1985 (reported in *The Times* and *Financial Times*, 18 July 1985).

[2] M. E. Beesley and S. C. Littlechild, 'Privatisation: Principles, Problems and Priorities', *Lloyds Bank Review*, July 1983.

[3] Sue Cameron, 'UK Privatisation: What the Managers Think', *Financial Times*, 20 July 1985.

ports and gas.[1] This could be remedied by removing the remaining statutory restrictions on entry and by re-structuring the nationalised industries into several smaller components before privatisation. The Government has been accused of sacrificing competition in order to maximise the proceeds from the flotation of the resulting private monopolies. The Financial Secretary to the Treasury has denied this charge, claiming that a policy to maximise proceeds from flotation would have a quite different character from the policy actually followed (though precisely what the differences would be were not explained).[2]

An alternative explanation for present policy, more consistent with the economic theory of politics, is that creating competitive conditions is politically difficult. Witness the resistance from management and unions in British Telecommunications, British Gas and British Airways, and the backbench pressure against de-regulation and re-structuring of the National Bus Company. Smooth and speedy privatisation requires the support of the industry concerned, especially the chairman. Privatisation can thus be extended to more industries in the time available if fewer steps are taken to challenge the company's position.

The scale of the privatisation programme depends on its political popularity. To ensure this, the potential gainers (consumers) are effectively having to compensate the potential losers. The privatisation of British Telecom was as near to a Pareto-improvement (with some gaining and none losing) as one is ever likely to find in practical politics.

On this interpretation, the relevant trade-off is not between competition and flotation proceeds, but between 'depth' and 'breadth' of competition. Admittedly, privatisation policy has tended to protect certain industries from the full force of competition. Nonetheless, if account is taken of the political context,

[1] J. A. Kay and Z. A. Silberston, 'The New Industrial Policy—Privatisation and Competition', *Midland Bank Review*, Spring 1984; M. Ashworth and P. K. Forsyth, *British Airways*, Report Series No. 12, Institute for Fiscal Studies, London, 1984; D. Starkie and D. Thompson, *Privatising London's Airports*, Report Series No. 16, Institute for Fiscal Studies, London, 1985; C. Robinson and E. Marshall, 'Why Ministers have lost sight of their ideals', *Financial Times*, 10 July 1985.

[2] John Moore, 'Privatisation Achievement', speech at Eccleston Supper Club, 18 July 1984.

present policy is more effective in promoting competition in the nationalised sector as a whole than its critics allow.

Externalities

Austrians recognise that externalities arise from loopholes in the system of private ownership. This imperfection could be better remedied by the creation and enforcement of private property rights than by government regulation or through taxes and subsidies. However, there has been little development of policy along these lines.

The Law of the Sea treaty envisages a supra-national body to franchise operations in and below international waters and to redistribute revenues, but does not propose privately-owned and transferable property rights. This omission is likely to prevent the efficient use of ocean resources.[1] Austrians would sympathise with British and US refusal to sign the treaty.

US authorities are beginning to tackle air pollution in a novel way, by creating and allocating 'pollution rights'.[2] These allow a company to emit up to, but not beyond, a specified quantity of pollutants. Any potential entrant wishing to engage in production, or any existing company wishing to expand production, must purchase the necessary pollution rights from an existing holder. The total amount of pollution in the area is thus held constant. The advantages of the system are:

(i) new entry and expansion can be allowed where it would otherwise have been denied;

(ii) the need to purchase pollution rights provides a financial incentive to adopt new low-pollution and pollution-free technologies; and

(iii) the ability to sell pollution rights provides a financial incentive to reduce or abandon existing high-pollution technologies.

A number of sales of pollution rights have already taken place. In 1981 Borden Chemical Co. bought 25 tons of hydrocarbon credits from B. F. Goodrich, at a price of $2,500 per ton

[1] D. R. Denman, *Markets under the Sea?*, Hobart Paperback 17, IEA, London, 1984.

[2] T. H. Tietenberg, 'Market Approaches to Environmental Protection', in H. Giersch (ed.), *Reassessing the Role of Government in the Mixed Economy*, J. C. B. Mohr, Tubingen, 1983, pp. 233-58.

per annum, instead of installing more expensive control technologies which would have cost $5,800 per ton per annum. The system is still in its infancy, and is by no means perfect, but it represents an imaginative and promising approach to the air pollution problem. Similar property rights have been envisaged for water pollution.[1] The UK might usefully explore this approach.

The Department of Trade and Industry recently commissioned a study into the possibility of pricing and creating property rights in the radio spectrum. At present, the government decides who is to get particular frequencies, and what they are to be used for. New entry and changes of use are frequently precluded by prior commitments of limited spectrum capacity. It would be possible, instead, for the rights to use frequencies to be initially allocated (perhaps, but not necessarily, by auction to the highest bidder) and subsequently transferred between users and uses as in the normal market system. Thus, bidding between private users, mobile radio companies, British Telecom, TV companies (and perhaps the Ministry of Defence) would tend continually to re-allocate limited spectrum resources to the highest-value uses, as these gradually change over time.

Conclusions

During the 1960s and 1970s UK governments of both major political parties were vulnerable to the 'Austrian critique' for failing to appreciate the nature of the market process, and in particular the crucial rôle of information and incentives. The policies adopted were more likely to exacerbate than to alleviate the alleged 'market failures'.

The Conservative Government which came to office in 1979 has accepted, at least in principle, the concept of a market economy rather than a mixed economy of the 1960s and 1970s variety. But have its actions been consistent with this aim?

In many respects, they have. Price control has been abolished. National planning has largely been abandoned, though

[1] J. H. Dales, *Pollution, Property and Prices*, University of Toronto Press, Toronto, 1968.

vestiges of industrial and regional policy still remain. The pressure to intensify merger control (in order to foster company efficiency rather than competition) has been resisted. Restrictive agreements in some services are beginning to be abandoned. Statutory restrictions on competition in some professions have been lifted, and advertising is now permitted in others. There have been significant reductions of barriers to entry in the nationalised sector, and a very substantial programme of privatisation is well under way.

On the debit side, merger control is likely to remain unpredictable and to limit some forms of competition. There has been no attempt to extend monopoly and restrictive practices legislation to labour agreements, and trade unions continue to enjoy many legal privileges. There is much scope left for reducing statutory barriers to entry in the nationalised sector. More could have been done to promote competition in the course of privatisation. There is little understanding of property rights as a means of solving externality problems. Recall, too, that we have not considered major social services, notably education, health and pensions, where virtually nothing has been done to promote market forces.

Clearly, there is much left to do to meet the 'Austrian critique' in its entirety. But while there are many policies characterised by little or no change, it is difficult to find examples of policy developing in a direction contrary to Austrian analysis. In several respects, indeed, the achievements of the present Government in enhancing the rôle of market processes have been more remarkable than could ever have been expected in 1978.

October 1985 S. C. LITTLECHILD

TOPICS FOR DISCUSSION

1. Which aspects of traditional economic theory do you think are consistent with the principles of subjectivism and 'methodological individualism', and which not?

2. What role do you think empirical testing should play in economics? In what ways has the quality of economic advice to firms and governments been improved by the invention of the computer?

3. Explain the recent history and current practices of one industry in the light of the theory of the competitive process.

4. Identify two or three industries which would be significantly affected by the abolition of patents, and trace the likely effects of such a policy.

5. To what extent is it possible for an 'intelligent radical' (J. E. Meade) to support the mixed economy? What role in industry would *you* advocate for government, and why?

6. What rôle would you advocate for the Monopolies and Mergers Commission? Ought the criteria for referring and assessing a merger to be formerly restricted to the impact on competition instead of the wider but more ambiguous 'public interest'?

7. How far do you think decisions about the use of nuclear energy should be transferred to the private sector?

8. Why does Hayek argue for a revised constitution in Britain? What modifications would you make to the present constitution?

9. How far has the sharpening of competition within the professions led to improvements in service or reductions in prices?

10. How true is it that the Government has sacrificed competition in order to maximise the proceeds from selling off nationalised industries? How, if at all, would you have privatised British Telecom and British Gas?

FURTHER READING

A good introduction to modern Austrian economics is a set of lectures given by Kirzner, Lachmann and Rothbard at a conference in South Royalton, Vermont, in 1974:

Dolan, E. G. (ed.), *The Foundations of Modern Austrian Economics,* Kansas City: Sheed & Ward Inc., 1976.

Hayek's recent lectures constitute an elegant and hard-hitting statement of Austrian views on current government policy toward inflation:

Hayek, F. A., *Full Employment at Any Price?,* Occasional Paper 45, London: Institute of Economic Affairs, July 1975.

The 'classics' of Austrian economics most pertinent to the topic of this *Hobart Paper* are:

Menger, C., *Principles of Economics,* 1871, translated by J. Dingwall and B. Hoselitz, Glencoe: Illinois Free Press, 1950.

Menger, C., *Problems of Economics and Sociology,* 1883, trans. by F. J. Nock, ed. L. Schneider, University of Illinois Press, 1960.

Mises, L. von, *Human Action,* Chicago: Henry Regnery Co., 1st Edn. 1949, 3rd Rev. Edn. 1963.

Hayek, F. A., *The Counter-Revolution of Science,* New York: The Free Press of Glencoe, 1952.

Hayek, F. A., *Individualism and Economic Order,* Chicago: University of Chicago Press, 1948.

Two of the most important articles reprinted in this last volume are

'Economics and Knowledge' (*Economica,* Vol. IV, 1937, pp. 33-54) and

'The Use of Knowledge in Society' (*American Economic Review,* Vol. XXXV, No. 4, September 1945, pp. 519-30).

Their full significance for economic theory and policy, respectively, has not yet been widely appreciated.

A minor Austrian classic is a short paper which argues that the market will prevail over the state:

Böhm-Bawerk, Eugen von, 'Control or Economic Law?' ('Macht öder ökonomisches Gesetz?'), originally published in *Zeitschrift für Volkswirtschaft, Sozialpolitik und Verwaltung,* Vol. XXIII, 1914, published in English by Consumers-Producers Economic Service, South Holland, Ill., 1951.

Lachmann's perceptive and very readable contributions are unfortunately widely scattered, but have recently been collected into one volume:

Lachmann, L. M., *Capital, Expectations and the Market Process,* Kansas City: Sheed, Andrews & McMeel, 1977.

A comprehensive treatise on economic principles, heavily influenced by Mises's *Human Action,* and aimed at the beginner, is:

Rothbard, M. N., *Man, Economy and State,* New York: Van Nostrand, 1962 (paperback version: Nash Publishing Corporation, Los Angeles, 1970).

An excellent (but out-of-print) intermediate textbook which integrates the Austrian theory of market process with the neoclassical 'mainstream' approach is:

Kirzner, I. M., *Market Theory and the Price System,* New York: Van Nostrand, 1963.

In my opinion one of the most important contributions to micro-economics of the last quarter-century is:

Kirzner, I. M., *Competition and Entrepreneurship,* Chicago: University of Chicago Press, 1973.

* * *

More recent publications are referred to in my 'Postscript, 1985', above, pp. 83-106.

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