The Anatomy of Economic Advice

PART III

BY ISRAEL M. KIRZNER

In the first article of this trilogy we explored some of the ambiguities and difficulties that surround the very idea of "economic advice" based on economic science. In the second article we set forth some of the basic foundations of economic science (with special reference to what the science can teach us about what we called the "benign" character of the spontaneous market process). We are now ready to draw together the various strands of our discussions and to set forth the scientific legitimacy of economic advice based on an accurate understanding of the nature and significance of the free-market process.

As was developed in the preceding article, economic science has explicated the nature of the forces that govern the market process. What we saw was that the market process is made up of powerful tendencies set into motion by "erroneous" market decisions. Such "erroneous" (that is, uncoordinated) market decisions are responsible for "imbalances," in which over-optimistic expectations are frustrated and disappointed, while over-pessimistic expectations are translated into overlooked opportunities for mutually beneficial exchanges. The market process consists partly of forces that tend to modify over-optimism, replacing erroneously hopeful decisions by more realistic market bids and offers (and more realistic production plans); and it consists, in addition, of "entrepreneurial" tendencies toward the discovery of hitherto overlooked opportunities. At any given time these coordinative tendencies are operating to eliminate the earlier errors—at the same time as "exogenous" changes in consumer preferences, resource availabilities, and technological possibilities are altering the very framework against which "error" is to be defined.

To the extent that production decisions are geared, not to the satisfaction of *current* consumer needs, but to the satisfaction of *future* needs, our above capsule description of the market process must be deepened. We must recognize that a production decision may be "over-optimistic" not only in overestimating the urgency of consumer demand for today's fresh milk, but also in overestimating the future demand for a particular style of automobile. Such a production decision may be "over-pessimistic" not only in failing to realize that today's market will express an unsatisfied demand for cheese products (which might have been even more profitable than the production of fresh milk), but also in failing to realize that (perhaps as a result of advances in medical research), in five years' time the demand for fresh fish (and thus the profitability of *now* producing fishing trawlers) may increase substantially.

To recognize all this does not require us to change our basic understanding of the nature of the forces that make up the market process. It merely requires us to recognize that these forces operate along channels that permit us to apply our elementary understanding of the "law" of supply and demand to levels of intertemporal complexity not noticed previously. Ultimately, however, the intertemporal coordinating forces unleashed by the "law" of supply and demand operate in ways fundamentally similar to the operation of this "law" in the simplest of markets. Market decisions are continually modified to take more realistic account of future possibilities; entrepreneurs are continually alert to the possibilities of

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discovering hitherto unnoticed gainful opportunities (whether these opportunities are short-run or long-run in their nature).

Is the Market Process Really Benign?

Our discussion in the preceding section (and in parts of the preceding article) may suggest that each step of the market process is, at least in its tendency, socially beneficial. After all, this process tends to correct the erroneous expectations that individuals may have. It tends to discourage individuals whose over-optimism might otherwise inspire them to undertake projects doomed to failure. And it tends to inspire individuals to discover hitherto overlooked ways in which they can be useful to each other. To the extent that we would hope that such opportunities would be discovered, the market process, it would seem, is "benign" in its tendency. But what about the possibility that the successful achievement of mutually beneficial exchange between parties A and B is seen by party C as an undesirable development? (Economists term such situations "externalities.") We may consider several different scenarios.

a) Suppose, as a result of newly discovered trade possibilities between A and B, C (who had previously enjoyed B's spending as a customer in his store) now finds his income reduced. Of course he is dismayed by the newly discovered mutually gainful exchange opportunity between A and B. (C would be similarly dismayed if, as one who *used* to buy from A at a low price, he now finds himself forced to match the higher price that B is now paying A in their newly discovered mutually gainful exchange.) While C certainly feels himself to have been "hurt" by the discovery, does this compromise our earlier judgment that the latter discovery is socially beneficial? The basis for our earlier judgment was the implicit assumption that the trade between A and B benefits them both (which is certainly the case) without affecting anyone else negatively (which is *not* the case in our present scenario).

Without entering into any deep philosophical issues revolving around comparisons between the "harm" suffered by C and the gains enjoyed by A and B, let us carefully notice that C has *not really been harmed at all*. What has happened is merely that C, who *had* enjoyed income received by selling to B *as a result of B's earlier ignorance*, is now no longer able to do so. (Or, in our alternative case, C, who *had* enjoyed being able to buy cheaply from A, *as a result of A's earlier ignorance*, is now no longer able to do so.) C has *not* been harmed in the sense of having lost any of his physical assets. Nor, as we shall see, has he been harmed in the sense of having lost some of the established *true value* of his assets; his "harm" consists strictly in his having now to live with a *more realistic* assessment (by himself and others) of what his physical assets are worth, and have *really* been worth, to others. Up until now he has, as is presently apparent, been extracting an unrealistically and unjustifiedly higher value from others, in exchange for what was really a lower-value asset.

But what if the exchange between A and B does indeed physically harm C; suppose that what A sells to B is his service as a musician and that this music played by A is so loud and so repulsive to C that the latter feels as if physically assailed. Let us consider this as scenario b).[1]

b) A sells live music to B; C's life is totally disrupted by what he considers atrocious noise. Surely we cannot describe the discovery by A and B of this opportunity for mutually gainful exchange as constituting an unambiguously socially benign development. Surely the gain to A and to B has to be offset, at least in part, by the harm caused to C. Let us distinguish two cases: (i) one in which the law recognizes C's right not to be disturbed by other people's music and (ii) one in which the law does not restrain individuals from disturbing others with their noise. In case (i), C's right not to be disturbed will certainly have to be taken into account by A and B. They will, if they wish to trade with each other, have to pay C to persuade him to permit them to do so. If C accepts such a payment, we would have a three-way trading arrangement in which everyone (at least in his own estimation) has been made better off. B gets to hear music at a total cost that he apparently believes to be worthwhile; A plays his music for a net price (after paying C) that he finds worth his while; C, while he must now sacrifice his peace and quiet (to which he is legally entitled), finds that the payment he receives from A and/or B is more than sufficient to make it worthwhile to do so. *Everyone* (to whom the trade between A and B is of relevant interest) has gained from trade.

In case (ii), in which the law does *not* recognize any

right not to be disturbed by the noise of next-door music-lovers, C's pain will be *legitimately* ignored by A and B (unless of course they choose to act altruistically to consider C's suffering). But C *has* a way of making sure that his pain is taken into account by A and by B; he can offer them money to sign a contract undertaking not to play music during agreed-on periods. If they accept his money, C will consider himself to have gained (since he has purchased peace and quiet, to which he had *not* previously been legally entitled). If they do *not* agree to such a contract, C will indeed suffer from the music; but it is the legal system that is the source of this pain. The market process merely translates the legally recognized rights of A and B into corresponding realities. In both case (i) and case (ii) the market process benignly tends to reveal *all* relevant opportunities for mutually beneficial gain—*within the given framework of legally recognized (and enforced) individual rights*. We may approve or disapprove the morality of the legal system of rights, but *given that system*, whatever it may be, the market process benignly tends to inspire mutual discovery; it tends to *bring about coordination among the decisions of all those who are considered relevant by society's adopted system of law*.

Has Economics Proven the Market Process to Be Morally Good?

We have seen that elementary economic reasoning shows that the market process tends to promote the discovery of hitherto overlooked possibilities for mutually beneficial exchanges. We have therefore described the process as "benign" in its tendency. Does this mean that the market process is morally "good"? Have we shown that, since the market process is *economically* good, we have scientifically demonstrated that public policies which promote the market process are *morally* good policies, while those which hinder the process are morally bad? Have we used science-based "is" statements to generate morally compelling "ought" statements? Careful examination of our reasoning will show that we have *not* demonstrated any necessary moral goodness in the market process—but that we have nonetheless succeeded in securing a valid basis for economic policy, properly understood.

What we have called the "benign" results that tend to flow from the spontaneous market process are benign in a very special, limited, sense. It seems a pity that Jones, who prefers *a* (which he does not have) to *b* (which he does), is somehow (let us say as a result of unnecessary ignorance—unnecessary in the sense that it could be eliminated with virtually zero cost) held back from trading with Smith, who prefers *b* (which *he* does not have) to *a* (which he does). A market process that tends to reveal to both Jones and Smith a way in which they can mutually benefit each other (without harming anyone else) seems to be an obviously "socially" beneficial process. But the beneficial character of this process is strictly relative to Jones's and Smith's *given* preferences. *If* these preferences are, in a moral sense, praiseworthy, the process that promotes their fulfillment can be seen as morally praiseworthy too. But suppose that the *a* which Jones prefers is a cholesterol-laden dessert that is likely to trigger a heart attack; suppose further that the *b* which Smith prefers is a hectic ride on a wildly unsafe motorcycle on a busy highway. Surely many observers would think the world a morally better place *without* the implied exchange. But—and this is the important point—the economist who applauds the market process is doing so *not* as a moralist; he is doing so strictly within the "instrumentalist" framework of his profession. He is pointing out that, from a purely *economic* point of view (that is, in terms of *given* preferences and given resources), free exchange is "beneficial" in its tendency, for all relevant parties.[2]

An educational psychologist who has been consulted on the best color that might be chosen for the walls of a classroom may recommend a bright color that will stimulate alertness and learning. But before pronouncing this color to be *morally* superior to other possible classroom-wall colors, we would want to be sure that the classroom is to be used for morally good teaching purposes. If the classroom is to be the arena in which students are indoctrinated into hateful ideologies, we would probably consider a color which *slows down* the learning process to be morally superior to the alertness-inducing color. "Goodness" is strictly relative to the professional focus of the expert. For the educational psychologist this focus is the promotion of alertness to new information—regardless of the moral status of that information. For the economist the professional focus is the fulfillment of mutually beneficial opportunities for

exchange, based on given preferences and resources—regardless of the moral status of those preferences.

But if this is properly understood, it does not appear to be wrong to label a coordinative economic policy to be "good economic policy," since it does promote mutual discovery among the Smiths and the Joneses. The economist who argues that one economic policy is economically better than another policy is doing so strictly within his professional framework.

What We Have Not Claimed

There are other claims that are not implied by our claim on behalf of the economic goodness of the market process. To show this does not, however, call for philosophical or moral insight; it simply requires rigorous economic reasoning.

For example, take the idea that free markets maximize national wealth. Now the great economists who were the founding fathers of the discipline—the "classical economists"—did indeed define their science as the "science of wealth." It is well known that the (short) title of Adam Smith's classic work is *The Wealth of Nations*. As we noted in the first article, Smith, followed by the other classical economists, took it for granted that the objective of good economic policy is to increase national wealth. Yet the very meaning of the term "aggregate national wealth" (especially if confined as it was in classical economics to *material* wealth) begins to crumble away, as a scientifically useful term, as soon as it is subjected to analysis.

Two bushels of wheat *may* certainly appear as more wealth than one bushel. But are they also more wealth than, say, a package of one bushel of wheat and one sack of potatoes? And even when we consider only wheat, are we sure that two bushels owned by a single wealthy person constitutes more wealth than one bushel that has been somehow distributed among several desperately poor large families? Simply drawing attention to the valuation problems of adding up apples and oranges, or to the complications introduced by the insights of subjectivist (and especially, Austrian) economics, explains why economists at the end of the nineteenth century sought to replace the criterion of aggregate national wealth by less-physical concepts. One such concept, which came to be associated particularly with the work of British economist A. C. Pigou, was that of the aggregate national "economic welfare." What good economic policy seeks to maximize, according to this approach, is the aggregate economic well-being of the members of society.

But the idea of treating individual economic welfare as something that might in principle be added together with someone else's individual economic welfare is one which could hardly be sustained. In particular Austrian economics, which had pioneered the subjectivist understanding of consumer utility, could never accept any such aggregate notion. Moreover, attempts to replace *direct* notions of aggregate welfare by less-direct formulations (that is, those implied in the notions of aggregate efficiency in the allocation by society of its economic resources) are easily seen to be doomed to failure.

Thus, it turns out, economic policy advice cannot meaningfully claim to be based on the idea that a particular policy should be described as economically "good" because it tends to promote aggregate wealth, or aggregate economic welfare, or a more efficient allocation of a society's economic resources.[3] We seem to be forced back to the more modest (but yet enormously important!) claims examined earlier—that certain economic policies may be shown to promote mutual discovery by potential market participants (and may therefore be considered to be "economically good" policies). Sometimes, as we have indicated, this is expressed by pointing out that such policies promote "coordination" among the decisions made in a society. They tend to alert relevant market participants about the possibilities available to them, tending thus to ensure that potentially beneficial opportunities for innovative production, and mutually gainful exchange, do not go unnoticed and unexploited. Implicit in the work of Ludwig von Mises, however, are insights into several *additional* criteria for judging economic policies to be good or bad.

Ludwig von Mises and the Goodness (or Badness) of Economic Policies

Mises never did fully explain the basis on which he felt able to pronounce an economic policy to be good or bad. He never (as far as I am aware) explicitly discussed the "coordination" criterion for good economic policy to which we have repeatedly referred. But

there are grounds for believing our position in this article to be consistent with Mises's philosophical and economic perspectives. In his explicit discussions Mises seems to have grounded his judgments (on the goodness or badness of economic policies) on one or more of three separate foundations:

Self-Frustrating Economic Policies: A policy that can be shown by economic science to bring about results that are emphatically *not* desired *by the policymakers themselves* is bad policy. A classic Misesian example of this was the policy of urban residential rent control. Whatever the merits might be of the results hoped for from a policy of rent control, it must be pronounced a bad policy. Economic analysis shows that it tends to generate housing shortages—which were *not* (one hopes!) the objective of the legislators.

Unsustainable Policies: A policy that can be shown to be *inherently* impossible to be successfully carried out is an obviously flawed policy. For Mises a policy of monetary inflation (to fuel a boom in the initiation of long-term capital-using ventures) is a bad policy because economics shows how extremely unlikely it is that any such sustainable boom will result. Such a boom can be sustained only through long-run consumer sacrifices, which the consumers are *not* in fact prepared to make. Such policies amount to attempts to run simultaneously in two opposite directions. Economics can show that a particular policy cannot expect to be successfully completed. Such a policy may be described as bad policy.

Violations of Consumer Sovereignty: Mises (like most economists) apparently supposed that most people believe it to be a "good thing" for members of society to fulfill their preferences. He therefore shared the conviction of most economists that a policy which structures a society's allocation of resources in patterns clearly at odds with the dynamics of consumer preferences is an economically "bad" policy. A policy that creates a pattern of excise taxes tending to nudge consumer purchases away from goods and services the *consumers* prefer, toward goods and services *legislators* believe to be "better" for consumers—is a policy that Mises believed to be "bad," because it violates consumer sovereignty.[4]

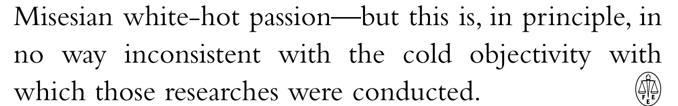
Science and Passion

We noted in the first article in this series that writers have been puzzled by the *passion* with which Mises denounced what he believed to be bad economic policies. Fritz Machlup, an eminent economist and devoted student of Mises, was one of these writers. Mises's passion seems, at first glance, difficult to reconcile with his own insistence on the absolute necessity for scientific *wertfreiheit*—detached objectivity—in social science. When Mises denounced socialism as a disastrous economic system—one that tends to impoverish society, to bring misery on its members, and to threaten the very survival of Western civilization—he waxed passionate. He was firmly convinced that economic science shows all this to be true. (In particular he was convinced that economics demonstrates how the most benevolent of would-be national planners would not be able to plan [that is, to *coordinate* individual activities] at all! Thus a policy of socialism—that is, a system in which an integrated, single, national plan is sought to replace the "anarchy" of innumerable individual plans in a free-market society—is one that is simply impossible to carry out [just as would be a policy aiming to run in two opposite directions at the same time].)

But by now it should be clear that there is *no* inconsistency in Mises's positions. Because Mises believed—on *objective, scientific* grounds—that socialism is a sure recipe for misery and worse, he believed it to be his *moral duty* to communicate his belief to society with whatever passion might be able to command attention and inspire political relief. Machlup may have seen this as a violation of *wertfreiheit*. Mises would have vehemently disagreed. His passion was—like the passion of someone earnestly preaching the health dangers of tobacco smoking—based on cold, objective science.

As we saw in the first article, the eminent economist George Stigler believed that *any* "preaching" by any economist for *any* particular economic policy is, on grounds of consumer sovereignty, out of order. Stigler believed that the public *already* knows full well what the likely results of any economic policy are likely to be. If the economist is preaching against a policy voluntarily adopted by the public through its political channels, he is simply attempting to promote what *he* believes to be better for society over what *society* believes to be better.

But economic science surely has, again and again, revealed how particular policies result in outcomes *not* foreseen by policymakers, or by those who elected or appointed them. Economics shows how imperfect knowledge may be responsible for enormously valuable (and completely overlooked) opportunities remaining unexploited. It is no violation of consumer sovereignty to demonstrate where such ignorance has been (or is likely to be) responsible for disastrous results. In fact, to demonstrate this is to *promote* consumer sovereignty. As long as the philosophical and moral detachment of economic science is well understood, this science *can* be used, *in a wertfrei manner*, to inform the public of *what it does not yet know*. Where the results of such ignorance are likely to be serious, the economist (in his capacity now of a citizen fully alive to society's suffering) may consider it his *moral* obligation to bring the results of his objective scientific researches to the attention of the public. Such moral obligation may indeed be expressed with Misesian white-hot passion—but this is, in principle, in no way inconsistent with the cold objectivity with which those researches were conducted.

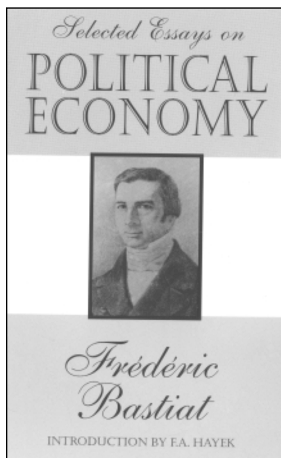


1. This scenario has been extensively explored in a literature pioneered by Nobel laureate Ronald H. Coase; see his celebrated paper, "The Problem of Social Cost," *Journal of Law and Economics*, Vol. III (October 1960).

2. For the classic statement of these insights, see Lionel C. Robbins, *An Essay on the Nature and Significance of Economic Science*, 2d edition (London: Macmillan, 1935), especially Ch. VI.

3. See further my paper, "Welfare Economics: A Modern Austrian Perspective," published as chapter 11 in Israel M. Kirzner, *The Meaning of Market Process, Essays in the Development of Modern Austrian Economics* (London: Routledge, 1992).

4. For a pioneering discussion of coordination, as introduced into normative economics by eminent Austrian economist Friedrich A. Hayek, see Gerald P. O'Driscoll, *Economics as a Coordination Problem, The Contributions of Friedrich A. Hayek*. See also my "Coordination as a Criterion for Economic 'Goodness,'" published as chapter 7 in Israel M. Kirzner, *The Driving Force of the Market, Essays in Austrian Economics* (London: Routledge, 2000). See also Israel M. Kirzner, *Ludwig von Mises: The Man and His Economics* (Wilmington, Del.: ISI Books, 2001), pp. 163–71.



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