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Correspondence

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Comment on Joseph Farrell, "Information and the Coase Theorem," Fall 1987, pp. 113–129.

Joseph Farrell addresses one of the fundamental issues in socioeconomic organization: how to utilize the vast and dispersed privately held information to allocate goods and services in a reasonably efficient manner. This "knowledge problem" was the central point of criticism advanced by Ludwig von Mises and F. A. Hayek of both Marxian socialist and, later, market socialist proposals.

However, Farrell is led into misunderstanding Hayek because he associates Hayek's argument too closely with that of Ronald Coase. Farrell is completely correct when he states that "the strong form of the Coase theorem—the claim that voluntary negotiation will lead to fully efficient outcomes—is implausible unless people know one another exceptionally well." But this line of reasoning does not affect the Mises–Hayek discussion of the market process.

Ludwig von Mises (1920; 1922) launched the debate over the feasibility of economic calculation under socialism. Mises argued that complex industrial production required private ownership in the means of production. Without private ownership of the means of production, Mises argued, there could not be any markets for the means of production. Without such a market, there could not be any money prices for these goods. And without money prices reflecting the relative scarcities, there could not be a rational economic calculation.

Implicit in Mises's reasoning was the recognition that no one mind or group of minds could possess the necessary economic knowledge to deliberately plan the economic system. The socialist proposal was argued to be technically impossible from an economic point of view. Without the use of monetary calculation, which Mises (1922) referred to as "the guide amid the bewildering throng of economic possibilities," complex industrial production could not be rational. The abolition of the processes of market exchange and rivalry would result, Mises argued, in the elimination of the only means available to human beings for rational economic calculation under conditions of advanced industrial production.

Mises's associate and student, F. A. Hayek, developed this argument against centralized administration of economic life even further. Hayek pointed out that market knowledge is dispersed among many market participants, and that much of the knowledge utilized in the interplay of market exchange and production is inarticulate or tacit. This epistemological perspective precludes both the theorist and the planner from treating market knowledge as "data."

In contrast, Farrell argues if the central authority can ensure that people will reveal their true preferences through an appropriate mechanism design, then Hayek's argument, may not be as strong as it first appears. The argument is that in regard to certain goods, like public goods, the mechanism design of the market system is a poor mechanism to give people an incentive to reveal their private information. In such an instance the market will produce suboptimal results, while even a "bumbling bureaucrat" might produce better results.

Beyond the point about market problems when goods possess certain "publicness" aspects, Farrell misunderstands Hayek's argument against planning and the use of knowledge in society. Rather than ignoring the demand revealing processes of the market, the demand-revealing function is essentially Hayek's point of criticism. The competitive market process serves as a vehicle for the discovery and conveyance of private information. In the absence of the competitive process, according to Hayek, there is no practical way to ensure that individuals will reveal their preferences for goods and services.

To Mises and Hayek the whole point of the market process is to coordinate that dispersed and often conflicting plans of market participants. The "marvel of the market," to use Hayek's terminology, is how this process produces social cooperation in anonymity. The coordinating role of the market is to generate incentives and reveal knowledge that leads to the dovetailing of diverse expectations.

Adam Smith and F. A. Hayek never claimed that the competitive market would produce results that would be no less efficient than a government-dictated outcome, as Farrell suggests. Rather, the argument is a stronger one; that individuals pursuing their own purposes and plans would generate results that would be more efficient than if any one of them had intended the result. The social institutions of the market which promote or generate the desirable outcomes of decentralization are the results of human action, but not of human design. Paris gets fed—the economists need not assume it, it happens—his role is to understand and explain how it happens.

Farrell does not recognize the fundamental analytical point of Hayek's criticism of planning. The ubiquitousness of the tacit component in our knowledge prevents either the theorist or the planner from treating knowledge as scraps of information (even if held in little bits). Market expressions of valuation are only revealed within the actual playing out of market activity and cannot be known in advance.

Surely the stumbling and erring bureaucrat, necessarily ignorant of the privately held assessment of trade-offs that economic actors possess, cannot obtain the economic knowledge necessary to accomplish the task he sets before himself, and, at worst, bases his decision upon political rationales (such as catering to special interests or maximizing his bureau's budget). Given these arguments it seems economists have some sound reasons to support not only the practical advantages of decentralization, but the theoretical advantages of the decentralization of economic activities.

Farrell raises some serious criticisms of the standard defense of market solutions to economic problems found in the Chicago tradition and it did much to stimulate thought, but it did not address the fundamental welfare problem that all economic systems face; in Hayek's (1948, p. 78) words, "how to secure the best use of resources known to any of the members of society, for ends whose relative importance only these individuals know. Or, to put it briefly it is a problem of the utilization of knowledge which is not given to anyone in its totality."

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On "Anomalies, Parimutuel Betting Markets: Racetracks and Lotteries," by Thaler and Ziemba, Spring 1988, pp. 161–174.

Thaler and Ziemba in the Spring 1988 issue of this journal describe, among other things, the favorite-longshot bias in racetrack betting. "Specifically, the expected returns per dollar bet increase monotonically with the probability of the horse winning. Favorites win more often than the subjective probabilities imply, and longshots less often." Two explanations imply that different betters have different characteristics. The two can easily be distinguished empirically.

One explanation can be summed by quoting Thaler and Ziemba (p. 171): "After all, $2 is a cheap thrill." That is, small betters [sic] are satisfying recreational desires, not rationally maximizing expected wealth or expected utility from same. Let us accept that what (with exaggeration) is called the "professional better" maximizes expected wealth. The distinction between expected wealth and expected utility therefrom is minor. This means that favorite horses are more favored the larger the bet, the more often the better visits the track, and by betters who study the racing form.

That favorites are more favored by those making large bets is easily testable and corresponds to a casual observation made the last time I went to the track (which was while in high school). Four of us pooled money to make a $2 bet because we liked the number 3. The winner and overwhelming favorite was not number 3. There were long lines at the $50 bet collection window, not at the lower denomination windows. These people appeared well heeled. Thus, a significant difference between expected wealth and expected utility therefrom seems unlikely.

The other explanation can be introduced with a casual observation concerning a community's cock fights. The observation has been part of an explanation of the Friedman-Savage utility function. "When I bet $5 (the minimum bet) at a cock fight, the distinction between relative wealth and utility is small. When a non-resident alien laborer bets $50 (often nearly double his daily wage), however, his behavior may represent a response to a Friedman-Savage utility function." The meaning for horse racing is that the favorite-longshot bias could represent the influence of a Friedman-Savage utility function of the large betters. Then the bias would increase with the size of the bet—an easily testable hypothesis and contrary to what results from the explanation based on the small better satisfying recreational desires.

A curiosity: A U-shaped function for size of bet versus the horse's odds is a distinct possibility.

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