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DO MARKETS WORK?

A CRITIQUE OF THE POSITIVE AND NORMATIVE
CONTENTS OF THE AUSTRIAN THEORY

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A CRITIQUE OF THE POSITIVE AND NORMATIVE CONTENTS OF THE AUSTRIAN THEORY

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ABSTRACT. The Austrian position according to which « markets do work » involves both positive and normative aspects: does it mean that markets produce some desirable outcome according to some normative principle, or simply that they constitute a stable context which, differently from other institutional arrangements, have not yet collapsed and, on the contrary, are in rapid expansion? The objective of the article is to separate the positive and normative issues and to appraise the Austrian contribution to both of them. The analysis is based on a critical discussion of the Hayekian and Kirznerian theories of convergence of the market process. After having shown a number of problems of internal consistency in the Austrian theory of convergence of the market process, we propose a formal scheme of the process of convergence which is used to analyse both the positive and normative issues. The analysis leads (1) to question the interpretative power of the theories of Hayek and Kirzner and (2) to cast doubts on the possibility to coherently derive a positive appraisal of the market system on the basis of the Austrian framework.

Markets do work. They work so obviously well that our scientific curiosity is aroused to seek understanding of the counter-intuitive phenomenon of this success.
Kirzner (1992)

Austrian economists affirm that *markets do work*. Does it mean that they work *well*, i.e. that they produce some desirable outcome according to some normative principle, or simply that they constitute a stable context which, differently from other institutional arrangements, have not yet collapsed and, on the contrary, is in rapid expansion?

Although the question is simple, it is not clear to what extent the Austrian theory can in fact provide a clear and straightforward answer.

In this paper we discuss the contributions of one of the historical leaders of the Austrian school, Hayek, and of his major follower, Kirzner. In the theories of these two authors, the analytical reference on which the statement that markets do work is based is the discussion of the problem of convergence of the market process. The basic thesis is that the market process is convergent, i.e. that the inconsistencies among individual plans tend to be eliminated in the course of market interactions. The problem however is that in the theory of convergence of the market process positive and normative aspects tend to overlap with each other: the specification of the conditions that guarantee the convergence of market process, on the one hand, solves the problem of making the mechanisms of the market system intelligible and, on the other hand, constitutes an argument in favour of the desirability of free market. In this way, in the Austrian framework, the theory of convergence is used, in fact, for a twofold objective, a positive one and a normative one.

These two objectives are not in our view compatible. As a matter of fact, the Hayekian and Kirznerian theories do not provide any rigorous analytical proof of the convergence of the market process, but seem rather to take convergence as a matter of empirical observation. If this is effectively the case, it is clear that the convergence of the market process, being an empirical fact, should not give rise to any normative implication. If otherwise it is the issue of desirability of (some form of organisation of) the market system to be at stake, the question of convergence should need a rigorous demonstration and the empirical argumentation should not be considered legitimate. In other words, if convergence is *assumed* then the content of the Austrian theory should be restricted to purely positive questions; if, on the contrary, normative prescriptions want to be deduced, then convergence should be *proved*.

But, in our opinion, the very problem is not much that the two objectives are incompatible within the Austrian framework, but rather that Hayek and Kirzner fail, in fact, to realise both of them.

Positive and normative contents of the Austrian theory of market process

The problem of convergence of market process concerns the effects of market interactions on the compatibility of individual plans: market process is said to be convergent if it generates processes of revision of individual plans that lead to eliminate all the (eventual) incompatibilities among them.¹ At the limit, if the process of convergence is completed, a situation of full compatibility is reached and, unless unexpected changes, the system reaches its final state of equilibrium. According to the Austrian theory, however, the possibility to reach the equilibrium position is only theoretical: in general, before the process of convergence is completed, the data that define the equilibrium position change, moving the gravitation point itself which is supposed to attract the system.

The idea underlying the convergence of market process is (1) that interacting in the market individuals modify their plans according to the signals provided by market interactions and (2) that such signals are sufficient to lead individuals to formulate more and more compatible plans.

The analysis of Hayek and Kirzner of the process of convergence focuses on the effects of market interactions on individual knowledge. Their idea is that market interactions spread knowledge among individuals leading them to modify their plans in such a way to eliminate progressively all incompatibilities.

According to Hayek, knowledge is time and place specific and the potentiality of market process lies in the possibility to exploit such a specificity instead of eliminating it.² The convergence of market process does not imply at all that individuals end up with a common knowledge; on the contrary, it is their different knowledge that allows them to formulate plans that, in the course of market process, become more and more compatible.

The process of convergence is specified in more details in Kirzner's theory of entrepreneurship.³ According to such a theory, it is the *alertness* of individuals (entrepreneurs in particular) that assures the convergence of market process: alert entrepreneurs perceive the existing profit opportunities and by exploiting them, they progressively eliminate all the manifestations of disequilibrium.

The Austrian school rejects firmly the possibility to use value judgements in economic theory.⁴ The attempt to avoid value judgements is carried out through the enhancement of the notion of *coordination* to an absolute normative principle.⁵ A situation of coordination is a situation in which individuals accomplish their plans. The reason why the coordination of plans constitutes a value-free

normative criterion is that it does not require any interpersonal comparison, but rather respects individual objectives, whatever they be.⁶

We can thus see how in the Austrian conception of market process as a process in which individual plans converge to their full compatibility *positive* aspects (intended to make the mechanisms of market system intelligible) and *normative* ones (of evaluation of the desirability-efficiency of market system in its different forms) go hand in hand: the positive analysis of the mechanisms which guarantee the convergence of individual plans to their full compatibility is immediately translated into normative prescription as soon as one notices that the convergence of plans implies the accomplishment of individual preferences, i.e. the social desirability according to the Austrian normative criterion of coordination.

Before going on to examine the drawbacks of the Austrian theory of convergence of market process, let us discuss the assumption itself of the principle of coordination as a normative criterion. We notice in this a basic contradiction (1) with the Austrian method of analysis of market process and (2) with the Austrian *free market* normative prescriptions.

First, the Austrian analysis of market process is coherent only to the extent that equilibrium (or full coordination) is not reached, otherwise there would be no market *process*: if plans become compatible during the market process, the process itself ends and the Austrian theory is irrelevant. In the Austrian framework, thus, market process is, by definition, a process in which individuals do *not* accomplish their plans.

Second, if the analytical framework is developed to analyze the *process*, normative evaluation too should be referred to the *process*, not to the *final state*.

But then, the contradiction that we see is that notwithstanding the assumption that individuals act in a situation of lack of coordination, the Austrians consider the market process efficient (and desirable). If the sole normative criterion is *coordination*, how can one argue for the desirability of a system that, by assumption, is *uncoordinated*?

The hypothesis that full coordination never happens prevents in fact Austrian economists from coherently arguing the desirability of capitalism. All that the Austrian theory allows to deduce is, on the contrary, a negative evaluation of the capitalist system: conceded that the working of capitalism be correctly represented by the Austrian theory, capitalism is not a *first best*.

Nevertheless it would remain open the possibility that among all institutional systems, the capitalist one be the less worse. In other terms, capitalism might be a *second best*. But, how is it possible to set such an institutional comparison within the Austrian framework? As said, the principle of coordination is useless, since it is inconsistent with the foundations of the Austrian theory (in the Austrian framework, individuals, at least partly, do not accomplish their plans). The only way out should be to measure the *degree of uncoordination*. The Austrian economists however do not develop any analysis of such a kind.

What the Austrians should prove is that market process (in particular market processes governed by laissez faire policies) produce *less uncoordination* than other processes of social interaction. But such a project is inconsistent with the Austrian framework, since its solution requires value judgements and interpersonal comparisons. Once recognized that market process is based on the incompatibility of plans, the normative issue raises questions such as: *who are the individuals that fail to accomplish their plans? And to what extent do they fail?*

The incapability of the Austrian theory to provide answers to such questions points out the limits of a disequilibrium framework in which normative prescriptions pretends to be derived on a value-free basis. In order to understand why some individuals fail and some other succeed (and the

extent of their failures and successes) it is necessary to investigate the mechanisms through which plans incompatibilities are solved ex post through market process, leaving some individuals completely satisfied, some other less, and still others completely unsatisfied. In a system in which competition is a disequilibrium process the analysis of the outcomes of social interaction should pass through the discussion of the forms and degrees of the uncoordination that the competitive process produces.

Some analytical drawbacks of the Austrian theory of convergence

Our thesis is that Hayek and Kirzner are not able to prove the convergence. Three kinds of criticism are advanced.

A first critique stems from a problem originally raised by Richardson (1959) with regard to the theories of perfect competition and, in particular, to the theory of general equilibrium (GE). The fact that a critique of GE applies also to Kirzner's theory must not surprise for Kirzner himself considers his theory compatible and complementary to the theory of GE.

The second critique concerns still the complementary character of the Austrian theory with respect to the theory of GE. In particular, according to us, Kirzner's attempt to integrate the GE model with a theory of convergence towards equilibrium does not take into account the neoclassical results concerning the stability of GE.⁷

Finally, a third critique stems from the underestimation of the problem of expectations which, in the Austrian framework, is developed, in particular, by Lachmann.

Ex ante coordination

According to Richardson market process does not provide individuals with sufficient elements to let them develop decision-making processes compatible with the convergence to equilibrium (nor with its maintenance in case it be, in some way, reached). The problem is particularly relevant for entrepreneurs: Richardson shows that in the GE model there is no condition that guarantee that entrepreneurs have the necessary information to undertake investments activities:

A profit opportunity which is known by and available to everybody is available to nobody in particular. A situation of general profit potential can be trapped by one entrepreneur only if similar action is not intended by too many others; otherwise excess supply and general losses would result.⁸

The existence of a profit opportunity which is clearly perceived by all the (alert) entrepreneurs is exactly what prevents such opportunity from being exploited. It is thus precisely the condition of alertness that, in a situation of perfect information, impedes the coordination of entrepreneurial plans. In order to let competition work in the market it is thus necessary, according to Richardson, the existence of *ex ante* coordination devices able to guarantee investment activities.⁹

The mechanisms of ex ante coordination if interpreted from the viewpoint of the pure competitive model appear as imperfections (collusions, forms of monopoly, etc.); without them, however, the competitive mechanism of market process cannot work. The implications on the desirability of a pure market system are straightforward: if the price is the result of the interaction between the principles of coordination and competition, observes Richardson (1990, p. 37), it loses

its property as an efficient signalling device. Richardson's critique, thus, although not explicitly addressed to the Austrian theory, brings down the Austrian thesis of the desirability of the market system, which is based precisely on the signalling role of the price system.

GE stability

A second critique to the theory of convergence of market process concerns a technical argument related to the question of stability of GE. According to Kirzner, the theory of the entrepreneur-arbitrageur is sufficient to guarantee the convergence to GE:

Consider the simple theorem that predicts a market tendency towards achieving a single price for a given good in a given market. (...) This tendency obviously rests upon the economist's confidence in the speed and success with which entrepreneurs will pounce upon the pure profit opportunity created by any price discrepancies (...). A little reflection must surely convince us that economist's confidence in this powerful tendency supports not only their understanding of this tendency itself, but also (...) their confidence in equilibrating tendencies in general, both in the context of the Marshallian single market and in that of the Walrasian system of inter-linked markets.¹⁰

The passage from the Marshallian scheme to the Walrasian one is not obvious. The problem of stability of the equilibrium exists in both cases, but it is in the latter that the Neoclassical theory has reached the less encouraging results. In the passage from a verbal exposition to a formal analysis of market process, the efficiency of the price system cannot be maintained. The stability problem in the GE model depends precisely on the informational content of disequilibrium prices. In the case of interdependent markets, besides the problem of elasticities of demand and supply, stability problems arise because the interdependence of markets can produce perverse reactions of the price system. The only way out is to eliminate perverse cases by mean of ad hoc hypotheses, but this does not solve the problem of plans compatibility, it cancels it.¹¹

Starting from such a negative result, we ask ourselves in what way the Kirznerian theory of entrepreneurial activities can remedy. We must consider two possibilities.

(1) interacting in the market individuals develop a systemic awareness of the system, understand their unanimous convenience to realize the GE (Pareto efficient by assumption) and learn how to move the system to such a situation. To put it differently each individual learn to solve the GE model. In this conditions however the price system loses its (supposed) property of being a synthetic system of efficient signals.

(2) market interactions do not lead individuals to any systemic awareness: in this case it is exactly the entrepreneurial attempt to exploit the existing profit opportunity (signaled by disequilibrium prices) that can have disequilibrating effects. The stability problem remains thus open.

In both cases Kirznerian theory does not solve the problem of GE stability; on the contrary, it is valid only if the problem of the stability is eliminated by assumption.

The (implicit) assumption of stability of GE is essential also to Hayek's argumentation. In "*The Use of Knowledge in Society*" Hayek develops the famous example of the tin:

Assume that somewhere in the world a new opportunity for the use of some raw material, say, tin, has arisen, or that one of the sources of supply of tin has been eliminated. [...] All that users of tin need to know is that some of the tin they used to consume is now more profitably employed elsewhere and that, in consequence, they must economize tin. There is no need for the great majority of them even to know where the more urgent need has arisen, or in favor of what other needs they ought to husband the supply. [...] The whole acts as one market, not because any of its members survey the whole field, but because their limited individual fields of vision sufficiently

overlap so that through many intermediaries the relevant information is communicated to all. Hayek (1945 [1949, pp. 85-6]).

What matters, according to Hayek is “the knowledge of the particular circumstances of time and place”¹² of each agent: it is thanks to it that the system automatically adjusts towards the new equilibrium. What makes possible to carry out such a “marvel”¹³ is the price system, which communicates the relevant information to all agents and makes them “move in the right direction”¹⁴.

Hayek’s example corresponds to the second case we have analyzed (nobody has a systemic awareness and everybody uses only his own knowledge). This implies that Hayek implicitly assumes that disequilibrium prices convey the right signals in the process of coordination of individual plans. But this is true only if (1) the economic system originated by the new discovery has an equilibrium solution and (2) if such a solution is stable.¹⁵ Remove one of these assumptions and the direction in which agents move is the *wrong* one.

Our conclusion is that Hayek’s and Kirzner’s discussion of the problem of markets interdependence is superficial and this leads them to attribute to the price system properties that could not be claimed by the light of more rigorous analytical developments.¹⁶

The problem of expectations

Lachmann is perhaps the main figure within the Austrian school to raise doubts about the necessary convergence of the market process. The author accepts Hayek’s idea that theoretical progress in economics is in relation with the extension of subjectivism. However, according to him, the Austrian school has deepened the subjective analysis of preferences (and knowledge) but has not developed the problem of subjective expectations. It is Shackle who has developed such an issue. Lachmann’s project is thus to integrate the Austrian tradition with the Shackle’s subjective analysis of expectations.¹⁷

The development of subjectivism is linked to the time dimension: in Lachmann’s model, knowledge, expectations and preferences change continually; the dynamics of their change however cannot be predicted precisely because of the radical subjectivist approach:

As soon as we permit time to elapse, we must permit knowledge to change, and knowledge cannot be regarded as a function of anything else. (...) Expectations must be regarded as autonomous, as autonomous as human preferences are. To be sure, they are modified by experience, but we are unable to postulate any particular mode of change.¹⁸

The implications of the extension of subjectivism to expectations for the problem of convergence of the market process are straightforward: even accepting the analysis of the informational problem developed by Hayek and Kirzner, the introduction of a model of subjective expectations is sufficient to question the overall convergence of market process since it is not possible to assume that market disseminates expectations in the same way that it does with information.¹⁹

This allows to clarify the implicit assumptions of Hayek’s and Kirzner’s theories: according to Hayek and Kirzner, market process assembles dispersed knowledge and, at the same time, disseminates among agents the market knowledge relevant for the formulation of their plans, eliminating progressively plan incompatibilities. But Hayek’s and Kirzner’s theories are thus more theories of *convergence of knowledge* than not general theories of convergence of market process, since the problem of expectations is not integrated in the analysis of the market process.²⁰

We conclude that in the Austrian framework there are not sufficient elements to guarantee the convergence of market process. This has implications on both positive and normative viewpoints.

On the positive side, it is legitimate to ask what contribution does in fact the Austrian theory provide to the purpose of making the working of the market system intelligible: as a matter of fact, if it is true that the possibility of divergence cannot be theoretically excluded, it is also true that the market system does not seem to be close to its final collapse. If the pure principle of competition is not sufficient to theoretically explain the convergence of the market process, then some other theoretical principle should be considered in order to explain the (relative) stability of the market system.

On the normative side, if convergence cannot be analytically proved and has to be considered only as an assumption the typical *laissez faire* positions of Austrian economists comes to be deprived of any analytical foundation: if the market process is *assumed* to produce coordination, then the market system cannot be *proved* to be desirable (according to the coordination principle), since hypotheses cannot be proved.

The process of formulation of individual plans

Three teachings stemming from our criticism of the Austrian theory should be taken in mind: (1) the process of formulation of individual plan plays a central role in the convergence of market process and should thus be deepened; (2) a theory of market process based uniquely on the principle of ex post competition is internally inconsistent if not completed by the analysis of the principle of ex ante coordination; (3) the discussion of the problem of convergence in a disequilibrium framework should take explicitly into account the heterogeneous abilities and potentialities of the participants of market interactions to realise their own plans when incompatibilities exist. Let us start by developing the first point, which will give us the opportunity to discuss the other two points too.

In order to clarify the assumptions necessary for the convergence of market process let us consider the process of formulation of individual plans, formalised in figure 1.

Individual *knowledge* is determined by the information available to each individual and the way it is processed (i.e. by the interpretative models); knowledge indeed does not emerge automatically from the information set, but derives from the subjective elaboration of interpretative models through which data are conceptualised, ordered and elaborated. This definition implies that the same objective information may generate different individual knowledge according to the circumstances and the subjective interpretative models of individuals.²¹ *Expectations*, besides information and interpretative models, depend on imagination, since in order to *expect* something one should at least be able to *imagine* it. Individual *objectives*, besides the three elements considered, depends on individual preferences. On the basis of their knowledge, expectations and objectives, individuals formulate their plans and, on the basis of such plans, they interact in the market. Market interaction, in turn, induces revisions of plans by modifying (some of) the elements from which individuals derive their knowledge, expectations and objectives.

-Insert Figure 1 (see at the end of the manuscript).

The scheme proposed can be used to decompose the problem of convergence of market process into three interdependent sub-problems concerning respectively the convergence of knowledge, expectations and objectives.

What all the theories of Austrian economists have in common is the assumption that the process of formulation (and revision) of individual plans is regulated only by the principle of competition. What instead differentiates them are the elements of the process of formulation of plans which they focus on.

Expectations

The difference between Hayek e Kirzner on the one hand and Lachmann on the other is manifested at the level *B*: Lachmann discusses explicitly the problem of expectations which Hayek and Kirzner (implicitly) consider as solved. The problem, however, is at the level *A*: Lachmann's analysis shows indeed that the impossibility to assert, under general conditions, the convergence of expectations derives from the role of imagination as an autonomous element of subjective change.²²

Knowledge

The investigation of the level *A* allows us also to better specify the assumptions that are necessary to affirm the convergence of knowledge.

In particular the Kirznerian theory of convergence of knowledge seems, ultimately, to be a theory of convergence of information: the convergence of interpretative models is, in fact, assumed, not derived by the analysis of the properties of the market process.

Hayek's position is more articulated: on the one hand he writes that the explanation of conscious action is a task for psychology but not for economics or any other social science, what seems to deny the relevance of the problem of convergence of interpretative models in the discussion of the convergence of market process;²³ on the other hand however he gives important contributions to the analysis of interpretative models exactly developing his work towards lines closer to psychology than to economics.²⁴ The problem, as noted by Hodgson (1988, pp. 60-61), is that Hayek refuses to provide a link between the two lines of investigation and this makes Hayek's analysis of the market process basically extraneous to the question of interpretative models. As a consequence, the whole analysis of Hayek of convergence of knowledge is problematic.

The consequences of the lack of an economic theory of the relations between the evolution of interpretative models and the convergence of information are clearly visible in Lachmann: although he accepts the Hayekian analysis of the informational problem he maintains, as we have seen, that both knowledge and expectations (besides preferences, of course) must be considered exogenous. Such a position, in our view, stems exactly from his extension of radical subjectivism not only to imagination, but also to interpretative models.²⁵

Objectives

A third problem (besides those concerning knowledge and expectations) that takes place at the level *B* concerns the definition of individual objectives. In the Austrian theory such a problem is supposed to be solved by the assumption of given preferences: it is not denied that individuals' objectives may be influenced by factors such as institutions and culture; however, the basic attempt consists of explaining even institutions and culture as products of purposeful individuals. Such an attempt is at the centre of controversies, since it has been noted that if it is recognised the existence of a mutual causation between individuals and the institutional context, neither individual, nor social factors should be given an absolute explanatory primacy.²⁶ Independently from such controversies, the explicit specification of the process of definition of objectives clarifies the implicit assumptions of the Austrian theory: in order to establish a stable relation between preferences and objectives, Austrian theorists implicitly assume that information, interpretative models and imagination are stable and non-problematic elements of the process of definition of individual objectives.

As we can see the Hayekian and Kirznerian theories of convergence focus mainly on the convergence of information: (1) imagination and preferences are considered exogenous and their dynamics are *supposed* to be compatible with the whole convergence of market process; (2) the endogenisation of interpretative models, when developed, is not put in direct relation with the problem of convergence of market process.

At a closer analysis, however, even the Austrian discussion of the problem of information is ambiguous. Let us define the information set as the union-set of (1) the set of the possible actions (*decision-making set*), (2) the set of the states of nature²⁷ and (3) the set of the consequences deriving by the combination of one decision and one state of nature. What, in our view, makes the Austrian theory problematic is the discussion of the individual decision-making sets. Such sets define the objective constraints that each individual faces in his decision-making processes. Constraints can be classified into two groups: (1) constraints deriving by imperfect and/or asymmetric information on the decision-making sets; (2) material constraints. The constraints of the first group restrict individual's possible actions to the sub-set that he effectively knows, those of the second group, on the contrary, operate also in case of symmetrical information and restrict the individual's possible actions according to the institutional rights.²⁸ The point, in the analysis of the contributions of Hayek and Kirzner, is that there is no discussion of the relations between the rules of the market process and the evolution of the material constraints of different (classes of) individuals. This means that Hayek's and Kirzner's theories can at best contribute to explain the process of discovery of information, *given* the material constraints, but cannot explain the evolution of individuals' material constraints in the course of market process. On the normative ground, although it may appear paradoxical, the Austrian thesis of the desirability of market interactions is founded, in fact, precisely on the assumption that material constraints are given.

Another aspect of the Austrian theory of market process which deserves attention is the definition of the principle of competition as universal and unique. Such a principle, in the Austrian framework, works *ex post* in the sense that it is the real manifestation of plans incompatibilities that generates processes of revisions of individual plans that are supposed to eliminate progressively the existing incompatibilities.

However, as Richardson's critique has pointed out, the principle of *ex post* competition is not sufficient to explain the working of the market system if not completed by the principle of *ex ante* coordination. If Richardson's suggestion is developed in the context of the process of formulation of

individual plans, the analysis of the conditions of convergence of the market process should take into account the existing mechanisms through which in the market system plans incompatibilities can be eliminated (or simply reduced) in the course of the process of formulation of individual plans without incompatibilities being necessarily manifested in the market. The problem of the intelligibility of market process should thus be redefined by analysing the interaction of the two principles of ex ante coordination and ex post competition.²⁹ In this context, the existence in real capitalist systems of a number of institutions that have precisely tasks of ex ante coordination may concur to explain the relative stability of the market system.

The separation of the positive and normative problems

We have now all the elements to determine the theoretical origin of the identification of the positive and normative issues in the Austrian framework: the devices through which Austrian economists maintain a strict relation between the positive and the normative contents of the theory of convergence are (1) the assumption, in the analysis of the market process, of exogenous preferences and interpretative models and (2) the narrow definition of the problem of information in such a way to avoid the discussion of the evolution of the material constraints of individuals.

If indeed preferences and/or interpretative models were considered (at least partly) the product of market interactions, the normative content of the Austrian thesis of convergence would become problematic: if interpretative models are a product of the market process, the sovereign appraisals of the effects of market process (individuals) would become themselves a product of the market process, which would cast doubts on their effective sovereignty.

Likewise if it is not possible to appraise the role of the evolution of the material constraints in the process of formulation of individual plans, the assertion that the market process is convergent should hardly be considered a value-free normative prescription. Notwithstanding its triviality, the point here is that individual plans are formulated under material constraints and the definition itself of individual objectives depends on such constraints: at the limit, to say that in equilibrium plans are fully compatible may simply mean that the material constraints faced by individuals become so binding in the course of market process that individuals do not even try to pursue some objectives.³⁰ But thus, the compatibility of plans is simply a wrong question with respect to both positive and normative problems: (1) from the positive viewpoint there is no reason to exclude that the market system can function and reproduce itself notwithstanding plans incompatibilities; (2) from the normative viewpoint there is no theoretical foundation for the relation *plans compatibility* ↔ *social desirability* if the question of constraints is not discussed.

If the problem is a positive one, the market process has to be analysed by discussing the ability of capitalistic institutions to reproduce themselves and evolve through market interactions, changing their quantitative and qualitative relations but maintaining unchanged the foundations of capitalist social interactions (private property of the means of production and commodification of labour power).³¹

If, on the contrary, the problem is a normative one, the analysis of the mechanisms of the market system that allow it to reproduce and expand itself should be completed by an appraisal analysis in which the subject appraiser and the system of value judgements used should be made explicit.

Positive analysis

As regards positive analysis, if the objective is to grasp the dynamics of the market system we see no reason to *a priori* neglect the possibility of feed backs of market interactions (or, more generally, of social interactions) on all the four basic elements of the process of formulation of individual plans, information being only one of them.³²

In the Austrian framework, notwithstanding the formal assertion in favour of a dynamic approach, the *a priori* neglect of feed backs of the social context on individuals does not allow to go very far in the dynamic analysis of the problem of convergence. The logic underlying the Austrian definition of the problem of convergence is that keeping some initial conditions (individual preferences, imagination and perhaps interpretative models) unchanged, it is possible to analyse the eventual convergence of market process to a final state of affair (in which, according to the Austrian theory, plans are compatible). The focus is thus on the point of arrival of the process.³³ To put it differently, the Austrian theory attempts to explain how the system moves towards a determined point but renounce to explain the dynamics of such a point.³⁴

In this way, the positive problem ends up being narrowly defined since the question itself of the dynamics of the market system are put out of the enquiry of the economist. The reader that expects the Austrian theory to answer his questions about the ability of the market system to evolve, modifying its own institutions but preserving the general features of capitalist social relations cannot but remain unsatisfied: the definition itself of the positive problem as a problem of *convergence* prevents from seeking the causes of the dynamism of capitalist systems and leads to arbitrarily separate the problems (1) of the general stability of capitalism as a system and (2) of the evolution of its specific institutional arrangements in the course of its history.

But even in this narrow definition of the positive problem the Austrian school further restricts its enquiry taken for granted that the stability of the market system implies the convergence of individual plans. Such a position, in fact, is never sufficiently discussed by Austrian economists. It seems that they simply assume that in case individuals were incapable to realise their plans the system would collapse, without even contemplating that in order to change the system people's dissatisfaction is a necessary but not sufficient condition.

In Kirzner's words, the problem of the working of the market is stated in the following terms:

Markets do work. They work so obviously well that our scientific curiosity is aroused to seek understanding of the counter-intuitive phenomenon of this success.³⁵

If such propositions are interpreted in pure positive terms,³⁶ it seems to us that it is exactly the empirical observation that *markets do work* that leads to pose the intelligibility problem looking for the forces of convergence. If however we try to specify in more details the empirical observation that arises Kirzner's and our curiosity we find out a more complex reality. The problem is not to understand why markets *do* or *do not* work, but rather to explain the mechanisms through which capitalism reproduces itself, changes its quantitative and qualitative features and overcomes its crisis, maintaining intact the foundations of its social relations. If the empirical observation is stated in this more articulated terms, the intelligibility problem leads to look for both the convergent and divergent forces capable to explain the dynamism of capitalist systems notwithstanding their ability to maintain intact the foundations of capitalist interactions.

In this sense, the problem of convergence is, basically, a false one: the observation that markets do work has no implication for the problem of realising individual preferences and needs, nor it means that plans incompatibilities tend, in the course of market interactions, to be eliminated; it

implies instead that plans incompatibilities are such to take the system in continuous motion even though, until now, have not been such to make the system collapse. This means that both convergent and divergent forces should be understood in order to deal appropriately with the empirical observation that markets do work.

If this definition of the positive problem is accepted, the dynamics and the relative stability of the market system should be explained by analysing the cumulative processes that take place between individual action and social interaction: in such processes all the elements that determine the formulation of individual plans may be, in principle, analysed as dependent on the form of the social interaction. In this context, the scheme of formulation of individual plans may constitute a theoretical framework in which to analyse the dynamics of the market process. The logic underlying such a framework is constituted of the following four elements:

- (1) social interaction influences the process of formulation of individual plans through its effect on (a) individuals' information sets (on both material and informational constraints) and, at least in principle, (b) individuals' interpretative models and (c) individuals' values;
- (2) once plans have been formulated, the social interaction that flows from it modifies the institutional context in which individual plans are formulated;
- (3) the cumulative processes determined in the sequence *individual plans* → *social interaction* → *individual plans* produce both convergent and divergent forces.
- (4) the combination of convergent and divergent forces is the ultimate cause of the relative stability of the market system and of its inner dynamics.

The endogenisation of values and interpretative models constitutes, in our view, a fundamental element that the Austrian school has failed to grasp (for obvious methodological reasons) in its attempt to stress the forces of convergence of market process: not only market process can diffuse information in such a way to let individual preferences be realised, but also preferences may change in such a way to preserve the compatibility of individual plans.

The analysis of the process of formulation of individual plans suggests that a number of factors not contemplated by the Austrian theory may contribute to the convergence of the market process: (1) material and informational constraints may restrict the decision-making options of various individuals in such a way to prevent them from realising destabilising plans; (2) social interactions may influence individual values and the perception itself of the economic system by individuals in such a way to preserve the general compatibility of plans.³⁷ In this sense the convergence of market process (to the extent that forces of convergence are effectively dominant) may simply be a consequence of the fact that individuals learn not to put in their plans objectives that cannot be realised (given the existing constraints and their perception of them) and/or not to desire what they cannot have.

Normative implications

The limits of the very particular definition of the positive problems are reflected also on the normative ground. Once broken the link between the stability of the system and the compatibility of individual plans, there remains no basis on which to derive the desirability of the market system from the thesis that the market process is convergent, not even referring to the coordination principle, since the system might reproduce itself and evolve in the face of the impossibility for some individuals to realise their plans.

But even accepting the very narrow specification of the positive problem according to which the stability of the system is made coincide with the realisation of individual plans, Austrian economists may be accused of neglecting the analysis of the many channels by which social interactions act on the process of formulation of individual plans without any necessary social desirability. If indeed the compatibility of plans is obtained by means of processes of convergence of preferences and interpretative models induced by social interactions some caution in deriving normative prescriptions should be required and value judgements should be made explicit. As already noted, the fact that individual preferences and interpretative models may be influenced by the forms of social interactions casts doubts on the very significance of the coordination principle as a neutral normative criterion, since individuals should be considered (at least to some extent) the product of society. Although such a criticism can be easily rejected by Austrian economists (for its incompatibility with methodological individualism), in doing so the Austrians risk to miss important positive and normative aspects of the forces of convergence of individual plans.

What is sure is that in a disequilibrium framework (in which individuals are supposed not to realise their plans) the social desirability cannot be established on the basis of *all* individual preferences. Some ethic criterion must be introduced and the groups (classes or whatever) that are taken as the ultimate appraisers should be stated explicitly.

Conclusions

The Hayekian and Kirznerian theories of convergence of the market process present analytical problems. Three orders of critiques (concerning respectively the problem of ex ante coordination, the implicit assumption of GE's stability and the problem of expectations) have been considered. Furthermore, we have noticed that even conceding that their *proofs* of convergence were consistent, their normative conclusions would anyway violate the epistemological assumptions of the Austrian school (value-freedom). Finally, we have seen that the theory of convergence of the market process developed by Hayek and Kirzner is not general at all:

(1) the theory of convergence of market process does not take into account the problem of convergence of expectations and objectives; at best it can thus be a theory of convergence of knowledge;

(2) the theory of convergence of knowledge does not take into account the problem of convergence of interpretative models (and values); at best it can thus be a theory of convergence of information;

(3) the theory of convergence of information does not take into account the distinction between evolution of the material constraints and evolution of asymmetric information, a distinction that, as we have shown, is crucial for the analysis of convergence of market process; at best it can thus be a theory of evolution of asymmetric information.

In addition to these analytical problems, the Austrian theory is subject to ambiguous interpretations since the separation between its positive and normative contents is not straightforward.

If the problem is a positive one, i.e. if the theoretical purpose is to explain the general stability of capitalism as a system, there is no reason to investigate the sole forces of convergence, nor to exclude that certain individuals may systematically fail to accomplish their plans: if the role of such individuals in the social interaction is not such to create problems to the reproduction of the system, *markets can work* notwithstanding the impossibility of these people to realise their objectives. But

then, on the normative ground, even accepting the principle of coordination, to say that *markets do work* has nothing to do with the desirability of capitalism.

Notes

- ¹ In the Austrian terminology, expressions such as “convergence of knowledge”, “convergence of expectations”, etc. are used to mean that in the market process knowledge, expectation, etc. are modified in such a way to eliminate plans incompatibilities.
- ² Hayek (1945; 1946; 1978).
- ³ Kirzner (1973).
- ⁴ Rothbard (1956, p. 243) for instance affirms: “It should be clear that economics by itself cannot establish an ethical position”.
- ⁵ “Modern Austrians have converged on the notion of *coordination* as the key to normative discussion”. Kirzner (1987, p. 11), emphasis in original.
- ⁶ Kirzner (1976, pp. 84-6), Kirzner (1973, pp. 212-42).
- ⁷ As we will see such a critique applies to Hayek as well.
- ⁸ Richardson (1959, p. 233).
- ⁹ The problem raised by Richardson was presented to Kirzner by Boehm (1992) in an interview published on the *Review of Political Economy*. The reasons why Kirzner’s answer is unsatisfactory are discussed in Palermo (1999).
- ¹⁰ Kirzner (1992, p. 56).
- ¹¹ For a discussion of the problems of the stability of the GE model, cf. F. Fisher (1976).
- ¹² Hayek (1945 [1949, p. 80]).
- ¹³ Hayek (1945 [1949, p. 87]).
- ¹⁴ Hayek (1945 [1949, p. 87]).
- ¹⁵ Notice that it is exactly when such conditions are not satisfied that the problem of compatibility of individual plans assumes complex forms such to require an *overall vision* of the economic system. In this case, *the knowledge of the particular circumstances of time and space* not only does not solve the problem of compatibility of plans, but it worsen it.
- ¹⁶ The unjustified assumption of a tendency towards equilibrium is a problem which concerns also (although for slightly different reasons) the Austrian stream of Mises and Rothbard. Cf. Cowen and Fink (1985).
- ¹⁷ Lachmann (1976-a; 1978).
- ¹⁸ Lachmann (1976b, pp. 127-129).
- ¹⁹ According to Lachmann it is exactly the insufficient attention paid by Austrian economists to the subjective analysis of expectations that has lead them without any reason to neglect the possibility of divergence: « Professor Hayek dealt with expectations, (...) but not with the causes and consequences of their divergence. In fact, expectations were (...) regarded as being of analytical interest only to the extent to which they converge ». Lachmann (1976a, p. 59).
- ²⁰ In the next session we will question also the possibility to interpret such theories of convergence of market process at least as theories of convergence of knowledge.
- ²¹ According to the Austrian economists the problem of knowledge concerns also individual preferences: preferences are *given* but not (completely) *known* and it is market interaction that leads individuals to discover them. Individual preferences thus interact with information and interpretative models in the process of knowledge (1) by guiding the whole process and (2) by being themselves an object of knowledge discovery.
- ²² If our interpretation of the work of Lachmann is correct a further problematic element in the analysis of the convergence of expectations lies in the hypothesis that also interpretative models are considered exogenous.
- ²³ Hayek (1949b, p. 67).
- ²⁴ Hayek (1952).
- ²⁵ If Lachmann insists on the exogeneity of knowledge too is in fact, in our opinion, because he assumes the exogeneity of interpretative models.

- ²⁶ One of the central elements that has given rise to such a controversy is the theory of group selection through which Hayek (1967) discusses institutional and cultural evolution. Such a theory, in fact, breaks the strict methodological individualism of Hayek's theory of market process. Within the Austrian framework, attempts to build a theory of cultural evolution entirely compatible with the assumptions of methodological individualism are developed by Vanberg (1986) and Witt (1993, 1994) who explicitly take the distance from Hayek's theory of group selection. According to Hodgson (1991, 1993) however the problem is a deeper one, since the tension between methodological individualism and the theory of cultural evolution arises from the impossibility itself to develop an evolutionary theory on the basis of a strict methodological individualism.
- ²⁷ Composed of only one element in the case of deterministic theories.
- ²⁸ Think for instance at the system of property rights and its implications on the individuals' budget constraints.
- ²⁹ Our most organic attempt to analyse the interaction of the principles of coordination and competition is developed in Palermo (1997).
- ³⁰ If, on the other hand, the problem of plans compatibility is defined abstracting from the existing constraints the thesis of convergence is at best *naïve*: if both George Soros and I want to use his luxury cars, yachts and apartments as a result of our identical preferences, our plans will never become compatible; if they are compatible in reality is only because in the definition of my plans I take account of the institutional protection of Soros' properties.
- ³¹ As a non-secondary consequence, this leads to redefine the problem of preferences with respect to the Austrian approach. From the positive viewpoint, the *problem of preferences* is not to determine whether individuals realise in the course of market process higher and higher utility levels as it is assumed by the Austrian theory, but rather to determine how preferences (and needs) evolve as an *effect* of market process and influence, in turn, the working of market process itself.
- ³² If Austrian economists are probably right in renouncing to discuss the effects of market interactions on individuals' imagination, the choice to neglect the effects of market interactions on individuals' preferences and interpretative models may be acceptable only if it were the result of an analysis of the weakness of the existing links between social interaction and individual action but not as a result of *a priori* methodological positions (like the adherence to methodological individualism).
- ³³ The possibility that the process reach effectively its final point of arrival is explicitly contemplated by Kirzner, whereas Hayek suggests that unexpected changes in the data which define equilibrium will generally take place before the final state is reached. In any case, the assumption that data (in particular information and imagination) can change during the process does not modify the substantial problem (the final point of the process), since it is denied the possibility to investigate the economic causes of such changes.
- ³⁴ In order to shift the attention from the point of convergence to the process itself the relation between individual action and social interaction should be considered as a mutual one: if we assume (1) that individuals define their actions on the basis of the four elements of the process of formulation of individual plans and (2) that such elements are, in turn, (possibly) modified by the social interaction, the point of arrival of the process becomes analytically irrelevant since the data which define it are continuously modified in the course of the disequilibrium process and it is the process itself which acquires analytical relevance.
- ³⁵ Kirzner (1992, p. 60).
- ³⁶ If, on the contrary, the proposition expresses an appraisal of the market system according to the Austrian normative principle of coordination, it is simply false and contradictory, since many people considers the market system inadequate to satisfy their needs and preferences and those of many others and the fact itself that for someone markets *do* work and for some other they *do not* work, implies that markets *do not* work according to coordination principle.
- ³⁷ Symmetrically, under certain circumstances, the same factors may act as divergent forces.

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Figure 1. **PROCESS OF FORMULATION OF INDIVIDUAL PLANS**

