

What Should Economists Do? Price Theory or Microeconomics?

By Rosolino A. Candela

In his 1963 Presidential Address to the Southern Economic Association, later published as “What Should Economists Do?”, James Buchanan called for “economists to modify their thought processes, to look at the same phenomena through ‘another window,’ to use Nietzsche’s appropriate metaphor. I want them to concentrate on ‘exchange’ rather than on ‘choice’” (1964, p. 217). The notion that economic theory is a “window” is a very appropriate metaphor, particularly when economists come to different conclusions from observing the same phenomenon. Thus, alternative conceptualizations of economic theory serve as different “windows” from which the economists draws different conclusions about the world, particularly how markets work.

Just as Buchanan often used this metaphor from Nietzsche, I wish to adopt it here to draw an important distinction between “price theory” and “microeconomics,” which are often conflated. Although the distinction may seem to be one of semantics, as I will explain and illustrate below, the subtle differences between the two have important implications about what we “see” when markets operate, and the extent to which we conclude whether markets “work” or “fail.” Just as the same individual will observe different aspects of the same automobile traffic from different windows of a building, we draw different conclusions about a particular market based simply on whether we are looking from the window of “price theory” or “microeconomics.”

What is the distinction between the two? As Buchanan suggested above, “price theory” is primarily about the study of how individuals pursue their separate goals through exchange, which in turn create exchange ratios (i.e. market prices) as by-products of their purposive behavior. Such market prices, in turn, *guide* individuals in their consumption and production decision-making. Human choice is not absent in price theory; rather, it is a necessary subset of price theory, though not sufficient, for understanding the invisible hand processes that generate social order. Nor does price theory imply that markets allocate resources instantaneously according to omniscient human actors. Rather, a price-theoretic approach to economic theory is one in which there is an *indirect link* between a human agent and the tendency towards equilibrium, one in which market outcomes are not directly reducible to the individuals that constitute a market. That is, prices emerge from the act of exchange between individuals engaging in open-ended choice under a world of uncertainty, but not of human design. However, once emerged, prices then *become* guides for future action. Thus, whether markets “work” or “fail” do not depend on the behavioral characteristics of individuals, but whether institutions secure and enforce the ability for individuals to exchange (i.e. private property). A “market failure” in this respect is not a failure of markets to “work” but a failure to establish the conditions for a market to exist, unleashing future profit opportunities to establish such conditions.

Moreover, it is not enough for prices to reflect full and available information *quickly*, as suggested by the efficient market hypothesis; real-world market prices are not sufficient statistics to approximate an allocation of resources consistent with equilibrium. Rather, market prices must translate the tacit and dispersed knowledge of millions of individuals into publicly held information *correctly* (see Boettke 2012, 2018). As the famed value investor, Howard Marks, makes this point, market prices are “efficient” in “the sense of ‘speedy, quick to incorporate information,’ not ‘right’.” (2011, p. 8). Thus, although not immediately obvious by its epithet, price theory crucially depends on the study of *non-price competition*. As Harold Demsetz argues, “[m]arket processes work neither instantaneously nor with full knowledge, so perfect competition

hardly exhausts the many ways in which self-interest is pursued. Competing through product quality, contractual arrangements, and institutional innovation, and through tactical quickness and alertness, all become meaningful” (1982, p. 18). Price theory, properly understood, is a window from which to understand how individuals are able to learn how to cooperate with one another without command under a division of labor. Such “cooperation”, counterintuitively, is manifested in a peaceful and cooperative form of cooperation: *productive specialization and exchange*.

Contrast this window of economic theory with “microeconomics,” which is what Buchanan refers to as the “science of choice” (see also Buchanan 1969). In microeconomics, the logic of human choice is not a subset of economic theory, but its defining characteristic. Microeconomics, as it practiced today, is understood as an exercise of *constrained maximization* within which prices serve not as variables of human choice, but as *constraints* to which individuals passively respond like a set of marching orders. A choice-theoretic approach to economic theory is one that collapses the optimizing activity of an agent onto the conditions of general competitive equilibrium. Such a conflation implies a *direct link* between the rational agent and an equilibrium outcome, which is simply an aggregation that can be directly reduced to the individual “choice” of individuals. To summarize briefly, in microeconomics, where perfect competition occupies the foreground of analysis (rather than the background as in price theory), individuals are all price takers, not price makers. The irony of microeconomics, in which perfect competition is in the driver seat of analysis, is twofold. First, human “choice” is defined out of existence, since the optimal choice is dictated by equilibrium prices, to which individuals passively respond. Secondly, and counterintuitively, the only margin upon which individuals make decisions is in terms of price. But because competition in the active sense of the term doesn’t exist, since all the gains from trade have been exhausted, all other margins of competition are considered unnecessary or redundant, in terms of advertising, quality differences, or recognition of differences in consumer preferences (Hayek 1948, p. 96; Boudreaux 1990, p. 47). Hence, if individuals are guided by “false prices,” which are inconsistent with perfectly competitive equilibrium, a market is said to “fail” to achieve optimal conditions.

Much of what I’ve said may seem to be purely a difference of degree, rather than of kind, and indeed this might be a fair conclusion, since often times the terms “price theory” and “microeconomics” are used interchangeably by economists. The difference in these different “windows” of economic theory can be best illustrated by the argument in George Akerlof’s seminal paper, “The Market for ‘Lemons’: Quality Uncertainty and the Market Mechanism” (1970). This paper demonstrates how a “market failure” can arise to due asymmetric information between buyers and sellers, utilizing used car markets (as well as other markets) as an example. Without stating so explicitly, Akerlof’s argument is based on the premise that prices are analogous to a public good, in the sense of providing information that is non-rivalrous and non-excludable. Like any public good, the claim is that private markets will underprovide such a good due to free-riding. According to Akerlof, “*good cars and bad cars must still sell at the same price* – since it is impossible for a buyer to tell the difference between a good car and a bad car” (emphasis added; 1970, p. 489). This assumption is consistent with the microeconomic “window” I outlined above, since the premise of this argument is that there is uncertainty over the quality of cars, but buyers can’t distinguish good cars from bad cars (or “lemons”) based *solely* on price, and hence, according to Gresham’s law, the “bad” cars tend to drive out the good cars. This is because, as Akerlof states, since both good cars and “lemons” must sell at the same price, “there is incentive for sellers to market poor quality merchandise, since the returns for good quality accrue mainly to the entire group whose statistic is affected rather than to the individual seller” (1970, p. 488). Thus, without

the ability to credibly signal high quality of the car, the seller who knows that a car is “good” incurs a concentrated cost, with little benefit to his credibility as a reputable seller by acting on his subjective knowledge that the car was truly of high quality. This is because, as Akerlof points out elsewhere, the “cost of dishonesty, therefore, lies not only in the amount by which the purchaser is cheated; the cost also must include the loss incurred from driving legitimate business out of existence” (1970, p. 495). Thus, in a market for “lemons,” dishonest car dealers can freeride on the good will on honest car dealers, given that car dealers *acting as price takers* generate an outcome consistent with a “market failure” to due asymmetric information over the quality of cars.

Note that Akerlof’s argument is completely valid, but one that follows from a microeconomic window of how markets “fail.” This does not imply that microeconomics only illustrates market failure; it indeed illustrates the efficiency of markets under perfect competition. However, looking at markets through this window, in both cases, whether we are demonstrating that markets are optimal or suboptimal according to the conditions of perfect competition, “*the heuristic value of equilibrium is sacrificed*. By ignoring the dynamics of disequilibrium, both traditions [of market failure and market optimality] obscure the possibility that real-world market institutions may have coordinative properties even in the presence of dispersed knowledge, pervasive ignorance, the irreversibility of time, and changing conditions” (emphasis original; Boettke 1997, p. 24).

This brings us to the “window” of price theory, from which we can observe that instead of demonstrating the case of market failure, Akerlof is also illustrating the exact opposite in the very same paper! How can this be the case? As Buchanan points out, different windows can direct our attention to concentrate on different aspects of the same phenomenon. By his own admission, Akerlof states that “private institutions may arise to take advantage of the potential increases in welfare which can accrue to all parties” (1970: 488). Such “counteracting institutions,” as he refers to them, are consistent with an account told by price theory, one in which a market failure represents a profit opportunity for entrepreneurs to correct for a market failure. These include, for example, guarantees, brand names, or other forms of advertising that are consistent with non-price competition. Such a window is consistent with F.A. Hayek’s understanding of the price mechanism (1945), which provides entrepreneurs high-powered incentives to act on their particularized and subjective knowledge, *not vice-versa* as Akerlof’s account would suggest. But as Hayek also argues, the communicative function of relative prices is predicated on non-price forms of competition, such as advertising, which serves to communicate economic knowledge about the availability of substitute goods and services, their quality, and the reputation of its sellers, thus allowing for price adjustments in a manner reflective of underlying information. As Hayek argues, “equilibrium analysis can really tell us nothing about the significance of such changes in knowledge, and it would also go far to account for the fact that pure analysis seems to have so extraordinarily little to say about institutions, such as the press, the purpose of which is to communicate knowledge. It might even explain why the preoccupation with pure analysis should so frequently create a peculiar blindness to the rôle played in real life by such institutions as advertising” (Hayek 1937, p. 53).

To conclude, why, then, does Akerlof’s paper continue to be identified as an example demonstrative of “market failure”? I would argue it is because of the distinct difference in the windows that microeconomics gives us about how markets *ought to work*, rather than price theory giving us a window from which to see how markets *actually work*.

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