

## STUDY GUIDE

### Questions on Hayek's "The Use of Knowledge in Society"

1. According to Hayek, what is the fundamental problem that economic organization needs to address?
  - a. Using specific information.
  - b. Literally, "the problem of the utilization of knowledge not given to anyone in its totality".
2. How does "scientific knowledge" differ from "knowledge of the particular circumstances of time and place"?
  - a. Transferability.
  - b. I suppose in Hayek's world, scientific knowledge relates to engineering knowledge about production processes and local knowledge can only be gained by direct, individual experience. It can then potentially be transmitted (at a cost), but could not have been known before the experience took place. For example, until I listen to a new CD I don't know whether I like it.
3. In what situations can an economic order be based solely on scientific knowledge, and when is knowledge of particular circumstances important?
  - a. Example: producing commodities like steel or electricity versus consumption goods: relative success and failure of the USSR economy in the 1930s and the 1980s.
  - b. Hayek says "economic problems arise always and only in consequence of change". I suppose the implicit assumption here is that all local knowledge is scientific in a world that never changes (potentially because all local information could have been communicated or transferred). Another implicit assumption is that local knowledge takes time to communicate, since otherwise it would immediately become general, scientific knowledge.
4. How do central planning systems compare to market systems in their use of knowledge?
  - a. Centralization versus decentralized use.
  - b. More artificial, usually less powerful, less internalizing incentives; as compared, in essence to property rights (not in Hayek but should we mention them when analyzing it? I.e., should we be rigorous with respect to the author or to the topic?).
5. Why might people not appreciate the role of the price system as a means of economic organization?
  - a. A first point is that intellectuals may not even value local information because it is mundane and not profound.
  - b. Intellectuals may resent the price system because it is an alternative rationalizing institution: a competitor.

- c. I also see a connection with our discussion of institutions in topic 1. There we said that institutions are the reason we have a modern world (and not that we have institutions because we have a modern world). Hayek makes the same point about the price system. Nobody “designed” it, it has evolved naturally and let us engage in increasingly complicated exchanges.
- 6. Analyze the extent to which the creation of internal markets within government bureaucracies solves the fundamental problem you identified in question 1.
  - a. This is a very good question. I would say, it aims to solve the problem, by eliciting information on utility from users and information on costs from providers.
  - b. However, given that internal markets lack proper property rights (does not Hayek’s paper also miss their role?) this process is incomplete:
    - i. users do not pay full prices;
    - ii. providers are not pay the residual profit; and, perhaps even more important,
    - iii. planners with perverse incentives are often running internal markets, instead of the invisible had.
  - c. E.g., consequently to (iii), we see that information provided by users (for example, when parents choose to send their children to chartered schools (“escuelas concertadas” in Spain), planners react by constraining their growth instead of closing down or at least reforming public schools.

### **Comparing Coase’s “The Problem of Social Cost” and Varian’s *Intermediate Microeconomics***

1. The Varian pages describe the interactions of two people, one of whom imposes an externality on the other. If they can trade with each other, what is the outcome?
  - a. The outcome is that they agree to a Pareto efficient outcome.
2. According to Varian, what is the main problem that gives rise to the problem of externalities?
  - a. According to Varian (see text in italics) the problem is a lack of property rights.
3. According to Coase, if property rights are fully defined, do externalities ever lead to inefficient outcomes? Why or why not?
  - a. Yes, in the presence of transactions costs, even with fully defined property rights, inefficient outcomes can arise. There is a role for public policy in helping parties achieve efficient outcomes. For example, could we use smoking ban as an example? (Better, the situation before the ban, because the ban, even if it grants everybody a right to impede smoking, such right is not alienable—i.e., it forbids trading.). Bar owners do own the air in their bar, so should be willing to accept payments from non-smokers to ban smoking, but clearly to implement the Coasean bargain on a nightly basis that determines whether smoking is allowed is impractical and expensive. So a ban might make sense.
  - b. Social norms had informally developed long ago about smoking fine-tuning the allocation of rights: e.g., not in the presence of women, only in smoking rooms, etc.

4. To what do you attribute the divergence between what Coase writes and how Varian interprets Coase?
- a. Stigler provided the first formal statement of the Coase Theorem. As a mathematical, modeling, object the standard Coase theorem is an elegant counterpoint to those advocating government intervention. Coase himself advocated an approach that was more case-by-case and holistic, and I would argue this in some ways runs against the spirit of micro theory, which is more concerned with abstract generalizations rather than contextual details (for better or for worse).
  - b. Another possible, related, reason is that analyzing transaction costs necessarily gets your hands dirty in institutions (the law and so on). Economists prefer to imagine the world. It is not by chance that Coase founded the discipline of law and economics, and its main journal. But he later reneged from the evolution of law and economics, because it became mostly mainstream microeconomics applied to legal issues.
  - c. Also related: Coase's position is not "the market is supreme" (as most in Chicago at that time) but "let us compare the performance of real alternative solutions which often have mixed elements of markets and politics (i.e., regulation)".
  - d. Lastly, what Varian et al. have in mind when talking about clear allocation of property rights is a simple matter. It is not. E.g., there are different types of property rights, contractual and in rem, which pose very different problems and most of property law deals with in rem rights. However, in Coase and most of his followers, all rights are purely contractual.

#### **Further Questions on Coase's "The Problem of Social Cost"**

1. According to Coase, what is the role of public policy (or institutions more generally) in addressing the problem of externalities? Why might governments not perform this policy role effectively?
2. What role does the firm represent with respect to solving problems of externalities?
3. Using your knowledge of microeconomics, define what a Pigovian tax is. Outline Coase's critique of Pigovian taxation as a policy instrument for dealing with externalities.
4. What methodology does Coase propose for addressing externality problems in practice?