Do Free-Market Economists Practice What They Teach?

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This short piece on methodology concerns the extent to which the knowledge assumptions of the economics employed by free-market critics of public policy logically permits any meaningful critiquing of government intervention to take place at all.[1] I apply this question first to those who generally employ a perfect-information-based economics, which I argue, in this case, gives rise to a contradiction between theory and empirical application. The elimination of this contradiction, I maintain, is accomplished most fruitfully when the underlying economic theory allows for the possibility of genuine human error to occur. Admitting this possibility, however, itself appears to give rise to a paradox, which I attempt to resolve by using what that more apposite economic theory teaches us about the nature of the market process.

A Contradiction

In the nineteenth century, Bishop Whately labeled economics "the dismal science" for the propensity of economists to tell people what was not possible or what they could not do. Economists still do this, and indeed it is one of their most important jobs. You cannot, for example, inflate the currency to stimulate short-term output without sowing the seeds of long-term malinvestment and social disruption; you cannot impose a minimum wage without chronically pricing the least-skilled and most vulnerable workers out of the labor market; and you cannot erect trade barriers to protect domestic import-competing industries without at the same time undermining the foreign demand for domestic exports.[2] You cannot, in short, violate economic principles any more than you can run in two directions at once.

How useful this dismal task is would seem to depend on the degree to which people actually make mistakes. Obviously, if no one errs persistently there is no

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[1]It takes up a theme discussed in Kirzner (1979b).

[2]Excellent examples of politico-economic analyses of this kind can be found in Sennholz (1955) and (1979).

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opportunity for anyone to suggest a more correct or appropriate path. Only when a pattern of genuine errors occurs is it even possible to offer useful economic advice.

Now, in standard economic theory, for purposes of modeling decisions that take place in the market, the presumption is that human actors possess the optimal amount of information. When faced with a problem, such as whether to take a job or continue formal education, standard microeconomics presumes that an actor will spend resources in learning about the problem until the cost and benefit of an additional unit of information are equated. Becoming informed beyond that point would add more to his cost than his benefit and would therefore be against his self-interest. Because modeling an actor's choice when he is unaware of all the expected benefits and costs poses profound problems ("Do the marginal curves cross? If so, where?"), standard economic theory side-steps the problem by assuming that all choosers know at least the expected values of the marginal benefits and costs. In this set-up, a rational actor thus chooses to forgo information that he could have learned but for the expected cost. This kind of ignorance, a concept associated with the work of economist George Stigler, is often referred to as *rational ignorance* or ignorance by choice.

So, ignorance that is not by choice, ignorance pure and simple, is ruled out by the nostrum of standard microeconomics, in particular by the assumption of "perfect knowledge." This means that the actor, in assessing the marginal costs and benefits of working versus formal education, not only seeks to act in his own interest as he sees it, but that he knows all relevant alternatives and can anticipate their consequences. If he chooses not to know something, in a real sense he still knows what he is missing. This leaves no room for any *ex post* regret. All ignorance in the perfect-knowledge approach of standard microeconomics, the economics that many free-market advocates explicitly rely on, is therefore rational ignorance.

This means, however, that if people persist in doing something that the economist himself typically regards as foolish or irrational, and if it is assumed that they possess the optimal amount of knowledge, then their actions, strange or wrong though they may appear, are not really foolish or irrational at all. The presumption would have to be that the cost of adjusting to a more "rational" form of action, one more agreeable to the economist, is too high. All action would be rational in the sense of not only being in the interest of the actor but also of being the best possible course in light of all relevant information.

Now here is the rub: Why is it frequently the case that many economists, even those whose background is only in this sort of standard microeconomics, are also advocates of the free market and critics of government intervention? If people do in fact have the optimal amount of information, and if they do persist in supporting such things as inflation, minimum-wages laws, and protectionism, logical consistency with the underlying theory would dictate that pointing out the "fallacies" and "errors" would be useless and a waste of valuable resources. There would be little that such persons could learn from economists beyond what they have already chosen to know. They are not fallacies or errors from their viewpoint even if in a real sense they suspect that their beliefs are "wrong," because they would have already decided that the benefit of convincing themselves they are wrong would exceed the cost of doing so.

Moreover, if economists were as perfectly rational as the agents they assume to be modeling, and consistency would seem to dictate this too, they should already be perfectly aware of the above argument and should therefore not even consider advising and critiquing anyone, anywhere, anytime. But they do! Thus, if they really think there is a possibility of their doing some good by offering information to *public choosers* (i.e., those responsible for making decisions about public policy), this is an admission, at least a tacit one, that the perfect-knowledge-based economic theory they teach in their classrooms is fundamentally at odds with their desire to offer public-policy advice to systematically change how the world works.

Removing the Contradiction

To eliminate the contradiction between economic theory and the justification for its application, some aspect of the economist's theoretical understanding of how the world works must admit of something more than rational ignorance. There must be in other words a kind of ignorance that is not the result of deliberate choice, but is rather in the nature of sheer or *radical ignorance*.[3] This sort of ignorance would go beyond simply not knowing something, but would entail not even knowing that you do not know it.[4] I am ignorant by choice of the contents of some of the books on my library shelf because I have judged the cost of reading them (for now) to be higher than the benefit,[5] but I am radically ignorant of books that I do not even know to exist.

Radical ignorance in fact gives character to the world that we actually know, in which regret and surprise, error and discovery are the foundations of profits and losses, success and failure. This is because with the possibility of radical ignorance comes the possibility of genuine error. It is only when I might not know something that is in my interest to know, where the benefit does indeed outweigh the cost, that my actions might correctly be characterized as erroneous.[6] Not realizing that I could have purchased at a lower price than I did, when the cost of discovering this fact is zero, is certainly an error and grounds for regret.

Just as important, however, is that with genuine error comes the opportunity for genuine learning. That is, with genuine error comes the possibility for public choosers (or anyone else) to learn something that is in their interest to learn. So, discovering the lower price before buying would constitute a pleasant surprise. Acknowledging the existence of radical ignorance within one's theoretical framework thus leaves room for both error and the discovery of error.

Uncovering a Paradox

But this in turn seems to lead to an *apparent* contradiction—a paradox. To reiterate, the dismal economist is evidently doing his job when he helps the public see the bad consequences of various kinds of policy. Given enough sound instruction, public choosers of goodwill are supposed to be able to trace these bad consequences back to particular actions or set of actions. Once they are made aware of these consequences, which frustrate their original intentions, they are in a position to correct their previous errors. (Of course, if they are ill-willed to begin with, if malice and not mistakes informs their actions, lessons in ethics might be more appropriate, though perhaps no more effective, than instruction in economics.) Yet one of the important things that an economics based on the possibility of radical ignorance teaches us—the economics that follows in the tradition of Carl Menger, Ludwig von Mises, and Friedrich Hayek—is that

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[3]This concept is developed extensively by Israel Kirzner (1979c).

[4]It is possible that it also entails "not even knowing that you don't know that you don't know that you don't know…," *ad infinitum*, so that we might speak of there being degrees of radical ignorance. Not knowing that you do not know, however, is sufficiently radically ignorant to drive the point being made here.

[5]Of course, I might very well discover upon reading it that the contents were quite different from what I thought they would be. Indeed that is why we read books.

[6]Erroneous, but still rational in the sense of being purposeful. See Mises (1966, p. 19).

for every action we take there will always be consequences, many of which may impinge on our plans, that no one could have foreseen. Because our knowledge is not perfect, we are going to be aware of only a fraction of the consequences of each of our actions even if it is in our interest to know all or most of them.

This goes for all human actors, including, of course, economists. Radical ignorance appears to stand as an impenetrable veil against the future ramifications of present action. But if we acknowledge the existence of radical ignorance, and this means that important consequences of any action, by government authorities or private individuals, will be unknown, then how in good conscience can we as economists wag our fingers at government intervention? How can we know that the policy of limited intervention in the market process has the kind of negative unintended consequences *in comparison* to the market process? That is to say, if error infuses action in all social spheres, whether public or private, why should economists not be limited to simply saying, in effect, "I don't know what's going to happen? Just be careful"? Where do we get the idea of criticizing such policies as rent control or credit expansion, without having just as much enthusiasm to criticize entrepreneur-capitalists for investing in projects many of whose long-term effects no one can foresee?

Resolution

In the private sector, however, the negative consequences of erroneous actions tend to be corrected through the pressures of competition and self-interest as long as certain market institutions are in place. That is, if property rights are well defined, if an effective system of contractual enforcement operates, and if there are appropriate norms of trust and reciprocity, the results of actions taken today will tend to fit within an order that emerges, unplanned, moment-to-moment (Hayek 1967). In the market process, success is determined by how well you are able to anticipate and respond to change, and the system of relative prices that forms within the market process constitutes the essential tool for facilitating such adjustments and promoting spontaneous plan coordination. If you do not make a better or cheaper mousetrap you will go out of business, if your actions harm innocent third parties you could be subject to legal action, and if you cheat your customers you will lose their trust and could be sued. As Mises and Hayek explained long ago, in the context of these market institutions, the price system is able to adjust from continuously to the ever-changing expectations and valuations of myriads of actors following their own self-interest. Mistakes are punished with losses just as profits are the reward for making right decisions.

This means, however, that economists should not say (though some do), "If you invest in such-and-so, you will get rich," because the future that results from the complex interaction of millions of choices today cannot be known with certainty. But what sound economics allows them to say with complete confidence, though at a higher level of generality, is that within the market process incentives exist to drive spontaneous entrepreneurial forces to correct the errors that radical ignorance generates. It permits them, moreover, to point out when government policies hamper the operation of this error-correction process—as indeed in the cases of inflation, price regulation, and protectionism. Though this process never operates with perfection, it is the sort of continuous, systematic adjustment that the governmental process—even with voting, exit, and voice—is incapable of producing. The monopolistic character of governmental bureaucracy also contributes to the sluggishness, especially as the scope of its activity grows in relation to the market.[7]

[7]For a discussion of this view and a summary of the nature of the "governmental process," see Ikeda (1997, chap. 3).

Conclusion

There is then a fundamental inconsistency between theory and application for political economists who both rely on standard microeconomics for their support of the free market and scorn government intervention. Theory matters in free-market critiques of public policy. It matters, however, not only in determining the content of those critiques, but also, from a methodological standpoint, in the sense of whether the world-view presupposed by theory is one that leaves room for any meaningful critique to take place at all.

It should not be news that the authorities in charge of public policy are ignorant. Surprisingly, if we start from the presumptions of perfect-knowledge economics we would be logically led to conclude that those authorities indeed never make mistakes, or if they do that it must have been planned that way all along. Fortunately, political economists working in the Austrian tradition are, as they have been since Böhm-Bawerk's and Mises's devastating critiques of Marxian economics and socialism, free from having to maintain this curious point of view.

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