

Knowledge and Coordination: A call to renewal for academic economists

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Introduction

Knowledge and Coordination is Daniel Klein's manifesto for an economics rooted in Smith-Hayek liberalism: a liberalism wholly in the humanist tradition, a liberalism that points people toward the beauty of spontaneous order (Klein 2013). Strands of this liberalism, one that has a "presumption of liberty" rather than an axiomatic claim of liberty's value, are all around us, and Klein's task is to pull readers toward seeing this as a coherent worldview.

It is a personal book, with a short, insightful intellectual autobiography, a number of self-described homilies, and calls to the audience to change and improve their ways of thinking. This is a book for economists and would-be economists who sense something valuable in the economic way of thinking, but also sense something is missing—something about the beauty of the market order. The book is not rejectionist about mainstream economics—instead, it calls for us to look at what we do professionally through the lens of Smith and Hayek.

Contrast is Klein's key tool for showing us how his worldview differs from conventional economics: he contrasts the older use of "coordination" (emergent order, the invisible hand, concatenate coordination) with a newer use of coordination (mutual coordination, as when two people walk toward each other down a hallway and each decide to step to the right). Klein isn't against the second usage of the term—he's clearly an admirer of Thomas Schelling, a key figure in the theory of mutual coordination—but rather he sees the decline of the earlier usage as a sign that something has changed in the way economists think, and something valuable was diminished.

This is the first sign of a recurring theme: that economists used to live in a larger, richer mental world, but the quest for tractability, for ease of explication, led us to talk about a flatter world. In many settings, it was easy for

economists to support and defend liberalism in that flatter world—textbook microeconomic theory is a fantastic tool for showing some of the surprising benefits of free competition—but something was lost along the way, something that once made liberalism feel like humanism. And that loss has made liberalism less effective as a worldview, since the competing progressive movement focuses on the idiosyncratic, the touching, the emotional. If the choice of political worldviews is one of cool rationality or emotional warmth, it's easy to see why progressivism does so well. Economics used to be a natural tool for explaining a humanistic liberalism, but it's more difficult for it to serve that end today.

He illustrates the theme in his discussion of knowledge versus mere information. Klein argues that mainstream economics obscures the power of discovery, especially the discoveries associated with entrepreneurship. He uses Somerset Maugham's short story "The Verger" to illustrate this: a man is fired from his job for being illiterate, and wandering the streets looking for a cigarette, he realizes none are to be found. He decides to open a tobacco and sweets shop, which gives him an entirely different life—and which meets a need that clearly wasn't being met before.

On its face, this story sounds entirely consistent with mainstream economics: a profit opportunity gets noticed by an entrepreneur and the profit opportunity thereby vanishes. Market efficiency with a bit of a time lag. But as Klein tells the tale, one can't help but think about the epiphany involved, about how motivated attention, an entrepreneurial attitude, was central to the outcome of the story. And once one reads this story, one might start seeing it everywhere. At least in my case, it reminded me of real life stories of friends and acquaintances who stumbled across opportunities for honest profit and (sometimes) made the most of them.

Maugham's story doesn't prove that an entrepreneurial spirit is always and everywhere a path to economic efficiency, but instead it suggests that, by and large, a society where individuals have the motivation to look for opportunities—where they aren't held back by restrictive social norms or government rules—will turn out to be the kind of place we'd probably want to live. Economists sometimes say that good mathematical models can be an "engine for intuition"—but a well-told tale can do that as well. And a key point of this tale is that some important knowledge is at the local level.

I believe Klein is largely correct: that the economist's tendency to "flatten down" knowledge to mere bits of "information" makes the world appear artificially manipulable to planners, bureaucrats, and economists, and that it makes the cost of government intervention appear artificially low. In Klein's view, the flattening process began well before the neoclassical

revolution in economics, indeed, not long after Smith's death (2012: 241ff), but the neoclassicals carry the banner for today's flattened economics.

However, I want to note that for myself, and I suspect for many other economists, the search processes built into some endogenous growth models really do appear to capture the need for discovery, the power of surprise, and the possibility of endless future growth. Just as importantly, I think that endogenous growth models and models of innovation—equations and all—often awaken a sense of wonder that is quite similar to the insight I had the first time I understood Smith's tale of the pin factory or Hayek's discussion of local knowledge.

For me, it was Charles Jones's treatment of endogenous growth in his textbook *Introduction to Economic Growth* that showed me a previously hidden part of the vast concatenation of innovation, working, saving, and career exploration that occurs in advanced economies (Jones 2002). In his model, workers have to decide whether to work as researchers or as producers of final goods; capitalists have to allocate their efforts between research and final goods; monopolists take raw materials and convert them into an ever-increasing variety of specialized capital goods; and innovation is embodied in those same specialized machines: innovation and specialization become two sides of the same coin. This model was no mere exercise in social hydraulics, though the algebra made it easier to track stocks and flows in such a complex toy economy. Instead, one of the best ideas in microeconomics--the Law of One Price--kept showing up as workers moved between sectors when wages were unequal and as capitalists split their efforts between making final goods and innovation. Also, the nature of innovation mattered enormously: Ideas were created through conscious effort—really, by entrepreneurs who gambled on the possibility of finding a profitable idea that would, as an unintended consequence, increase the division of labor across society, unintentionally making all of the other ideas in society just *slightly* more productive.

Charles Jones's model—really, a mixture of a small number of endogenous growth models, simplified for textbook treatment—didn't capture all of the facets of innovation and its relationship to the overall economy, and of course it couldn't. But it captured quite a few facets that didn't make it into Adam Smith's insightful story of the pin factory, and it did more than just capture these additional actions: it connected them. There's something in this model and in some other formal models that can help build elements of Smith-Hayek liberalism.

“How does this matter in the real world?”

Klein wants to put living flesh on the bare bones of economic theory, and he’s right to think that it needs that flesh, that human element. The human element was there in Smith, but as math and formalization took over, it slowly withered away. Anecdotes and illustrations and fictional tales aren’t just a crutch for weak students to learn the model: they are the way we start training ourselves to see economics as a worldview, something more than a chalkboard model. One of the strengths of Klein’s book is that he actually helps out with the training: with his own parables and literary references (such as “The Verger”) and case studies, he shows how to do better economics.

His case study on the supply of and demand for assurance—for institutions that verify product quality—deserves to be read widely on its own merits and as an example of the potential for a Smith-Hayek economics. Critiques of the FDA are common among free-market economists, and it’s easy enough to note that the power of the seen over the unseen probably costs many lives: the person who dies before a drug is fully tested rarely makes headlines, but the person who dies from taking an unsafe drug will likely receive generous media attention. But Klein goes further than that, drawing our attention—and our imagination—to the entrepreneurial activities that provide customers with reasonably reliable forms of assurance in multiple areas of life. Corporate reputation, franchising, third-party reviews and seals of approval, middlemen, warranties, all get some attention. The multitude of real-world mechanisms reminds us that one size can’t, won’t fit all needs, and makes the existence of a single FDA to approve all prescription medicines and many medical devices appear all the more bizarre, all the more ill-suited to human flourishing.

It’s Hayek all the way down

One aside: Klein’s discussion of tacit “knowledge” versus flattened “information” made me appreciate Hayek’s “The Use of Knowledge in Society” more than ever (Hayek 1948). Neoclassical economists already know that one needs good incentives to generate valuable knowledge. And they know, on some level, the value of entrepreneurship in ways large and small. But Hayek and Kirzner and Alchian have a way of placing the value of local knowledge and spontaneous experimentation in the forefront of our minds. If one remains familiar with their ideas it’s nearly impossible to consider any potential government intervention without wondering, “How will this change the impetus toward entrepreneurial discovery?”

The “knowledge versus information” distinction is where Klein makes a (to me) new point: That all humor, and probably most entrepreneurial discovery, apparently comes from what Klein calls *asymmetric interpretation*. Two people see one story in two different ways, one more valuable than another: the result is entrepreneurial discovery. One person sees the same story in two different ways, as in Klein’s example of the famous Abbott and Costello *Who’s On First* routine: the result is humor. When neoclassicals flatten knowledge down to mere information, the data are too basic to misinterpret, too basic to asymmetrically interpret. But when knowledge is tacit, it’s not only *hard* to convey it to another human—it’s also *easy* for multiple, asymmetric interpretations to arise from the same bundle of knowledge.

Who beholds the concatenation?

In the conclusion, Klein takes the position that moral philosophy subsumes political economy: the fact that Adam Smith’s *Theory of Moral Sentiments* was written years before the *Wealth of Nations* becomes an allegory for what Smith-Hayek economics should look like. I instead prefer to see moral philosophy and political economy as *parallel* tasks because so often the insights that come from the invisible hand, from the economic way of thinking, rapidly shape people’s moral sentiments. If economics, narrowly construed, readily influences moral thinking, then since the influence running from morality to economic system is already widely accepted, parallelism is the best path forward.

We see the economics-to-morality channel at work whenever a student learns how apparently well-intended policies can easily have awful unintended consequences. The “man in the breast” beholds suffering and so someone decides to support rent control or stricter FDA regulation. But when a person is taught about side effects of these policies his support for government intervention often weakens and becomes more cautious. Learning about the invisible hand dissipates some moral fervor, and replaces it with another body of moral sentiments. Moral thinking will change when people learn more about the economic way of thought.

This brings us to an unresolved issue in Klein’s book: Who beholds the concatenation of social activity and judges it pleasing or displeasing? Who is the “impartial spectator” in Smith’s words or “Joy” in Klein’s allegory? Obviously each person has her own sense of moral judgment, and aside from a few well-identified common moral intuitions that exist across societies, the billions of characterizations of Joy in the world disagree routinely on moral issues. Wiser versions of Joy include those who, through some combination of good luck and education, see the importance of looking at intended

consequences, those who focus on both the seen and the unseen. Klein's version of Joy is clearly Klein's Joy: A Joy of well-informed classical liberalism, one cautious about government activity but not entirely hostile to it, one who values a cosmopolitan society where individuals are largely free to build the lives they choose.

But other characterizations of Joy are out there: A common version of Joy in the developed world is deeply pleased when she beholds a society with a strong safety net, growing stronger by the decade, where, for instance, the state manages an imperfect but mostly fair system of health care. Are these other characterizations of Joy making a mistake, or is the preference for one concatenation rather than another merely a matter of taste?

On this question, I'll just return to my previous claim: Those who have learned about the power of the invisible hand, who have learned the basics of microeconomics, are likely to experience a different, wiser version of Joy. Indeed, one of the goals of good economic training, from Smith onward, has been to shape each Joy's perception of the vast social concatenation.

The value of liberalism

On the last page of the concluding chapter, Klein says this:

In the lived context of meaning, little can be gotten from liberal intellectuals...the chief value of liberal intellectuals consists in telling the individual where *not* to search.

Amid the popularity of popular economics—and the prominence of economic thinking in policy circles—this claim is jarring. But by this point in the book, we know something of what Klein means: that the genuine joys of life are too idiosyncratic for any intellectual to list them, let alone to explain how to discover and enjoy them. And the liberal intellectual, more than others, knows about unknowability.

Klein follows the intellectual humility of the liberal economist to its logical conclusion a few pages earlier, noting that Smith-Hayek humility is somewhat different from modern libertarianism:

...today, libertarians, often fervent to abolish contraventions of the liberty principle, may seem anything but humble...[Smith]...draws from the presumption of liberty but also from another important presumption, namely, *the presumption of the status quo*...[W]e acknowledge a humility attaching to the presumption of the status quo, and it tempers

liberty's alacrity—a temperance that permeates Smith's writings and finds explicit recommendation (Klein 2012: 255, italics in original).

Smith-Hayek economists, with humility at their center, will often find themselves saying, “We don't know how this big reform push will work out, so let's try something smaller, more localized, and see how that goes.” Big Bangs of economic reform will be embraced only in the most dire of situations, tinkering before scaling up will be more common. Smith-Hayek humility has at least *something* in common with the “precautionary principle” favored by progressives: Both lead one to be skeptical and cautious about big changes.

Recommendation

If you teach first-year Ph.D. students in economics, assign chapter 2, “Discovery Factors of Economic Freedom,” to be read after they've worked through some search theory or endogenous growth theory. A few will have their lives changed and will be spurred to read the remaining chapters; the rest will at least know that there's another vision out there, a vision that is too rarely seen in academic economics.

References

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