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Econ 301—Bethany College

**Lecture 18: The Use of Knowledge in Society**

1. Math in economics
   1. There’s a lot of math in this class, and if you go on to graduate school in economics, there will be even more.
   2. Math is useful—it helps us formulize our thinking—but math is also dangerous since it robs us of the most interesting aspect of the economic system.
   3. Believe it or not, economists don’t become economists because we love doing Lagrangians. What’s exciting about economics it the process of economic activity, not its result.
2. *The Use of Knowledge in Society*
   1. In one of economist F.A. Hayek’s most influential essay, Hayek criticizes the emphasis on mathematics, advocating economists to focus on the role of decentralized knowledge.
      1. Planning occurs on all levels of the economy. The question is if it is better for centralized to decentralized plans.
      2. A central planner does not get to take full advantage of the knowledge of “time and place,” thus decentralized planning will perform better.
      3. Decentralized planning works because planners use prices to convey information.
   2. Local knowledge—knowledge of particular time and place
   3. Explicit knowledge—knowledge that can be easily articulated
   4. Tacit knowledge—knowledge that is difficult to convey
   5. Prices allow us to convey local knowledge, especially local and tacit knowledge.
3. Emergent Order
   1. A lot of economics is taking ideas you practice in your everyday life and apply them consistently to all avenues of human behavior. As a result much of what we talk about seems obvious, if controversial to some.
   2. One idea that is not obvious is *emergent order*—order appears without the central planning of anyone. It boils up in a sort of grassroots way from countless individuals. It is decentralized, contrasted with the centralized planning that people often associate with progress.
      1. Language is a powerful example of what the emergent order can do. The core of every language used today came from countless interactions from countless people. Attempts to centrally create a language (such as Esperanto) ultimately fail.
      2. Markets are, naturally, another powerful example. Remember this is what markets are: not the smoky backrooms of CEOs but the aggregate of the wants and constraints of thousands, millions, or billions of people.
   3. In most circles people call emergent order “spontaneous order” but this is a bit of a misnomer—it is not instant, unplanned, or impulsive. It *emerges*.
4. Qualities of Emergent Order
   1. There is no ultimate list of what emergent orders entails but here are some common themes worth noting. Each one of them relates to the core justification for the effectiveness of emergent orders: the disperse nature of knowledge.
      1. *Methodological Individualism*—A rather hefty way of saying only individuals act. When we speak of “China thinking this” or “Virginia doing that” we are actually speaking nonsense. While this can be convenient shorthand it can also devolve into notions that cannot meld with emergent order. The individual is the only relevant unit of inquiry.
      2. *Prices*—Aggregates relevant information so that it can be passed onto others easily. Because all these individuals are applying their knowledge to the same metric, the price then embodies all that knowledge. People react efficiently even if they don’t know precisely why they are reacting.
      3. *Invisible Hand*—Adam Smith’s famous metaphor to describe how resources are efficiently allocated without an allocator. It forms from individuals seeking their own self-interest through the pricing mechanism. This illustrates how stable cooperation seemingly magically appears from human societies.
      4. *Creative Destruction*—Joseph Schumpeter’s description of a process of constant innovation followed by the elimination of the less worthy developments; good ideas flourish in the competitive process and the bad ones fall away. This establishes how change in emergent orders occur and evolve into the new standard.
   2. Emergent order is not quick nor is it clean. Mistakes occur along the way and it takes time for people to discover and build upon good ideas. But these mistakes are functionally unavoidable if one is to get great ideas.
      1. People often forget this when evaluating popular culture. They compare *the best* of what was with *the whole* of what is—a tremendously unfair comparison. Horrible ideas swarm the bulk of each generation; it is the cost we pay for great ideas.
   3. Mistakes are inevitable in the emergent order, but they are also correctable and they are corrected rather quickly. This self-correcting nature not only eliminates problems when they appear but it also helps prevent problems. Mistakes are corrected quickly because they are costly. Because they are costly, people will work hard to avoid them.
      1. Lead paint in toys from China a few years back added to the call for more regulation on imports. But the market responded too: companies appeared specializing in toys made in the US while firms such as Hasbro deployed countless quality control managers to China.
5. Applying the Emergent Order
   1. Most of doing good economics comprises of asking “And then what?” whenever someone proposes a new policy or rule. This question reminds us that the emergent order is always with us and people will respond to change in seemingly unpredictable ways.
   2. We can use a similar strategy to judge the explanatory power of a claim. If it’s nonsense, then a reasonable response to the assertion wouldn’t be happening (unless there’s some sort of barrier preventing it from happening).
6. Pay gaps.
   1. It’s true—men, on average, are paid more than women. But is it mainly because of sexism?
      1. Suppose it is. That means there are millions of qualified women that a firm could hire for substantially less than a man. Since firms are greedy, we would expect to see that happen but we don’t.
   2. Economists generally argue it’s due to factors rooted in psychology and biology.
      1. For whatever reason women tend to dislike the natural sciences as well as economics and finance. Psychology, sociology, English, theatre, and fine arts are more common. Most of these disciplines (for unrelated reasons) tend to pay less.
      2. Because of the possibility for pregnancy (and thus several months to a year of no worker, plus the possibility of quitting altogether), women also tend to be paid less. Firms are less likely to hire them and, knowing they could be out of the job for a while, women tend to move to jobs with a low level of obsolescence (secretaries, data entry, etc).
   3. One way to check this is to compare men and women salaries under circumstances where most of these changes are not there.
      1. “Among college-educated, never-married individuals with no children who worked full-time and were from 40 to 64 years old—that is, beyond the child-bearing years—men averaged $40,000 a year in income, while women averaged $47,000.”[[1]](#footnote-1)
7. CEO Pay
   1. CEOs of large companies are paid a great deal, particularly if you include benefits and severance packages. Does that mean it’s too much?
      1. Suppose it is too much. Why do boards pay them it? Why don’t they hire someone else at a much lower cost?
   2. There are several reasons for their high incomes.
      1. Large firms have a lot at stake and even miniscule improvements in the CEO can mean saving millions.
      2. Even if a CEO does a bad job compared to other CEOs, that does not mean most people could do better. And a struggling business does not mean a bad CEO.
      3. Even if the CEO turns out to be really bad, getting rid of him or her could be worth paying a generous severance package. Avoiding office politics and court battles is very valuable. (Similar events happen with tenured professors and in divorce settlements.)
   3. Indeed the highest paid CEOs are ones who run companies owned mainly by financial institutions—the ones who see the company as an investment and have a vested interest in knowing the most about it.

1. Sowell, Thomas. *Economic Facts and Fallacies*, 2008. [↑](#footnote-ref-1)