



## Revisiting Hayek's Political Economy

Why Hayek Matters: The Epistemic Dimension of Comparative Institutional Analysis

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### Article information:

**To cite this document:** Peter J. Boettke Vlad Tarko Paul Aligica . "Why Hayek Matters: The Epistemic Dimension of Comparative Institutional Analysis" *In* Revisiting Hayek's Political Economy. Published online: 30 Nov 2016; 163-185.

Permanent link to this document:

<http://dx.doi.org/10.1108/S1529-213420160000021006>

Downloaded on: 06 December 2016, At: 07:25 (PT)

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# WHY HAYEK MATTERS: THE EPISTEMIC DIMENSION OF COMPARATIVE INSTITUTIONAL ANALYSIS

Peter J. Boettke, Vlad Tarko and Paul Aligica

## ABSTRACT

*Hayek's "Use of knowledge in society" is often misunderstood. Hayek's point is not just that prices aggregate dispersed knowledge, but also that the knowledge embedded in prices would not exist absent the market process. Later, in The Constitution of Liberty, he argues that this same idea can also be applied to the study of political and collective choice phenomena. Democracy is not just about aggregating preferences. Absent the democratic process, the knowledge necessary to solve collective problems is not generated. We compare this perspective on democracy to Bryan Caplan's and Helen Landemore's theories, and we argue that Hayek's account focused on "opinion falsification" is richer. Unlike Caplan or Landemore, who adopt a static perspective, Hayek is more interested in the long-term tendencies and feed-back mechanisms. For example, why do Western democracies seem to have gradually moved away from the most deleterious types of economic policies (such as price*

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Revisiting Hayek's Political Economy  
Advances in Austrian Economics, Volume 21, 163–185  
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ISSN: 1529-2134/doi:10.1108/S1529-213420160000021006

*controls)? Hayek's conjecture is that the democratic process itself is responsible for this. We connect Hayek's conjecture about democracy to the broader argument made by Vincent Ostrom, who has claimed that public choice should study not just incentive structures, but also collective learning processes. We believe that this line of research, that is, comparative institutional analysis based on the collective learning capacities embedded in alternative institutional arrangements, merits a lot more attention than it has received so far. The question "Which collective choice arrangements have the best epistemic properties?" is one of the most important neglected questions in political economy.*

**Keywords:** Hayek; use of knowledge; epistemic turn; public choice; democracy

[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 as possible to do harm when he was at his worst. It would scarcely be too much to claim that the main merits of the individualism 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. Their aim was a system under which it should be possible to grant freedom to all, instead of restricting it, as their French contemporaries wished, to "the good and the wise."

— Hayek (1948, pp. 11–12)

## INTRODUCTION

Traditional economics examines individuals' choices in light of their constraints. Actors must weigh the costs and benefits of each decision. In light of this conundrum of choice within constraints, we tend to talk about *incentives*. Yet any discussion of incentives (their nature, structure, function, and dynamics) implies a discussion of information, knowledge, and learning processes. In order for people to learn through time how best to cope with their constraints, they must not only have the incentives to get the decisions right but they must also have access to correct and relevant *information* for the context in which they decide and for evaluating past

decisions. Their environment should facilitate learning: from nature, from others, and from their own and others' past mistakes.

Both incentives and information are by-products of the *institutions* within which individuals make choices and learn from the past. Analysis that seeks to make progress in understanding the social world has therefore to account for the institutional environment within which they are acting in order to understand how information is produced, evaluated, and changed.

Political economy at its finest examines whether alternative institutional arrangements are conducive to, or a hindrance to, the realization of productive specialization and peaceful cooperation among diverse individuals constituting the society under investigation. As such, it has to combine an analysis of incentives with one emphasizing the epistemic processes taking place. This is the context of Hayek's contribution to political economy. One of the major merits of Hayek's work is that (a) he disentangled the epistemic dimension from the one focused on incentives; (b) he has developed a set of insights about the facets and operations of this dimension in the context of market processes; (c) he has created the foundations for extending the analysis of the knowledge process from market settings to political and governance settings, via institutional and constitutional analysis. In so doing, he has articulated a perspective that avoids the traps and temptations of scientism and social engineering, and which, as a result, has major normative relevance.

As the above quote suggests, Hayek has offered an approach claiming its roots deep in the moral philosophy and classical political economy of the Scottish Enlightenment. He aims to revive an alternative perspective on society to one that could be termed the "design" or "rationalistic" approach. The rationalistic approach, according to which human institutions can be a product of comprehensive conscious design, rather than just reasoned reform, has provided the main arguments for socialism and collectivism in the late 19th and 20th century. By contrast, the classical political economy tradition, revived by Hayek thanks to his analysis of the role of knowledge in society, holds that people are fallible creatures "whose individual errors are corrected only in the course of a social process, and which aims at making the best of a very imperfect material" (Hayek, 1948/1980, pp. 8–9). In brief, the theoretical perspective focused on epistemic processes, as developed by Hayek, has substantive normative undertones which, as mentioned, aim to avoid the temptations of scientism and rationalist constructivism.

Our paper revisits Hayek's epistemic perspective from several different but related and convergent angles. Our hope is that, in conjunction, they

illustrate the distinctive nature and specific relevance of the Hayekian vision. Next section discusses Hayek's turn toward an *epistemic* understanding of markets in the 1930s. It is this theme, we argue, that unites Hayek's research program from his paper "Economics and Knowledge" (1937) to his Nobel lecture "The Pretense of Knowledge" (1973). The section "The Epistemic Properties of Democracy" illustrates how epistemic insights similar to those acquired in the study of market processes emerge in a natural way in the field of public choice and governance studies. The development of the neoclassical theory of politics, or public choice, leads sooner or later to an interest in the epistemic dimension, on the same lines – *mutatis mutandis* – sketched by Hayek. The following section applies a Hayekian lens to the recent literature on the epistemic problem as related to modern democracy, in particular Bryan Caplan's *Myth of the Rational Voter* and Helene Landemore's *Democratic Reason* (2013), illustrating how Hayek's dynamic perspective illuminates the limits of those approaches. We conclude with a discussion of the relevance of the epistemic dimension in economics and politics, highlighting the continuing relevance of Hayek's ideas as part of a progressive research program in the social and policy sciences.

## HAYEK AND THE EPISTEMIC PERSPECTIVE IN ECONOMICS

In "Economics and Knowledge" (1937), Hayek argued that theorists had been misled by the assumption of perfect knowledge on at least two levels. First, he argued that if we take this assumption seriously, the model eliminates the profit motive driving economic activities, and hence obscures how the market process works. A profit opportunity known to everyone is realized by nobody. Perfect knowledge, rather than being an assumption, was the defining characterization of a hypothetical competitive equilibrium. To illustrate his point in a slightly different way, the optimality conditions of price equal marginal cost, and production at the minimum of average costs of production were not assumptions of the model, but by-products of the competitive process. Optimality results from the filters of the price system – freely adjusting relative prices and accurate profit and loss accounting – working to guide the production plans of some to mesh with the consumption demands of others. Prices guide production, and calculation enables coordination.

Second, Hayek argued that theorists were wrong to highlight behavioral assumptions, such as perfect knowledge, rather than the institutional conditions that enabled the price system to adapt and accommodate the ceaseless change of a dynamic economic system, and steered economic actors to learn what they needed to learn, when they needed to learn it, so as to coordinate their plans with those of others and to do so in a way that resulted in the achievement of an equilibrium state of affairs. Markets, in Hayek's rendering (1946/1980, 1968/2002), become learning mechanisms, and how effective they are at performing this function depends on the institutional environment within which they operate.

Hayek's basic insight is that the institutional framework within which economic activity takes place matters are better or worse at providing incentives for agents to discover and make use of information specific to their unique time and place, as well as providing feed-back mechanisms for updating this information as conditions change. The importance of context was lost with the assumption of perfect knowledge, and the theoretical apparatus of the perfectly competitive model de-emphasized the learning by economic actors in response to changing circumstances. As Hayek would put it in "The Use of Knowledge in Society," the economic problem that society must address is not the allocation of "given" resources among competing ends. The "data" of the market is never "given" to a single mind or even collection of minds. Rather, the problem is "the utilization of knowledge which is not given to anyone in its totality" (1948/1980, p. 78). Furthermore, the discovery and use of the relevant knowledge emerges only within the market process itself, as economic actors react and adapt to changing circumstances. "It is," Hayek wrote, "perhaps, worth stressing that economic problems arise always and only in consequence of change" (1948/1980, p. 82).

The price system, through relative price adjustments, is constantly adapting to the ever-changing circumstances of economic reality. The least cost method of production that an enterprise can pursue must be discovered and implemented, just as the flow of goods and services that will satisfy the demands of fellow citizens is revealed only in the pattern of exchange and production as it forms over time. Ellig (1994) notes that, in Hayek's account, "competition does not create its principal benefits by beating prices down to marginal costs," as in the simpler neoclassical formal approach which assumes that costs are given, but rather "competition for profits forces down costs, and prices eventually follow." Moreover, "competition for profits also generates value for consumers by spurring entrepreneurs to create new products and services." The incentive to

discover new methods of cutting down costs *on the relevant margins* only exists in the competitive market environment. The socialist calculation argument also applies to the problem of allocating research and development resources. In the absence of market prices for factors of production, research and development cannot be guided by economic calculation, but only by either ad hoc (“planned chaos” to use Mises’ term) or political reasons. The way in which the market system generates new knowledge is by incentivizing entrepreneurs to discover cost-cutting measures along the relevant margins, that is, the margins that give the biggest “bang for the buck” in terms of satisfying consumer demand. It is along those margins that the biggest profit increases can be made, hence the incentive. We thus see how, in this account, information and incentives are embedded in a unified account of entrepreneurial production. Indeed, one of the least well-appreciated points of Hayek’s (1945) account of the division of knowledge in society is that, absent the system of market prices, the knowledge will not be generated at all, because the incentive to find it (i.e., profit) is not there. Hence, in a centrally planned system, or even when prices are distorted, we are not dealing just with a failure of aggregating existing knowledge, we are dealing with an *incentive failure* to generate the knowledge that would allow the most efficient cost-cutting developments.

What follows from this argument is that the knowledge communicated and acted upon in this process of adaptation to changing tastes, technology and resource availability is not the sort of knowledge that can be entered into statistics. The knowledge used in the market economy is knowledge of the “circumstances of time and place” that only individuals actively engaged in the buying (or abstaining from buying) and selling (or abstaining from selling) of goods and services on the market. And, thus, we must reconceive of “the economic problem of society is mainly one of rapid adaptation to changes in the particular circumstances of time and place” (Hayek, 1948/1980, p. 83) and the price system as the solution to the problem by guiding production plans and coordinating those plans with the consumption demands of those willing to buy in the marketplace. It is the “higgling and bargaining” of the market economy, as Adam Smith taught, that brings about the coordination of economic activity through time.

Hayek came to focus on this issue of the acquisition of knowledge because the misunderstanding among economists about the limitations of the pure logic of choice and the nature of equilibrium had resulted in theoretical and practical confusion. As he would put it at the end of “The Use of Knowledge in Society,” there must be something fundamentally wrong with an approach – no matter how strong its merits – when it leads to the

disregard of the fundamental problem under investigation. We are, Hayek stressed, very imperfect creatures interacting with other imperfect creatures in a very imperfect world, and thus the central mystery of social cooperation under the division of labor is how certain institutional patterns will engender a pattern of human interaction where the necessary knowledge for plan coordination is constantly communicated and utilized by actors within the economic system. "Any approach," Hayek states, "such as that of much of mathematical economics with its simultaneous equations, which in effect starts from the assumption that people's *knowledge* corresponds with the objective *facts* of the situation, systematically leaves out what is our main task to explain" (emphasis in original). The pre-reconciliation of plans does little to explain the process by which disparate, and often divergent, plans come to be reconciled with one another. Again the *process* by which the knowledge necessary for this reconciliation of plans comes about is completely ignored in the analysis. As Hayek concludes, "I am far from denying that in our system equilibrium analysis has a useful function to perform. But when it comes to the point where it misleads some of our leading thinkers into believing that the situation which it describes has direct relevance to the solution of practical problems, it is high time that we remember that it does not deal with the social process at all and that it is no more than a useful preliminary to the study of the main problem" (1948/1980, p. 91).

Hayek's contention in this passage is that the equilibrium properties of the competitive system should be in the background of an analysis of the competitive market process, rather than in the foreground as they became in standard textbook presentations of the model of perfect competition and the overall model of general competitive equilibrium as it evolved during the middle decades of the 20th century of economics. To counter the dominance of perfect knowledge assumption and equilibrium modeling, Hayek argued in "Economics and Knowledge" that "we must explain by what process they will acquire the necessary knowledge" (1948/1980, p. 46). In this effort, the pure logic of choice is a necessary, but certainly not sufficient, component of the explanation of market coordination. The optimality conditions of competitive equilibrium must be understood as a by-product of the economic process under conditions of private property and freedom of contract, they should never be treated as the assumptions from which the analysis proceeds.

Hayek's "epistemic turn" in economics was precisely due to the tendency among his contemporaries in economics to evade the critical questions of the institutional infrastructure, or what more recently has been dubbed the



“ecology” within which human decisions and economic activity transpires (Smith, 2007). The assumption of “quasi-omniscient” individuals does little to help us make progress even in understanding fundamental propositions in economics such as the law of one price. Economic science emerges, Hayek argued, from the observation of the tendency of the subjective plans of economic actors to dovetail over time with the objective facts of the economic situation. To clarify, we can refer to the “objective facts” of the situation as the existing state of tastes, technology and resource availability, and the market process guided by relative prices, and the lure of profit and the penalty of loss, will tend to produce a situation where the pattern of exchange and production corresponds with the external facts. Rather than solving this central mystery of economics through the assumptions of perfect knowledge and perfect markets, Hayek argued that we must explore (1) the institutional conditions under which the tendency exists, and (2) the process by which the knowledge that individuals are acquiring and utilizing changes to bring about this dovetailing of economic plans through time.

## THE EPISTEMIC TURN IN PUBLIC CHOICE

Public choice economics emerged in the 1960s as a counter to the then-dominant market failure theory (Buchanan, 1979/1999, 1987/2001; Buchanan & Tullock, 1962/1999, chapter 5; Ostrom & Ostrom, 2004). The terms under which the socialist calculation debate was conducted between Mises-Hayek and Lange-Lerner had shifted to a considerable extent. In that earlier debate, Lange had ruled out questions about the incentives faced by socialist economic planners. He deemed such questions a matter of psychology and not pure economic theory. To counter Lange’s framing of the debate, both Mises and Hayek respectively sought mainly to challenge the assumption of omniscience, while granting the assumption of benevolence, although, as we have seen, when one discusses entrepreneurial production one must consider knowledge and incentives simultaneously. Nonetheless, Mises and Hayek were willing to grant, for the sake of argument, the assumption that economic planners, bureaucratic agents, state-owned enterprise managers, and the workers in the farm and the factory were all rightly motivated to do the right thing to achieve the public interest.<sup>1</sup> The question for Mises and Hayek was how would they *know* what is the right thing to do in order to realize the public interest in a complex economic order with shifting tastes, technology and resource availability?

Thus, the strategy pursued by Mises and Hayek was to leave the benevolence assumption alone and focus their efforts on examining the consequences of relaxing the omniscience assumption. At first, public choice economics seemed to do the opposite – leave the omniscience assumption alone, but challenge the benevolence assumption. What incentive, public choice economists asked, do public officials, voters, and special interests face in supporting, advocating, and implementing public policy? By systematically examining the incentives within the political process, public choice economists were able to identify numerous sources of systemic government failure (Mueller, 2003; Shugart & Razzolini, 2001; Simmons, 2011; Tullock, Seldon, & Brady, 2002). Markets may indeed fail, but the proposed governmental remedy might exacerbate that failure rather than provide the solution (Winston, 2006).

In developing the theory of government failure, public choice economists relied upon the consistent and persistent application of neoclassical economics to examine the arena of politics. The result was a theory that tended to emphasize interests rather than ideas in understanding political outcomes (Rubin, 2001). Yet the epistemic problem was looming in the background and sooner or later it had to reemerge to the limelight. In short, public choice reproduced the same tensions in the analysis of politics that Hayek had identified as tensions in the neoclassical model of the market (Ikeda, 2003). Rational choice theory morphed into a close-end model of decision science, and the examination of politics as exchange morphed into a single-exit model of a structure-induced political equilibrium. However, while the neoclassical logic was leading more or less automatically in that direction, the insights of some key public choice scholars were pointing in different directions.

Buchanan (1969, 1989/2001, 1993/2001) sought to resist this “conceptual closure” of public choice, and his own development of the constitutional level of analysis was one such attempt to offer an alternative that accounted for human decision makers engaged in bargaining activity, and transforming situations of conflict into opportunities for cooperation through constitutional craftsmanship. He was joined in that effort from different angles by authors such as Ostrom and Ostrom (2004, 2014) who argued that to truly grasp the importance of constitutional craftsmanship one had to relax the neoclassical constraints and pay attention to knowledge and learning processes. The idea of learning-based changes of the rules of the game was brought into the picture. Similar to Hayek’s suggestion with respect to market theory, a critical part of the Ostroms’ work was the rejection of the assumption of omniscience, and of the belief that one-size-fits-all solutions

to social dysfunctions exist. Instead, they focused on adaptability, resilience, and learning under conditions of change and uncertainty. That was done on a background on which beliefs, values, and language matter as basic parameters of the action situations and action arenas (E. Ostrom, 1998, 2005, 2010, 2014; V. Ostrom, 1999; Ostrom & Ostrom, 2014).

The epistemic perspective in public choice may be simply and straightforwardly seen as a natural evolution of its game theoretical apparatus. Once game theory has become a basic tool of the public choice paradigm, the “epistemic turn” claimed by V. Ostrom (1993) is not anymore surprising to anyone familiar with the evolution of applied game theory in the last half a century: From classical game theory via evolutionary game theory and behavioral game theory, towards epistemic game theory. Epistemic game theory focuses on the cognitive dimensions of strategic interactions, on the problems of knowledge, expectations, and shared understanding in strategic situations. That in itself clarifies any methodological or foundational-formal misunderstanding regarding the notion of epistemic processes (including epistemic choices and meta-level decision making regarding knowledge and information). Yet probably the epistemic dimension as framed within public choice is best understood in the context of constitutional political economy of which Buchanan and the Ostroms have been prominent practitioners. In both cases, the appeal to the epistemic element via a formulaic and formal invocation of game theoretic models would have seemed – as in Hayek’s case – an easy way to avoid a difficult social science challenge. Hence we see authors such as Buchanan and the Ostroms grappling these problems in institutional and political economy frameworks.

For instance, as Buchanan (1989/2001) put it, the pattern of outcomes in an economic system “emerge from the whole set of interdependent choices made by individuals as these choices are constrained by the *structure* of the economy” (p. 268). One individual’s choice *within* a given structure can exert only negligible effects upon the overall, aggregated, pattern of outcomes. As such, to the extent that “the pattern of results is subject to deliberative change,” this can only happen “through effective changes in structure, that is, in the set of rules that constrain the exercise of individual choices within the rules” (p. 270). But once again, assuming, especially within a democratic context, that “the individual can exercise no influence on the structure of the economy as he chooses separately and independently among the options that he confronts,” it follows that “any choice among alternative sets of rules must be, and can only be, collective.” That collective choice process requires however an information and knowledge base. Choice presumes a minimal understanding, an evaluation of

alternatives. Incentive-based analysis has to incorporate sooner or later the epistemic element. V. Ostrom's (1997) emphasis of the importance of "shared communities of understanding" for the emergence of productive social orders focuses on a deeper, "constitutive" level but follows the same logic. Meta-constitutional beliefs and values shape the very nature incentives are seen and operate. Ideas come into the picture both with a framing and a normative function. Once this is established, the questions about knowledge and incentives are now moved to the level of the collective. *Under what institutional system does the collective most effectively use available information and learns from past mistakes? What incentives do individuals have, under alternative institutions, to search for new ideas about how to change the structure of the economy such that the aggregated pattern of outcomes is improved according to the opinion of as many members of the community?* The interplay of incentives and knowledge processes in constitutional-institutional analysis becomes salient.

The analysis of coordination and cooperation in public arenas – that is at the core of public choice – thus assumes and implies the epistemic dimension in multiple ways. In more recent work, the incipient theory of "public entrepreneurship" can be seen as trying to map the action arena and the parameters of changing the structure of rules in a direction of increased self-governance (Klein, Mahoney, McGahan, & Pitelis, 2010; Oakerson & Parks, 1988). This is different from the more well-known theory of political entrepreneurship and rent-seeking, according to which political actors only cater to various special interests while harming less well-organized groups in society (Olson, 1982; Wagner, 1966).

One can further complicate the theory by acknowledging not only heterogeneity, but also the malleability of values and opinions (Katznelson & Weingast, 2005). Preferences need not be assumed as given and that introduces into the picture a process in which knowledge and learning are crucial. As Boettke and Coyne (2009) note, one can provide an entrepreneurial theory of social change by mapping the private benefits that "social entrepreneurs" can get as a result of becoming focal points and facilitating the emergence of a certain uniformity of values and beliefs. The presence of such entrepreneurs makes social coordination easier than one might believe just from a fixed preferences account. Furthermore, ideas come to serve as focal points, and ideas guide actions, including attempts at changing the institutional framework, and influence the way in which people interpret their private interests (López & Leighton, 2012; Storr, 2012; Tarko, 2015a).

In the same way that the Hayekian theory of competition as a discovery procedure melds together knowledge and incentive problems in an

inseparable whole, so must an epistemic-entrepreneurial theory of public choice. In such a theory one may look at institutions as facilitators and shapers of decisions at different levels (operational public choice, constitutional) via knowledge processes. Knowledge generation, aggregation, distribution and the uses of knowledge become both dependent and independent variables in relationship to institutional structures and change. In brief, there are multiple ways in which the epistemic dimension manifests and materializes itself in the public choice research program, at the level of its theoretical hard core as well as its peripheries, both in the older and in the more recent generations of scholars.

V. Ostrom's (1993) challenge to his fellow public choice theorists to move beyond envisioning the theory as little more than an appendage to neoclassical price theory is a plea to make more explicit and systematic what is already present in various forms and degrees. One needs to go beyond simple price theory, insists Ostrom, because, at the simplest and most elemental level of relevant neoclassical theory applications, as noted above, individual choices within rules don't affect much the structure of the economy, and price theory only describes choices within the given rules. The key is the nature and change of rules and epistemic processes are heavily significant for that. Discovery and diffusion of ideas matters. As argued by V. Ostrom (1993), if in the end all public choice amounts to only is an appendage to price theory ignoring the essential problem of knowledge discovery, then the future progress in public choice analysis is bound to be minuscule at best. But instead, the future and progress of public choice scholarship is to be found in puzzling over the complexities of social dilemmas and anomalies. It is only by taking the epistemic perspective seriously that public choice can be a progressive research program.

What does the "epistemic choice" perspective advocated by Vincent Ostrom mean more precisely in a political economy and institutional analysis context? Based on the existing literature four major areas emerge:

- (a) A useful starting point is recognizing that Hayek himself has noted and explored the implications of the knowledge problems for the evolution of social norms and institutions: The intricate web of mutual expectations that are at the foundation of basic social institutions, a system of mutual expectations that evolve over time and generate specific institutional configurations. This is in fact the most basic direction of epistemic analysis in public choice/institutionalism settings: The evolutionary and process analysis of the nature, structure and change of non-market institutions in the light of knowledge problems and their solutions.

- (b) The second direction is the study of the epistemic properties of specific institutions, the comparative analysis of the structure and performance of different institutions in the light of the knowledge problem(s). The comparative analysis of the epistemic properties and performance of market and democracy is a salient and easy example in this respect. The recent interest in “epistemic democracy” problems and its claim that “the rule of the many” outperforms as a public decision mechanism, alternative arrangements is another example, in this case one more strictly focused on a governance and public choice domain. We discuss these matters more in the next section.
- (c) The third direction is to go beyond the complex, emergent processes, and look at the capabilities and limits of institutional design and at the role of knowledge production and specialization in social systems. At its core, this approach explores the epistemic division of labor and the relationship between codified general knowledge and the informal, local and dispersed knowledge in social change, social design and social control (Devins et al., 2015). As Buchanan put it, to explore “the room left for the political economist or anyone else who seeks to reform social structures to change laws and rules with the aim of securing increased efficiency in the large” (1986, pp. 75–76). This line explores the role of social scientific knowledge and the tension generated by the idea that “any attempt to design, construct and change institutions must [within the spontaneous order setting strictly interpreted] introduce inefficiency” (pp. 75–76).
- (d) Last but not least, one must consider problems related to the so-called meta-constitutional level (Ostrom & Ostrom, 2004): the system of beliefs, values, ideas culturally and historically and evolutionary accumulated knowledge framing at a deeper level the constitutional, institutional, and public governance arrangements. The overview of the epistemic-based approaches reveals, at all levels, not only at this last one, a deep convergence and intertwinement with the institutionalist perspectives.

Ironically, though not necessarily recognized this way by the institutionalists and public choice scholars, it was Hayek who, alongside of his epistemic turn in economics, had taken an early version of the institutional turn in politics and institutional analysis. *The Road to Serfdom*, for instance, employs a combination of institutional and public choice elements in analyzing the epistemic properties of politics. Heterogeneous and diverse actors may be able to agree on broad principles of the way we should engage each other as equal citizens, but they cannot come to agreement on very specific

demands that would be required if socialist economic planning was to be pursued. Socialist planning, Hayek argued, was incompatible with the rule of law, and also with viable notions of liberal democracy. Liberalism, on the other hand, created a framework that unleashed and utilized the creative power of a free civilization. All that diversity and heterogeneity goes to work in the complex division of knowledge in society. Liberalism creates scope for learning within its operation, in fact, it depends on such learning. But this characteristic of the liberal order also means that the liberal order itself is learning. Just as Hayek had argued with respect to the learning capacity of the market, his theory of the polity also emphasizes the ways in which individuals come to learn how to build institutions for cooperation. To do so, they need to gradually build an institutional and cultural framework within which the benefits from cooperation outweigh the benefits from aggression, and the knowledge about how to improve the system can be discovered and acted upon.

The key to further elaborating the Hayekian perspective focusing on the epistemic dimension of social order is the parallelism between the analyses of epistemic processes defining the market and the extension of that type of analysis to non-market settings. Hayek has created through his studies of the market processes a model and a benchmark for a similar approach in non-market settings. The question is: How far can we take the market-based Hayekian insights into non-market territory? The problem for public choice and institutional theory is thus not only to acknowledge and take seriously the “epistemic choice” challenge. The key problem concerns the specifics. How to tailor the epistemic approach such that it can be applied to the entire range of diverse institutional structures of the modern society, economics, and politics?

## THE EPISTEMIC PROPERTIES OF DEMOCRACY

Let us take a step further now and – within the wide range of epistemic/knowledge process approach to non-market institutions inspired by Hayekian insights – focus on one specific theme or direction of analysis. In doing so, we’ll be able to advance our argument by using this theme, give it more substance, and better illustrate the complex dimensions of the epistemic processes analysis, while also anchoring it in more recent debates in the relevant literature. Hayek (1960, p. 171) noted that although “it is reasonable that [collective tasks] should be decided by the majority ... it is not obvious



that the same majority must also be entitled to determine what it is competent to do.” This position is currently a hotly debated area. The emphasis on how citizens learn, and how political systems process the necessary information for that learning, is now a very deeply discussed aspect of democratic society, and its contrast with non-democratic systems (Wohlgemuth, 2002).

Many recent works, such as Bryan Caplan’s *The Myth of the Rational Voter* (2007), have challenged the collective intelligence of democracies, not really on epistemic grounds, but on incentive grounds (see also Brennan 2016; Somin 2016). In Caplan’s theory, when individuals find themselves in an environment where holding wrong (but often psychologically satisfying) beliefs will not be penalized severely, we can expect to see more wrong beliefs being held; sometimes with great passion and even confidence. This, Caplan argues, is the realm of democratic politics, an environment where it is rational to be irrational about whatever opinions one holds and cherishes. Caplan maps out a number of highly relevant and widely held biases, and shows that these biases will not be canceled out in the democratic political process. Instead, mistaken public policies will predictably be adopted. Because people are not individually punished for holding mistaken beliefs about public issues, they have no incentives to learn and develop more accurate views. As a result, modern democratic governments suffer from a “garbage in, garbage out” problem.

One the other hand, the political theorist Helene Landemore in her book *Democratic Reason* (2013) attempts to argue by way of the “miracle of aggregation” that the “wisdom of crowds” saves democracy from the sort of problems that Caplan and others have identified. There is a subtle issue here that we should stress, and that is that Caplan’s argument does not necessarily turn on the intelligence of the voters, but on the incentives they face. Under *some* institutional environments, Landemore is indeed correct that the knowledge generated in the process will exceed the ability of any one mind or even sub-group of minds. The collectivity will in fact exhibit more intelligence and/or wisdom than any of the individuals within the system. But the critical condition to deriving that conclusion is the *right institutional environment*.

Landemore takes on the hard case of a democratic decision that goes against one of her cherished beliefs. However, upon reflection she believes that the result should feedback and give her pause about the correctness of her cherished opinion. Democratic citizenship requires such a willingness to learn from the wisdom of the crowd, as much if not more, than the capability of contributing to the collective formation of that wisdom through active participation in the democratic process of collective action. But how



general is this argument? Caplan deliberately chooses relatively uncontroversial issues for the economist, such as the belief that free trade is beneficial. How many economists are going to change their minds about this issue *because* the presumed “wisdom of the crowds” of the general population goes against it? We presume that very few of them. Which brings us back to the issue of the institutional environment. The reason why economists shouldn’t probably change their minds about such widely accepted issues is because the institutional framework of science is such that it generally leads to the discovery of truth (Polanyi, 1962; Tarko, 2015b; Tullock, 1966). *By comparison*, the institutional environment under which popular opinion forms is less conducive to the discovery of truth. In other words, our confidence in the opinion of professional economists over that of the general public is based on a comparative institutional analysis.

One can see Caplan and Landmore as two incomplete sides of the problem. Caplan analyzes incentive problems in knowledge formation about collective issues, while Landmore notes that under some conditions (of unclear realism) these incentive problems become more or less irrelevant. If one reads Hayek, one is bound to find this debate too static. After noting that “[d]emocracy is the only method of peaceful change that man has yet discovered” (1960, p. 172), and that “democracy is an important safeguard to individual liberty” because “it can scarcely be to the advantage of a majority that some individuals should have the power arbitrary to coerce others” (p. 173), he continues by saying that “democracy is the only effective method of educating the majority” and “[d]emocracy is, above all, a process of forming opinion” (p. 174):

Its chief advantage lies not in its method of selecting those who govern but in the fact that, because a great part of the population takes an active part in the formation of opinion, a correspondingly wide range of persons is available to select. We may admit that democracy does not put power in the hands of the wisest and best informed and that at any given moment the decision of a government by an elite might be more beneficial to the whole; but this need not prevent us from still giving democracy the preference. It is in its dynamic, rather than in its static, aspects that the value of democracy proves itself.

Interestingly, this dense passage contains a critique of both Caplan and Landmore. On the one hand, it accepts Caplan’s static argument about the irrationality of the public at each moment in time. In fact, anticipating Caplan’s technique of simulating the preferences of an “enlightened public,” Hayek explicitly writes that majority decisions don’t reflect “what it would be in their interest to want if they were better informed” (1960, p. 175). This, however, is less important for him than the fact that

democracy provides a mechanism for (1) altering public opinion rather than simply responding to it, and (2) fermenting change by offering a certain degree of free entry into the political arena. Point (1) is less well studied than it should be. For example, when one looks back even a few decades ago one finds not just that some remarkably bad policies were in place (such as extensive price controls), but also that they would be almost unthinkable today. *How* did the climate of opinion improve? Is Hayek correct that it is the democratic process itself that is responsible?

This being said, point (2) goes against Landemore's approach to defending democracy. Hayek, like Buchanan (1959, 1967), rejects the idea that democracy is a truth-seeking enterprise: "there is a convention that the view of the majority should prevail so far as collective action is concerned, but this does not in the least mean that one should not make every effort to alter it" (Hayek, 1960, p. 175). Moreover, "[o]ne may have profound respect for that convention and yet very little for the wisdom of the majority" (p. 175).

Instead of relying on the "wisdom of crowds," his defense of democracy hinges on the idea of peaceful contestation and competition, dovetails, and actually significantly strengthens, Buchanan's (1954) critique of Arrow's impossibility theorem (Arrow, 1951; see also Pettit, 2012). For Hayek, majority opinion at any point in time can never be trusted to reflect truth, and, yet, the process of democratic contestation and competition over time tends to eliminate the most deleterious views as the public learns what to *avoid*. Similarly, Buchanan stressed that (a) one should never expect to be able to aggregate across individuals into a stable social welfare function (see also V. Ostrom, 1987; Riker, 1982, p. V), and (b) that cyclical majorities is not a problem for democracy, but actually one of its strong points because the existence of such cycling means that no one group is exercising dominion of any other set of individuals over long periods of time. Instead, we would experience "turn taking" at exerting control over the institutions of political power.

The Hayekian focus on process and the dynamic of collective learning brings to mind further developments such as Friedman's "Long and Variable Lag." Milton Friedman argued that in making public policy decisions to address social ills, government analysts must first (a) recognize the problem at  $t_0$ , (b) design a policy response, (c) get that policy response implemented at  $t_1$ , and (d) wait for that policy to have an impact on a complex economic system in  $t_2$ . This policy-making process takes place through time ( $t_0$ – $t_2$ ). And that is precisely the potential problem, because (d) may actually be sometime down the road from (a), and in the meantime things may indeed have changed again such that (b) is no longer the right

response to the situation, and in fact may result in new destabilizing results in the economy. Friedman used a variant of this argument to make his case for rules versus discretion in monetary policy, and we are suggesting that it may have a much wider application to the world of public policy formation and implementation within a democratic polity. And thus this simple question of *timing* may impact the epistemic quality of the policy process.

Friedman's long and variable lag problem in policy design and implementation is joined in the rules versus discretion debate in public policy by considerations about credibility and strategic interaction. We cannot go into the credible commitment arguments here in any depth, but just want to mention them as another wrinkle in the discovery, conveyance and use of knowledge within the democratic system to determine the correct policy path to take to address social ills.

To conclude, Hayek's approach to the question of the limits of democratic decision making is quite different from either Caplan's or Landmore's (or of other contemporary proponents of "epistemic democracy"). Because, unlike Landmore, he has little trust in the "wisdom of the crowds," he is emphatic that democratic decision making should be constrained by rule of law requirements. On the other hand, while he actually agrees with Caplan that expanding the realm of markets and limiting the realm of issues decided collectively would be beneficial, he operates under a heterogeneity and subjectivity of values approach that forces him (like Buchanan) to take seriously the fact that many other people assign various non-classical-liberal functions to the economic-political system. As such, he cannot use economic efficiency itself as a universal benchmark for top-down evaluation. All he can do is think about institutional constraints such as the rule of law.

Moreover, while Caplan discusses the incentive problems faced by voters, he does not discuss the incentive problems faced by elites. As such, one may get the (mistaken) impression that Caplan's account is providing support for a move on the margin away from democracy and towards elite rule. Interestingly, as Hayek notes, while at any given moment in time "the decision of a government by an elite" may be superior to that of majority rule, nonetheless such a system would be problematic over a longer course of time. This is because of two types of incentive problems. On the one hand, along standard public choice lines of analysis, it's hard to establish a ruling elite that has the incentive to care about the general welfare more than a democratically elected political class (Olson, 1993). On the other hand, and this is the specifically Hayekian add-on, a ruling elite would also have less of an incentive to discover the proper information about how to improve various public issues (Wohlgemuth, 2002).

All in all, under the interpretation presented here, the Hayekian perspective on both the defense of democracy and the limits of democracy is quite different from the perspectives advanced by the existing literature on epistemic democracy. On the one hand, he offers a comparative institutions defense that does not overly commit itself to exaggerated claims about the efficiency of democracy. On the other hand, he provides an argument for rule of law as a constraint on democracy without making an ideological (classically liberal) argument. Part III in *Constitution of Liberty* is a unique piece of political theorizing in providing a genuine attempt (one may differ as to how successful it actually is) at a meta-ethical political system, that is, a political framework designed to fit more than just one single political philosophy. The brief discussion of this section has illustrated the resources of the Hayekian approach and the fact that these resources of the epistemic perspective offer a strong promise when it comes to contemporary debates.

## CONCLUSION

In taking the epistemic perspective in economics and politics, Hayek was one of the first modern economic and political theorists to switch attention away from the *behavioral assumptions* that were employed in the analysis towards the *institutional conditions* within which individuals interact with each other and with nature. Critical to the development of social theory is the recognition that some rules enable better than others diverse groups of individuals to coordinate and live better together. Those rules provide an incentive and epistemic ecology of the social space. Hayek's identification of progress with institutions conducive to the discovery, communication, and utilization of the unique knowledge of every individual in a society, and located in their specific circumstances of time and place, was made possible by the insights given by his epistemic perspective on economics and politics.<sup>2</sup> Far from being exhausted, today there are great opportunities for those influenced by Hayek's writings to continue in pursuing this epistemic approach through critical engagement with the emerging literature such as that on "epistemic democracy" or "political epistemology." The Hayekian revolution of the social and policy sciences is far from complete. Economists engaged in a largely failed effort to appropriate Hayek's ideas in formalistic models (see Boettke & O'Donnell, 2013) and political scientists have yet to fully come to grips with the full implications of the problem of the epistemic dimensions, capabilities and limits of economic, political, and social systems.

## NOTES

1. This is of course a rather unrealistic assumption. The very same factors that generate market failures also generate principal-agent problems in organizations (Miller, 1992a, 1992b).

2. Consider Hayek's claim from his Nobel lecture, "The Pretense of Knowledge" (1974) that "If man is not to do more harm than good in his efforts to improve the social order, he will have to learn that in this, as in all other fields where essential complexity of an organized kind prevails, he cannot acquire the full knowledge which would make mastery of the events possible. He will therefore have to use what knowledge he can achieve, not to shape the results as the craftsman shapes his handiwork, but rather to cultivate a growth by providing the appropriate environment, in the manner in which the gardener does this for his plants."

## ACKNOWLEDGMENT

A draft of this paper was used for discussion purposes at the Mercatus Center conference "40 Years After the Nobel: F. A. Hayek and Political Economy as a Progressive Research Program."

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