

Liberalism, Socialism, and Robust Political Economy

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We may admit that the director or the board of directors are people with superior ability, wise and full of good intentions. But it would be nothing short of idiocy to assume they are omniscient and infallible.

Ludwig von Mises (1966: 696)

Introduction

There are two routes available to the political economist in making a case for one system of social organization over another. There is the hard case, and the easy case. In taking the easy case, the political economist postulates that set of assumptions that are most conducive to the point he wants to make. The easy case consists of assuming the ideal conditions that make the theorist's system work. For instance, it is obvious that in an economy of complete and perfect information where all participants are equally informed, prices are perfectly flexible, markets are complete and all agents are perfectly rational that markets will clear and general equilibrium will obtain. The hard case, on the other hand, consists is postulating less than idealized conditions for the system at hand and determining to what extent the system retains its desirable attributes. In the limit, the

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hard case (i.e., the hardest case) means assuming the worst-case scenario. For instance, it is not so obvious that in an economy of less than perfectly rational, perfectly informed individuals where prices are sticky and informational asymmetries persist, that markets will prove efficient and general equilibrium will obtain. The hard case is hard because in order to demonstrate the desirability of a particular system under worse-case scenarios, the system must be robust. Robust systems, then, are precisely those that are able to stand up to the test of the hard case. In the face of less than ideal conditions, the system performs well nonetheless. Many systems can stand up to the test of the easy case, but very few remain standing when confronted with the hard case.

The argument for liberalism made by its ‘founding fathers’ in the 18th century aimed to pass the test of the hard case. Classical economists like Adam Smith and David Hume asked, how does the unhampered market perform when men are not angels? It is easy enough to see when men are omniscient and benevolent that market will work fine. But the early liberals were interested in constructing their argument for the free society on less friendly grounds. They asked, ‘how well does the market-oriented society function when men are not angels, but rather are men?’ The liberals successfully demonstrated the robustness of their political economy in answering this question.

In the twentieth century, liberalism’s greatest defenders were the Austrian economists Ludwig von Mises and F.A. Hayek. In the decades of the 1920s and 30s Mises and Hayek engaged in an intellectual battle over the desirability and feasibility of liberalism vs. socialism. Liberalism, they maintained, in principle presented no particular problem from an economic point of view. Because liberalism was founded on the principles of private property and exchange, in the unhampered marketplace prices would

emerge via the actions of trading parties, which serve to guide the actions of producers in such a way that resources under liberalism would tend to flow to those areas where consumers desired them most urgently. On the other hand, they maintained, because socialism lacked private ownership in the means of production, no prices indicating the relative scarcity of resources in alternative employments could emerge to guide the activities of producers. Rational economic calculation was impossible. It is important to note that the arguments made Mises and Hayek in their debate with the socialists questioned neither the benevolence of the would-be central planners nor the incentives (or lack thereof) individuals operating under socialism would have to direct resources to their most highly valued uses. They stressed only the impossibility of the central planners' ability to calculate, regardless of their goodness or their incentives to do so. In this way, Mises and Hayek, like the Classical economists who came before them, were tackling the hard case in their debate with socialists.

The assumption of public benevolence by both the Classics and the Austrians had two important rhetorical advantages that are often overlooked in discussions about the matter. First, by assuming the best of intentions, the analyst is less vulnerable to the charge of illegitimately importing his values into the analysis. Economic analysis is used as a tool of critique rather than as an engine of advocacy. Second, all political and economic systems must confront both knowledge problems and incentive issues. If we focus exclusively on incentive issues, then we fail to address the knowledge problem. By assuming benevolence, the analyst moves the epistemic issues to the forefront of analysis. It is just as useful to ask, 'given benevolence, how will individuals come to know what

the right thing to do in any given situation?’ as it is to ask, ‘assuming omniscience, what incentives do individuals face in making their decision to do the right thing?’”

Robust political economy requires that both the assumptions of benevolence and omniscience be relaxed so that both incentive issues and knowledge problems can be adequately addressed. In this paper we seek to I.) Develop an understanding of the application of robustness in areas outside of political economy and use this understanding to further our appreciation of the nature of robustness in political economics; II.) Explore the robustness of liberalism by considering how it performs under both worst-case motivation conditions and worst-case information conditions in the context of the arguments advanced by the Classical economists and Hayek; and III.) Explore the fragility of socialism under both best-case incentive conditions and best-case information conditions in the context of the arguments advanced by Mises and Hayek.

I. The Nature of Robustness

1. APPLICATIONS IN THE NATURAL SCIENCES

The *Oxford English Dictionary* defines robust as: “strong, vigorous, healthy.” The word comes from the Latin “robustus” meaning “of or belonging to oak.” The word’s Latin derivation provides a vivid sense of what we mean when we say that something exhibits robustness. Robustness means the ability of something to withstand various negative shocks or conditions.

Fields in the natural sciences have long made use of the robustness terminology. In botany, for instance, a plant is said to be robust if it is strong and sturdy, able to hold up to the harsh conditions of nature. In biology, a person, his organs, or some other part

of his physical make-up can be said to be robust if it is “strong and hardy in constitution.” The idea here is similar to that of robustness in botany. Individuals or some part of their composition is robust if it wards off illness easily or, once diseased, is able to fight off illness and retain its original degree of functionality once the disease is gone. The term is analogously used in zoology as well where animals are said to be robust if they are stout, thick-set and strongly made. The applications are virtually endless. We could call my table robust if it was able to withstand heavy weight and the severe abuse of rough usage it undergoes daily. The idea of robustness finds itself in nearly every science imaginable and is always employed to indicate the sturdiness of the subject and its ability to perform well when placed under high degrees of stress. In statistics robustness refers to a statistical test’s ability to yield correct or approximately correct results despite the false or problematic assumptions on which the test is based. Similarly, in engineering as well as in statistics, a calculation, process, or result may also be called robust if it is largely independent of the input going into the calculation or process.

2. ROBUSTNESS IN POLITICAL ECONOMICS

From the terminology’s usage in the natural sciences, we get a good sense of what robustness means in political economics as well. A robust political economy, as noted in the introduction, is one that can withstand the test of the hard case. It is a political economy that can readily deal with various obstacles and problems it is confronted with. Relatively large deviations from ideal conditions or the assumptions on which it is based do not result in the collapse of the system, but instead cause little or no interference with the system’s normal performance. Specifically, when dealing with political economy we

are interested in looking at two primary issues that every political-economic arrangement must deal with: issues of knowledge and issues of incentives. A robust political economy deals adequately with both of these issues. When information is costly, imperfect and asymmetric, a robust political economy produces rational allocation nonetheless. Likewise, when men are selfish knaves, a robust political economy produces socially-beneficial outcomes nonetheless. In short, conditions short of omniscience and benevolence do not cause the system to falter. Even in the face of these problematic imperfections, a robust political economy performs well.

II. Worst-Case Liberalism

1. WHEN MEN ARE KNAVES: THE CLASSICAL ARGUMENT

The Classical economist's argument for liberalism demonstrated its robustness in the face of less than benevolent individuals. It is easy to show that liberalism will work well when all individuals are assumed to be perfectly benevolent. But how does it deal with more realistic assumptions? The Classical economists sought to show that even in the worst-case scenario of a society populated by completely self-interested individuals, the market would ensure that the desires of men would be satisfied without problem. Smith's famous invisible hand postulate illustrated how the process of selfish individuals, each pursuing only their own interests, leads to the promotion of society's interests as a whole.

His most famous quote from the *Wealth of Nations* summarizes this point nicely:

“It is not from the benevolence of the butcher, the brewer, or the baker, than we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love” (Smith [1776] 1976:26-27). Smith assumed for his

analysis of liberalism that men were constituted of “natural selfishness and rapacity” and were driven by “vain and insatiable desires” (Smith [1759] 1976:184). He was taking the hard case. Even in the case of knavish men, however, Smith demonstrated that economic liberalism enabled peaceful social cooperation that lead to increases in productivity. Indeed, he pointed out that liberalism could not only deal with a world of selfish individuals, liberalism actually harnessed man’s self-interested motivation for the benefit of everyone. Under liberalism, selfish and rapacious man is “led by an invisible hand to promote an end which was no part of his intention”—the interest of society. (Smith [1776] 1976:453-71). It was in this framework that the Classical economists formulated their argument for liberalism. As Hayek stated it:

[T]he main point about which there can be little doubt is that Smith’s chief concern was not so much with what man might occasionally achieve when he was at his best but that he should have as little opportunity to do harm when he was at his worst. It would scarcely be too much to claim that the main merit of the individualism to which he and his contemporaries advocated is that it is a system under which bad men can do least harm. It is a social system which does not depend for its functioning on our finding good men for running it, or on all men becoming better than they now are, but which makes use of men in all their given variety and complexity, sometimes good and sometimes bad, sometimes intelligent and more often stupid (1948:11-12).

David Hume’s “On the Independency of Parliament” makes it clear that like Smith, he too is interested in developing a case for liberalism that satisfies the hard case rather than the easy one. “In constraining any system of government and fixing the several checks and controls of the constitution,” Hume argued, “every man ought to be supposed a knave and to have no other end, in all his actions, than private interest.”¹ In this way, Hume, like Smith, demonstrated how liberalism intended to construct a robustness political and economic system by way of a worst-case scenario. Even before Smith and Hume, Mandeville began constructing the case for liberalism’s robustness. The title of his famous essay “The Grumbling Hive” possess the sub-title “Knives turn’d Honest”. He

¹ This passage is quoted from Brennan and Buchanan (2000: 68).

argued that private vice could be harnessed to serve public virtue. As Mandeville(1988: 24) put it:

“The worst of all the Multitude
Did something for the Common Good.”

The early defenders of liberalism assumed the worst about man’s nature and used this to show how liberalism is able to bridle men’s greed for the common good with the market setting.

Ludwig von Mises went as far as to say that the Classical economists, through their insistence on the depraved nature of man, “contributed an essential element to the notion of the godlike state” (1966:690). In describing the worst-case scenario for itself, liberal political philosophy made the state appear as though it were “governed by a perfect superhuman being” in comparison (Mises 1966:690). Indeed, not only did the old liberals assume the worst-case about the nature of the individuals in their system, they also assumed the best-case scenario about those in government. “[T]he simple identification of what is morally good and economically expedient with the plans of the totalitarian dictator that characterizes all champions of planning and socialism was not contested by many of the old liberals” (Mises 1966:691). In fact, in this way, “they originated this confusion when they substituted the ideal image of the perfect state for the wicked and unscrupulous despots and politicians of the real world” (Mises 1966:691). In a world of perfectly benevolent bureaucrats and perfectly selfish market actors, the old liberals showed that “the market economy . . . ultimately attains the same results as a perfect king” (Mises 1966:691). However, precisely because the Classics assumed the

best-case scenario for the state and the worst-case scenario for the market, and were able to show that imperfect markets achieve the same results as perfect government, they were able to demonstrate the robustness of liberal political economy.

2. WHEN MEN ARE STUPID: HAYEK'S ARGUMENT

Just as it is easy to show that liberalism will work well when men are perfectly good, it is equally easy to show that liberalism will work well when men are perfectly informed. But how does liberalism deal with a society of ignorant individuals? Hayek's famous 1945 essay, "The Use of Knowledge in Society," addressed this very question (Hayek 1948). Hayek pointed out that analogous to the division of labor there exists an equally important division of knowledge in the market. No one person has all the knowledge necessary to make the market function effectively. However, precisely because knowledge is dispersed among the millions of individuals that comprise society, through the price system the market is able to effectively coordinate the disparate plans of all market participants. Through the guiding force of market prices, the plans of producers and consumers are harmonized. Prices enable producers to evaluate the past success or failure of their projects in order to determine whether or not they have adequately satisfied the desires of consumers. Similarly, they allow producers to make reasoned anticipations about the likelihood of future success or failure of current and future projects. Via the profit and loss system made possible by prices, resources move out of the hands of those who are not able to use them to consumers' satisfaction and into the hands of more capable producers. In this way, the price system, built on the diverse and decentralized knowledge of the individuals who compose the market, allows all market

participants to economize on costly information. Consumers need not know that they should curtail their consumption of gasoline this week because a natural disaster that hit some far away oil-drilling site destroyed some supply of the oil available. Higher prices at the pumps tell them all they need to know--gasoline is more expensive today—and they curtail their consumption accordingly. Similarly, automobile producers need not have knowledge of the weather conditions in foreign countries that might affect the ability of steel miners to mine on a particular day. All of the information relevant to the automobile manufacturer's decision in making cars is encapsulated in the price of steel. With this simple price he is able to modify his behavior in a way that ensures the coordination of his plans with those of everyone else. Hayek showed that via the price system, markets are able to cope with radically dispersed information and individual ignorance. By assuming the worst-case about the information held by actors under liberalism and showing liberalism's ability to thrive on this "imperfection," Hayek demonstrated the robustness of liberal political economy.

Hayek broadened his argument for the robustness of liberalism in the *Constitution of Liberty* (1960) and later in *Law, Legislation, and Liberty* (1973) where he developed the idea of the importance of particular institutions as the backdrop against which erring and ignorant agents can learn to adapt their behavior so as to coordinate their activities with those of others (Boettke 1999). According to Hayek, the institutions of private property, contract and consent, embedded in a system of general rules that protect these institutions are crucial in ensuring that economic actors are able to utilize their individual knowledge of time and place in making decisions in such a way that their plans may be realized. These institutions Hayek cites are precisely the institutions of liberalism. And

through them, Hayek shows us, liberalism is able to effectively deal with actor ignorance.

In fact, Hayek went as far as to argue that liberalism as an institutional arrangement to guarantee liberty is valued because of our ignorance:

If there were omniscient men, if we could know not only all that affects the attainment of our present wishes but also our future wants and desires, there would be little case for liberty. And, in turn, liberty of the individual would, of course, make complete foresight impossible. Liberty is essential in order to leave room for the unforeseeable and unpredictable; we want it because we have learned to expect from it the opportunity of realizing many of our aims. It is because every individual knows so little and, in particular, because we rarely know which of us knows best that we trust the independent and competitive efforts of many to induce the emergence of what we shall want when we set it (1960: 29).

III. Best-Case Socialism

As we pointed out in section II.1, liberalism's old defenders assumed non-liberal governments were comprised of men motivated by only the best of intentions who desired nothing more than to promote the public good. While it is questionable as to whether or not they actually believed this to be true, maintaining this position nonetheless had considerable rhetorical advantages. We also noted that Mises believed that the continuing myth of government benevolence originated in these thinkers. Because of their insistence on government's goodness, the terms of the debate when Mises and Hayek entered the scene to battle socialism were such that to attack the planner's motivations was to impugn the character of the planners. This sort of critique was deemed invalid. Indeed, Oscar Lange, in the height of the debate over socialism with Mises and Hayek, ruled questions of planner's motivations under socialism as outside the realm of economics and consequently off the table for debate. Such questions, he maintained, reside properly in the realm of sociology, not economics (1936-37: 143). This being the case, in their debate with the socialists, Mises and Hayek were forced (perhaps fortunately) to stick to the assumption of government good will that had its roots

in the Classics. The Classical's assumption, although later questioned by the Public Choice School of economics, was not the major problem confronted by later defenders of liberalism. The problem was when "people began to ascribe to the state not only the best of intentions but also omniscience. Then one could not help concluding that the infallible state was in a position to succeed in the conduct of production activities better than individuals" (Mises 1966:692). From the standpoint of robustness, however, that the incentive issue was unavailable to Mises and Hayek for criticism was a boon to the liberal cause. Mises and Hayek had no choice but to destroy the case for socialism purely on informational grounds, and in doing so they established the fragility of socialism even under best-case conditions. While they were unable to attack the incentive problem confronting socialism, the information question was wide open. Our opening quote from Mises expresses this attitude nicely.

Mises's response to the challenge of deconstructing the case for socialism on information grounds only was formulated in his 1920 essay, "Economic Calculation in the Socialist Commonwealth." Mises's argument in this essay devastated the socialist cause. He begins by assuming the would-be planners of the socialist system want nothing other than to satisfy the desires of the population and that they know the final valuations of the population. "We may assume, for the sake of argument, that a mysterious power makes everyone agree with one another and with the director in the valuation of ultimate ends" (Mises 1966:696). Furthermore, Mises assumes that "the board of directors are people of superior ability, wise and full of good intentions" (1966:696). He also grants, for the sake of argument, "that each individual in a socialist society will exert himself with the same zeal as he does today in a society where he is

subjected to the pressures of free competition” (1920: 120). By doing this Mises is assuming away the motivation problem and focusing on the informational problem socialism confronts. Before leveling the socialist system, however, he even grants the socialists part of the solution to the information problem. He assumes, the “administration may know exactly what goods are most urgently needed . . . It may establish the value attained by the totality of the means of production . . . It may also be able to calculate the value of any means of production by calculating the consequence of its withdrawal in relation to the satisfaction of needs” (1920: 107-108). Finally, he assumes in argument with socialist “that the director has at his disposal all the technological knowledge of his age. Moreover, he has a complete inventory of all the material factors of production available and a roster enumerating all manpower employable. In these respects the crowd of experts and specialists he assembles in his offices provide him with perfect information” (1966: 696).

Mises demonstrates that even under this best-case setup, socialist economy is impossible. While liberalism is characterized by private ownership of the means of production, socialism, by definition, means the absence of such private ownership. Without private ownership in the means of production, exchange in the means of production is not possible. Without exchange in the means of production no prices indicating the relative scarcity of resources can emerge. And without market prices to indicate the relative scarcity of the means of production, rational economic calculation regarding the most appropriate employment of scarce resources is not possible. In short, rational allocation is impossible under socialism. The goal of any economic organization, Mises tells us, is to allocate resources in such a way that no more highly valued desire

goes unsatisfied because the means required for its satisfaction have been devoted to some less highly valued use. Liberalism's use of market prices enables producers to use economic calculation to determine their past success and to appraise future projects. Via this process, resources tend to flow to their most highly valued uses. Socialism, on the other hand, has no method of economic calculation available to it and hence no rational method for allocating resources. Socialist economy is an oxymoron because economy means rational resource allocation. Thus, despite the assumption of best-case conditions socialism cannot work.² Socialism is fragile under best-case motivational conditions, precisely because it will not have in place the appropriate institutional arrangements which provide the necessary informational inputs for rational economic calculation.

Conclusion

Robust political economy requires that the system deal adequately with both motivation and information issues. Under ideal conditions of complete benevolence and omniscience, any political economic organization is workable. But in a world of gods, the notion of economy and with it the science of economics disappears. What political economists in the real world should concern themselves with is how stable various modes of social organization available to us are under real-world incentive and information conditions. Both Hayek and the Classical economists showed liberalism's resilience and ability to pass the test of the hard case. The argumentative strategy was to assume that only self-interested agents populated both the market setting and political positions of authority. They then explain how, on the one hand, liberal institutions of property,

² For a documentary history of the arguments for and against socialism see Boettke, ed. 2000. Boettke's (2000) introduction provides the historical context within which the different arguments were developed.

contract and consent within the economic realm enlist self-interest to generate social cooperation, and, on the other hand, how liberal institutions of constitutional constraint and checks and balances discipline knavery such that even though political man is not transformed he is unable to pursue his knavish ways with impunity. Liberalism, in other words, was an institutional arrangement that both enlisted and constrained our self-interest. Thus, under real-world conditions (and possibly conditions even worse), liberalism can work. Mises and Hayek, on the other hand, showed that even when better than real-world conditions are assumed under socialism, the system collapses. That is, it fails the test of even the easy case. Socialist political economy is proven fragile to deviations from the ideal. How then, can socialism be expected to robustly deal with real world or worse than real-world conditions in the way that liberalism can? Clearly, it cannot. Taken together, the arguments from the Classical and the Austrians demonstrate that while liberalism is robust under both worst-case motivation *and* information conditions, socialism is fragile under both best-case motivation *and* information conditions.

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