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## The Pretense of Regulatory Knowledge

Posted By [Sheldon Richman](#)

Advocates of the free market are sometimes parodied for their seemingly all-purpose answer to any problem: *Let the market handle it*. What may sound like a simplistic answer, however, is actually the most complex prescription imaginable. In the modern world, the workings of any particular market are so complicated, they are beyond the grasp of mere mortals. Moment by moment, day by day, so many subtly interrelated decisions are made by so many people worldwide that no individual or group could possibly understand the big picture in any detailed way. So there is nothing simplistic about proposing the market as a solution to an economic problem. It's short way of saying: let the multitude of knowledgeable people seeking profit, risking their own money, and responding to incentives find a solution based on persuasion not force. Translated that way, it sounds like a promising approach.

Ironically, those who don't appreciate markets are in fact the ones who offer a simplistic, even empty alleged solution to economic problems: government regulation. That phrase is uttered like an incantation, the magical answer to all doubts about how, in the absence of fully free markets, problems would be solved. The irony is that while "let the market handle it" can be unpacked and made specific, "regulation" cannot. It can only be interpreted this way: Appoint a czar or a committee to somehow watch over things, and all will be well.

We're hearing this idea a lot these days. It's the most popular suggestion for preventing a repetition of the turbulence in the financial markets: There's not enough regulation. We need *more* regulation. When free-market advocates point out that the problems were caused by government's [systematic and deliberate weakening of market discipline](#) <sup>[1]</sup> in order to promote corporate profits through homeownership regardless of income or creditworthiness, the other side seems to want to say, "If we have proper regulation, we don't need market discipline."

But chanting "regulation" and "oversight" is not a solution to anything. It raises more questions than it answers. Even if we assume the regulatory body would be populated by honest, disinterested people (a wild assumption, we should realize by now), how would they know what to do? As noted, markets are complex beyond imagination. One may have a great deal of knowledge about one's own sliver of a given market, but that would count for nothing were one called on to regulate the whole thing. Sure, the committee could collect data. But to what avail? Data are history. By the time it is collected, it is old.

### Knowledge, Not Data

And that's the least of the problems. The most important knowledge that fuels market activity is not data. It is not even convertible into data. It's the kind of knowledge, or know-how, that people may realize they possess only when confronted with unexpected alternatives. They might not have been able to tell you in advance what they would have done under those circumstances, and they might not be able to tell you how they knew to do what they did. They found themselves in a situation and, based on their experience, savvy, and hunches, they spotted an opportunity and acted. Much financial-market activity is like that. Split-second decisions based on un verbalized flashes of insight leading, under the right circumstances, to serendipitous results. Put *that* into a computer model!

How are regulators to keep things under control with all that going on? Sitting in an ivory tower and writing regulations for a complex market is a recipe for stagnation, even chaos. Should everyone be required to file a form with the regulators before doing anything different from what was done in the past?

Those who understand little about markets fret that people trade exotic derivatives that even *they* don't understand. Presumably, the regulators wouldn't understand them either. Does this mean no one should be permitted to engage in a trade with someone else before the regulators understand it? That would be the [precautionary principle](#) <sup>[2]</sup> applied to exchange, and it would scuttle valuable innovations in the

financial markets — innovations that would provide liquidity to underpin production. Everyone would be held down to the level of bureaucrats who have no incentive, much less ability, to spot promising innovations when they see them.

Calling regulators *bureaucrats* is not just an insult; it's also a description. Bureaucrats are not in the profit-and-loss game, as entrepreneurs in a (truly) free market are. They don't gain financially from producing value, and they have no capital at risk. As we've learned from the Food and Drug Administration, they tend to be overcautious because if they might err, it's better to err on the side of *not* letting something happen. They are more likely to be blamed if they allow something that later goes wrong.

When greater regulation is proposed after a crisis, it is assumed the regulators will keep an eye out for a repetition of the most recent problem. But that's usually not the one to be concerned about. It's the next, unforeseen problem that is worrisome. What reason is there to believe the regulators would be good at spotting that one?

These difficulties can be summed up by saying that regulation is plagued by the "knowledge problem" almost as much as central planning is. The regulator is nearly as knowledge-deprived as the planner is.

### Knowledge Problem

F.A. Hayek described the knowledge problem in his seminal 1945 paper, ["The Use of Knowledge in Society."](#) <sup>[3]</sup> There he wrote,

The peculiar character of the problem of a rational economic order is determined precisely by the fact that the knowledge of the circumstances of which we must make use never exists in concentrated or integrated form but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess. The economic problem of society is thus not merely a problem of how to allocate given resources — if given is taken to mean given to a single mind which deliberately solves the problem set by these data. It is rather a problem of how to secure the best use of resources known to any of the members of society, for ends whose relative importance only these individuals know. Or, to put it briefly, it is a problem of the utilization of knowledge which is not given to anyone in its totality.

In this light the government regulator more resembles a bull in a dark china shop than an intelligent guide for the market.

Hayek invoked the knowledge problem in expanding on Ludwig von Mises's [critique of central planning](#) <sup>[4]</sup>, which demonstrated that without private property and free exchange in the means of production, market prices and hence economic calculation were impossible. The planner can't possibly know what the multitude in a market "knows." (The quotes are to indicate that this is not all articulable information.)

Israel Kirzner followed up Mises and Hayek by applying the socialist-calculation critique directly to government regulation of the market in his paper "The Perils of Regulation: A Market-Process Approach." The value of Kirzner's argument lies in his pointing out that although the advocate of regulation — unlike the advocate of central planning — seeks not to obliterate the market but only to modify it, facts of life that inevitably haunt the planner also plague the regulator.

Kirzner shows that along with all the other well-grounded reasons for skepticism about the efficacy of regulation, the Austrian school of economics can make an additional, distinctive case that is tied to one of the school's core concepts: entrepreneurial discovery:

The perils associated with government regulation of the economy addressed here arise out of the *impact that regulation can be expected to have on the discovery process, which the unregulated market tends to generate*. Even if current market outcomes in some sense are judged unsatisfactory, intervention, and even intervention that can successfully achieve its immediate objectives, cannot be considered the obviously correct solution. After all, the very problems apparent in the market might generate processes of discovery and correction superior to those undertaken deliberately by government regulation. Deliberate intervention by the state not only might serve as an imperfect substitute

for the spontaneous market process of discovery; but also might impede desirable processes of discovery the need for which has *not* been perceived by the government. Again, government regulation itself may generate new (unintended and undesired) processes of market adjustments that produce a final outcome even less preferred than what might have emerged in a free market.

Kirzner's insights apply to today's financial problems in several ways. First, the immense constellation of market regulations and other interventions works against entrepreneurial solutions to the problems. For instance, there might be investors willing to buy, at a discount, the investment banks' bad mortgage-backed securities (this has happened in some cases), but why should a bank sell at the low current market price if the treasury secretary might be willing to pay more? Second, uncertainty about what new regulations are coming down the pike can only inhibit profit-seeking problem-solvers who may find their plans nullified by the regulators. Third, when new regulations are enacted, the market's discovery process will once again be stifled, as disconnected regulators require or forbid conduct without knowing what they are doing or what the consequences will be.

So-called re-regulation, the hot word in Washington now, makes no sense, for even if the current problems *were* caused by the free market — [which they were not](#) <sup>[5]</sup> — it would not follow that government regulation would produce better results.

In opposing government regulation, no free-market advocate believes the public should be left to the mercy of reckless speculators, short-sellers, and the like, whose activities have the potential to harm bystanders. The public does indeed need protection. What the free-market advocate understands, however, is that regulation is not protection but merely a shoddy, deceptive substitute for the only real protection available: market discipline.

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[3] "The Use of Knowledge in Society.": <http://www.econlib.org/Library/Essays/hykKnw1.html>

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[5] which they were not: [http://www.fee.org/in\\_brief/default.asp?id=2336](http://www.fee.org/in_brief/default.asp?id=2336)

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