ROBUST POLITICAL ECONOMY

Mark Pennington discusses the challenges and criticisms facing classical liberals today

When we look at some of the economic arguments advanced in favour of markets, economists have come up with good defences against various market-failure theories. In political theory, classical liberals have provided good responses to the kind of anti-market arguments made by communitarians and egalitarians. What has been lacking, however, is a unified theoretical framework that can bring together all these criticisms and the classical liberal responses to them. We don't have a unified framework that can respond not only to the economic objections that have been raised against classical liberalism but also to the political and ethical challenges that have been raised against the tradition as well.

There are three challenges that I think classical liberalism needs to respond to: the challenges from 'market-failure economics,' the challenge of communitarianism, and the challenge of egalitarianism. We can respond simultaneously to all three challenges within the framework of robust political economy.

What is 'robust political economy?' Something is robust if it is able to withstand various stresses and strains. In the context of political and economic institutions, we can define something as being robust if it is able to withstand the stresses and strains wrought by human imperfections. There are two human imperfections I want to focus on.

The first is the idea of 'limited human rationality.' Human beings are not fully rational agents—they also are not omniscient beings. Whenever they make decisions, they do so in a context of considerable uncertainty and there is always imperfect information. If decision-making takes place in a context of imperfect information, what kind of institutions facilitate learning over time, and what kind of institutions minimise the consequences of what will be inevitable human mistakes or human errors?

The second human imperfection is the problem of 'limited benevolence.' People may, under certain circumstances, act out of self-interested motivations. They may be opportunistic. We need, therefore, to evaluate institutions in terms of the incentives they provide to channel potentially opportunistic actors to behave in a way that increases the overall level of well-being in society—that generates positive rather than negative sum games.

Challenges to classical liberalism fail to meet the criteria of robustness. Their particular alternatives to the classical liberal ideal of a minimal state and open markets do not address how their own favourite institutions will deal with the problems of limited rationality and limited benevolence. The classical liberal case for a minimal state framework with an open-market economy based on the dispersed ownership of property is based on the claim that these institutions are more robust in the face of limited rationality and limited benevolence.

A competitive context is the best context to deal with the fact that people are imperfectly informed. When we have lots of different decision-makers making different sorts of

Mark Pennington is Professor of Politics at the University of London and author of *Robust Political Economy: Classical Liberalism and the Future of Public Policy*. This essay is based on his speech at the Cato Institute in March 2011.

decisions, we facilitate a process of trial-and-error learning that minimises the consequence of any particular error. If you centralise decision-making and people make mistakes—as they will—then the consequences are much more far reaching than if the decision-making power is more dispersed. Likewise, a classical liberal framework that provides for exit enables people to escape from the depredations of potentially predatory actors. If people are acting opportunistically, the capacity to exit from relationships with these actors provides a disciplinary check on potentially self-interested behaviour.

So what of the challenges to classical liberalism? Market-failure economics, or 'mainstream neoclassical economics,' evaluates market institutions against the benchmark of full-information equilibrium. Any departures from this full-information equilibrium are described as 'market failures,' which are considered ripe for some kind of corrective government action. If we take the perspective of robust political economy, and focus first on the idea of limited rationality, then this notion of perfection, or full information, simply isn't a valid standard against which to evaluate either market institutions or any other institutions. The case for markets isn't that they are 'perfect' institutions; the case for markets is based on the view that they are best placed to cope with the inevitability of imperfect information and limited rationality.

Take one of the notions neoclassical economists often focus on—imperfect competition is often considered ripe for corrective government action. If we're in a world of limited rationality, of imperfect knowledge, then knowledge of what should be produced and how it should be produced isn't going to be evenly distributed. Some firms are going to judge the market better than others. Some firms are going to make more profit than others. Other firms are going to make losses. It is precisely through these imperfections, or inequalities, that a competitive learning process is set in motion, so that people can learn over time to copy the more successful firms and avoid the business models that are adopted by the less successful firms. Any market that is based on imperfect information and unevenly distributed knowledge is going to look imperfect when judged against a standard of perfection. So what is the alternative to this imperfection? Is it a world where regulators somehow know what the ideal market structure is? If we're in a world of limited rationality, there's no reason to suppose that government regulators know the ideal market structure. And they lack access to a competitive mechanism that can reveal to them which sort of decisions work better than others.

> Markets are best placed to cope with the inevitability of imperfect information and limited rationality.

This kind of analysis may seem old-fashioned, but there are new market failure theorists such as Nobel laureate Joseph Stiglitz who are well aware that government is likely to fail in the way that markets fail. When push comes to shove, however, they always hold markets to a different standard than public policy interventions or government regulators. Stiglitz is fond of saying that the price system, because of its various imperfections, is too coarse a decision-making instrument to enable people to make effective decisions in the absence of government intervention. What he lacks is an account of why government regulators should be assumed to be less prone to imperfect information and misaligned incentives. As Stigliz himself says in *Whither Socialism?*

> A full corrective policy would require taxes and subsidies on virtually all commodities based on estimated elasticities and cross-elasticities. The practical information required to implement such a policy is well beyond that available at the present time.

So somehow we're supposed to trust that government regulators will improve market outcome. Stiglitz doesn't give any justification for this assumption whatsoever. He fails, in my view, to meet the standards of robust political economy.

Let's now turn to communitarianism. Communitarians challenge classical liberalism on the grounds that we shouldn't evaluate institutions on their capacity to respond to, or satisfy, given individual preferences. In the communitarian view, we should evaluate institutions on whether they have the capacity to challenge the preferences of individuals. What they're getting at is the notion that liberalism lacks any account of how we can elevate people's preferences or how we can encourage people or educate them to have a more informed or enlightened set of preferences. In a communitarian view, democracy is better placed than the market to challenge irrational or prejudiced preferences that people may have, precisely because it's based on majority rule. In a communitarian view, people's preferences have to be justified to the majority before they can be put into practice, and this majoritarian check will provide the context within which bad preferences can be weeded out, creating an overall elevation in the quality of preferences.

Majoritarianism, by its very nature, squelches the process of experimentation.

This kind of view, in terms of robust political economy, is based on a hopelessly romanticised view of how any democratic or majoritarian process can actually operate. It's based on a complete failure to understand how most people learn in most situations in life. The most important form of learning in society—especially if you take Hayek's ideas seriously—isn't the kind that takes place when we argue with one another in a public forum and come to a majority decision about which view is best. The most important form of learning takes place from seeing what other people do in their lives—and learning from their experiences. For that sort of learning, it's imperative that the widest possible number of experiences—or experiments in living—occur. Majoritarianism, by its very nature, squelches the process of experimentation. The way we get value change in most fields of life is by entrepreneurs, whether in the economic domain or in the moral domain, breaking from the majority position and doing something different. Only then, through an incremental process, does the majority view gradually change.

Hayek puts this very well: 'It is always from a minority acting in ways different from what the majority would prescribe that the majority in the end learns to do better.' A system of private-property rights that allows people to carry out experiments in living is much more likely to challenge existing prejudices and preferences than is any socialist or collectivist alternative.

Now it's not only in terms of this knowledge problem or the problem of limited rationality that the communitarian view fails. It also fails to adequately take into account notions of incentives. Bryan Caplan makes the point very persuasively, following people like Geoffrey Brennan and Loren Lomasky in the past, that the institutions of democracy do not actually provide people adequate incentives to challenge their own preferences. Why? Because if you try to revise your preference in a majoritarian context, it actually makes no difference to the final outcome that you will personally experience. That is going to be determined by whether everybody else challenges their preferences. In a market context, you can profit personally by challenging the prejudices you may have. If you're an employer with racist or sexist prejudices, you can profit by breaking from those prejudices, thus expanding your market. But nobody in a democratic arena can actually profit personally from challenging their own views when they can't change the outcome until they've persuaded everybody else to expect some change in the law. So again, when we judge the communitarian view against its *own* ideals, it fails to meet the requirements of a robust political economy because it lacks a persuasive account of how a majoritarian form of decision-making can deliver on these ideals better than the classical liberal alternative.

Finally, let me turn to egalitarianism. Of the several egalitarian thinkers I address in my book, I will focus on John Rawls. People influenced by Rawls are concerned with what kind of social rules and institutions meet the test of 'impartiality.' Rawlsians use various theoretical devices to determine what impartiality requires, but the most famous of these is the 'veil of ignorance.' Behind the 'veil,' people know nothing about their likely economic and social status in society. The purpose of this assumption is to make people reason impartially—to choose rules that everyone irrespective of their social standing would be willing to accept. The only information that people are allowed to have is access to 'basic facts of social theory'—knowledge about how particular economic systems operate. For Rawlsians, one of the impartial rules that would emerge if people could choose rules from behind such a veil is the 'difference principle'—that social institutions should 'maximise the position of the worst off.'

Many objections have been raised against the Rawlsian perspective. John Harsanyi, for example, famously argued that people behind the veil of ignorance would not choose to maximise the position of the worst off. They would instead favour a rule that would maximise average utility. Similarly, many critics have pointed out that the difference principle rests on assumptions of extreme risk aversion for actors behind the veil. From the perspective of robust political economy, however, there is a much more fundamental type of objection that can be raised against the Rawlsian approach. If one of the 'basic facts of social theory' we have to take into account when devising impartial institutions is a recognition that people are not perfectly rational actors, if people are not omniscient beings, then it is utterly implausible to suggest that they would opt into a 'once and for all' set of distributional practices. On impartial grounds, we can argue that people would choose to be in an environment that would enable them to learn about the effects of different distributional principles. It would allow for competition between different distributive rules so that through an evolutionary mechanism, we can discover what sort of arrangements people actually prefer. The Rawlsian view assumes that people have the rationality to decide what an ideal set of distributional principles is, but if people are limited in their rationality, this has to be abandoned—we need to facilitate learning in conditions where people lack the rationality and knowledge to agree on a single ideal of distributive justice.

The need for learning is ruled out in the Rawlsian model because it is assumed that people are choosing rules for a closed society. The justification given for this assumption is an attempt to take into account the problem of incentives or of 'limited benevolence.' The argument is that you must assume people are choosing rules for a closed society because you want to imagine a situation where the rules are being devised by your worst enemy—what kind of rules would you choose if you knew they were being implemented by your worst enemy and you couldn't escape. If people are self-interested, then according to Rawlsians, allowing an 'exit' option in the model is unsatisfactory because opportunistic agents may try to bargain for an 'unfair' advantage from behind the veil. Rawls deals with this incentive problem by specifying that actors from behind the veil are choosing rules for a closed social order. This has always been something of an odd move on the Rawlsians' part. If we take seriously the idea that 'incentives matter,' then surely when we are devising institutional principles—thinking what might happen if our worst enemies were in charge—then we would actually *allow* an exit option because that is what provides the best protection that people might have in situations where they may be 'ripped off' by opportunistic agents—assuming monopoly does not seem to be the most effective way to deal with the problem of 'limited benevolence.'

So, on both counts—of failing to recognise the problem of limited rationality *and* of failing to adequately address the problem of 'limited benevolence,' the Rawlsian approach fails to meet the requirements of robust political economy.

In this article, I have focused on the theoretical framework—robust political economy—which I believe provides a tool-kit through which classical liberals can respond to their most serious critics. In an age when it has become increasingly commonplace to hear all of the ills of the world blamed on 'excessive liberalism' and the supposed failures of 'capitalism,' there has never been a more urgent need to develop this response.