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Economics For Yesterday, Today, and Tomorrow

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Abstract
This paper seeks to explore what is enduring and what is fleeting in the basic teachings of economics. The core claim of the paper is that what is enduring in economics is most often politically unpopular, and what is fleeting in economics is usually politically viable and quite often popular. This results in a conflict between good economics and good politics that was evident from the time of Adam Smith to the contemporary world that we as researchers and teachers occupy.

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> "The latest 'new economics,' and in my opinion rather the worst for fallacious doctrine and pernicious consequences, is that launched by the late John Maynard (Lord) Keynes, who for a decade succeeded in carrying economic thinking well back to the dark age…The serious fact is that the bulk of the really important things that economics has to teach are things that people would see for themselves if they were willing to see.…'The time has come to take the bull by the tail and look the situation square in the face.'"
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> – Frank Knight (1951, pp.362–63; 364; 365)

* This paper was prepared for the occasion of receiving the Adam Smith Award from The Association of Private Enterprise Education in April 2010. I was (am) very grateful to have received this award from APEE, and my remarks from that evening can be found at: http://www.coordinationproblem.org/2010/04/2010-adam-smith-award-remarks-read-on-april-11th-in-las-vegas.html. I would like to thank Edward Stringham for editing the special issue of the *Journal of Private Enterprise* that consisted of essays of my former students in my honor that was organized to coincide with the Smith Award. I have learned more from these students than they can ever imagine, and I can only wish for them the wonderful experience in teaching economics throughout their careers that I have been able to have in mine because of them. Thank you.

I. Introduction

An important unsubtle point should be stressed in every economic conversation with peers, students, policy makers, and the general public concerning the Great Recession since 2008. John Maynard Keynes was wrong in both his analysis of capitalist instability and reasons for persistent unemployment in 1936, and he was wrong in 2008. The ideas Keynes developed in *The General Theory of Employment, Interest and Money* (1936) were as wrongheaded in the 19^{th} century as they were in the 20^{th} century, and as they are in the 21^{st} century. Keynesian economics is simply bad economics. And it is vitally important to always remember that in the field of economics, bad economic ideas lead to bad public policies, which in turn result in bad economic outcomes.[1] The realization of this string of logically connected "bads" might be long and varied, but it is inevitable. The Keynes of *The General Theory* was never right when it came to how an economy operates, let alone how to fix it when it teeters during crises. And the resurrection of Keynes among professional economists, public intellectuals, and especially politicians and policy makers in the wake of the global financial crisis of 2008 has been one of the most disappointing developments I have witnessed in my career as an economist.

Keynes was wrong because his analysis was based on a set of flawed premises. The earlier analysis of "effective demand" failure was first pioneered by Malthus but vehemently opposed by Ricardo and the other "classics," and was forced, according to Keynes, to exist "below the surface, in the underworlds of Karl Marx, Silvio Gesell or Major Douglas" (Keynes, 1936, p.32). Keynes believes that the complete victory of the "classics" is a mystery and reflects an unwillingness of professional economists after Malthus to recognize that disjoint between their theory and the basic facts of observation. "It may well be that the classical theory," Keynes argued, "represents

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[1] It is important to stress that simple and straightforward answers in economics need not be simple-minded answers – see http://austrianeconomists.typepad.com/weblog/2008/10/simple-answers.html), and as I will stress throughout, the only real economics is relative price economics, so the discussions of "macroeconomic policy" without reference to the role of prices get us nowhere – this is the underlying message of the argument, that although there may be macroeconomic problems of inflation, unemployment, and industrial fluctuations, there are only microeconomic explanations and solutions. Prices have to be allowed to do their job both of telling the truth and of redirecting the allocation of resources.

the way in which we should like our Economy to behave. But to assume it actually does so is to assume our difficulties away" (1936, p.34).

But there are good reasons why economists forced these theories into the underworld of economic opinion. They reflected bad economic analysis. What I mean by that is that they implicitly assume away scarcity and believe the fundamental problem of modern society is poverty amidst plenty; they explicitly deny both actor rationality and the coordinating role of prices, and the function prices serve in guiding decisions and the feedback and discipline provided by profit and loss.[2] If you postulate a world of post scarcity, then neither the coordinating role of the price system, nor the incentives of the property rights structure, is critical, and if you don't allow the individuals that populate your economy to learn from market signals, and you don't allow those signals to actually work, then of course the economy will not work! This is not mysterious. Without prices and the market process continually guiding economic actors on a path of learning and discovery "amid the bewildering throng of economic possibilities" (Mises, 1922, p.101), the economic future will indeed be ensnared by the "dark forces of time and ignorance" (Keynes, 1936, p.155).

It is important to stress, as J.B. Say did in his *Letters to Mr. Malthus* (1821), that all discussions of overproduction or underconsumption make reference to the price system. The cure to a "glut," Say argued, was neither monetary expansion nor fiscal stimulus, but to allow the prices to adjust to clear the market. In response to Malthus's theory of the "general glut," Say painstakingly explains how the market process coordinates the production plans of some with the consumption demands of others through market price adjustments. Say simply points out that "the slightest excess supply beyond the demand is sufficient to produce a considerable alteration in price" (Say, 1821, p.59). And this focus on market prices and the role price plays in the self-regulation of the market economy (and not his value

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[2] Hayek (1941, p.374) argues that Keynes's economics "is based on the assumption that no real scarcity exists, and the only scarcity with which we need concern ourselves is the artificial scarcity created by the determination of people not to sell their services and products below certain arbitrarily fixed prices." In fn. 1 on that page, Hayek adds that Keynes's economics is essentially a return to a "naïve early stage of economic thinking" and can hardly be regarded as an improvement in economic thinking.

theory, as Malthus had argued), Say argues, forms the true cornerstone of Adam Smith's lasting contribution to the science of political economy (see Malthus, 1821, p.20).

It is this last point raised by Say that I want to emphasize, namely that the cornerstone of Adam Smith's economics is to be found in his analysis of the price system and the self-regulating capacity of the market economy. This is where we find what is enduring in economics, whereas what is fleeting is found in that underworld of economic thinking that denies that analysis. Unfortunately, as has been pointed out by thinkers such as F.A. Hayek, James Buchanan,[3] and more recently Luigi Zingales, the Keynesian message appeals to technocrats and politicians.[4]

This is the economists' age-old plight, what is fleeting in economics is politically popular, whereas what is enduring in economics is politically unpopular. Hayek describes the economists' conundrum as consisting of being called upon to consult with politicians on matters of pubic policy more often than any other social scientists, only to have their advice based on the principles of the science dismissed as soon as it is uttered. Not only are the teachings of the discipline dismissed, but public opinion on the matters at hand seem to run in precisely the opposite direction of that of the economist. This position, Hayek argued, was not unique to his time, as it has been the plight of classical economists as well (see Hayek, 1933, p.17). But what is most fascinating as an issue for a theory of social change is that the ideas of economists in general are not dismissed because public opinion clearly reflects the ideas of economists of the previous generation. Unfortunately, the ideas that dominate are those that Keynes pointed to that had been relegated to

[3] Buchanan and Wagner (1977, p.4) argue that "Keynesian economics has turned the politicians loose; it has destroyed the effective constraint on politicians' ordinary appetites."

[4] Zingales (2009) argued that: "Keynesianism has conquered the hearts and minds of politicians and ordinary people alike because it provides a theoretical justification for irresponsible behaviour. Medical science has established that one or two glasses of wine per day are good for your long-term health, but no doctor would recommend a recovering alcoholic to follow this prescription. Unfortunately, Keynesian economists do exactly this. They tell politicians, who are addicted to spending our money, that government expenditures are good. And they tell consumers, who are affected by severe spending problems, that consuming is good, while saving is bad. In medicine, such behaviour would get you expelled from the medical profession; in economics, it gives you a job in Washington."

the underworld. This is precisely the situation we find ourselves in today. And as economic educators, we must, as the epigraph from Knight argues, stare the situation square in the face, acknowledge the ugly and unpleasant nature of things in our profession and the body politic, and take up the challenge of teaching the principles of economics to those who refuse to learn and in most instances even seriously listen.

II. What Adam Smith Did *Not* Say, and What He Did Say

Adam Smith was not the first economic thinker. But Adam Smith synthesized existing knowledge and did so in a way that has captured the imagination of intellectuals ever since. His is one of the towering achievements in the scientific and literary history of western civilization. Even to this day, Smith's legacy is hotly debated.

A new generation of scholars such as Emma Rothchild (2001) and Sam Fleischacker (2004) are battling to save Smith's legacy from the Adam Smith tie-wearing conservative policy community. Stressing the human and egalitarian sides of Smith's theory, they seek to counter the reading of Smith that focuses exclusively on self-interest and market efficiency. This caricature of Smith, as this egalitarian and progressive reading of Smith points out, is false. Smith never said "Greed Works" and that is that. His argument is much different. But the Smith of Rothchild and Fleischacker is also a confused caricature. Smith was not an egalitarian social democrat. He was an analytical egalitarian, but he was a classical liberal political economist. *The Wealth of Nations* develops the positive science of political economy, and Book V can be read as an attempt to provide on the basis of that positive science a set of rules that an enlightened statesman who desired to produce the "good society" could follow.[5] In Smith's work, the scale and scope of government is limited. While not non-existent, it is limited to basically the "night watchman" state of classical liberal political philosophy: protections from foreign aggressors, protection of person and property and the administration of justice domestically, and the provision of essential public works. Only a distorted reading of Smith could produce either the institutionally antiseptic "self-interest" only interpretation, or the Smith as precursor of the modern social democratic welfare state.

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[5] Two of my favorite examples are Smith's four maxims of taxation and his warning about the "juggling trick" of debasement to pay off public debt.

The more modern social democratic reading of Smith is a consequence of the caricature prevalent in our culture of the "self-interest" reading as that of the laissez-faire economists in general. To distance Smith from the "economists," they offer an interpretation that is more compassionate to the poor and the dispossessed.

An older literature exists in intellectual history, which also tried to drive a wedge between Smith's *Theory of Moral Sentiments* (1758) and *The Wealth of Nations* (1776). Called the *Das Adam Smith Problem*, it argued that Smith built his theory of moral sentiments on human sympathy, whereas self-interest drove his theory of the economy. In one book we get other-regarding behavior, whereas in the other we get self-regarding behavior; how can we reconcile these works? Many attempts have been made to address this problem, including Vernon Smith's "The Two Faces of Adam Smith." The bottom line is that the "problem" is really not a problem.

The Wealth of Nations is about social order among strangers – a social order in which our span of moral sympathy moves far beyond the realm of the familiar. "In civilized society," Smith argued, man "stands at all times in need of the co-operation and assistance of great multitudes, while his whole life is scarce sufficient to gain the friendship of a few persons." (1776, Bk 1, p.18) The market economy is about cooperation in anonymity, cooperation with strangers. In the chapter previous to the passage cited above, Smith presents the reader with the basic mystery of economic life. The number of exchange relations that must be coordinated to produce even the most common products we take for granted "exceeds all computation" (1776, Bk 1, p.15).

The source of the wealth of nations arises from social cooperation under the division of labor, and to realize this social cooperation certain fundamental institutions in society must be in place – the delineation and enforcement of private property, the keeping of promises through contract, and the acceptance of the legitimacy of the transfer of property by consent. Benevolence would not be able to achieve this social cooperation under the division of labor. The relationships exist at the outer bounds of our span of moral sympathy. But when the institutions of property, contract, and consent are in place, then the self-interest of individuals can be marshaled to realize the mutual gains from trade and the benefits of every refined division of labor in society. Our moral sentiments do not disappear as the span of moral sympathy moves from the intimate order to the extended order of the market. They are omnipresent, but we must be mature about them; otherwise, our moral intuitions will be in conflict with the moral demands of the market order. The moral sentiments within a commercial society manifest themselves in more general rules of just conduct (related to the institutions of property, contract, and consent), rather than specific outcomes of just division given a fixed resource endowment. The rules of the intimate order do not transfer to the extended order without sacrificing the gains from social cooperation under the division of labor, in which case we sacrifice the extended order itself.

Smith certainly did not teach that individuals should pursue their self-interest at all costs. But he also didn't even teach the more subtle presentation that the pursuit of self-interest will automatically translate into public benefits. *The Wealth of Nations* actually has plenty of examples in which the pursuit of self-interest can lead to socially undesirable outcomes. His discussion of the vocation of teaching in Oxford (bad) and in Glasgow (good) provides a classic example (see Smith, 1776, Bk V, p.282–84). In Glasgow, the teacher had a strong incentive to provide valuable instruction because salary was a function of fees paid by the students, whereas in Oxford, because an endowment guaranteed a teacher's salary, the professors had long ago given up even the pretense of teaching. Smith's work is full of such comparative institutional analysis. The pursuit of self-interest in one case leads to a socially desirable outcome, whereas in the other it leads to an undesirable one. The key point: Smith's analysis does not turn on the behavioral postulate of self-interest but instead on the institutional specifications that are said to be in operation. The institutional specification of a private property market economy guided by price signals and disciplined by profit and loss accounting will steer self-interested behavior in the direction of social cooperation. The vast division of labor is coordinated throughout the world, and the most common products – from a woolen coat in Adam Smith's time to a pencil in Milton Friedman's – are made available to individuals who will never know who played a part in the production of that good, and who if required to produce this product all by themselves wouldn't know where to start.

This is just another way to state Smith's "invisible hand" proposition. Individuals pursuing their own self-interest within an institutional setting of property, contract, and consent will produce an overall order that, although not of their intention, enhances the public good. Absent that institutional setting, self-interest may very well not produce publicly desirable outcomes, and in fact may produce the opposite. What matters for Smithian political economy is the institutional filter that individual actors work within, and which produces unique equilibrating processes.[6]

J.B. Say in his *Letters to Malthus* states that he revered Smith: "he is my master" (1821, p.21). As I mentioned before, Say had such a strong affinity to Smith because of his exposition of the fundamental role of prices in coordinating economic activity. As Say argued, exchange and the market prices that emerged in the "higgling and bargaining" among individuals formed the cornerstone of Smith's political economy. Smith's economics was price theoretic economics. But Smith's economics was also institutional economics. The link between the abstract function of price and the concrete role of institutions that Smithian political economy provides supplies the foundation for what endures in economics. However, in understanding the full implications of Smith's message about market theory, the price system, and the role of institutions, we also reveal why technocrats and meddlesome politicians find it unpopular.

Hayek (1948, p.11ff) has argued that Smith designed his political economy to be robust against both the stupidity and arrogance of actors within the system. Smith and his contemporaries (e.g., Hume) sought to discover a system of governance in which bad men can do the least harm, and which did not require for its operation that only the best and the brightest be in charge. They sought, in other words, a system of societal governance that treated men as they are – sometimes good, sometimes bad; sometimes intelligent, sometimes not so bright – and that would use their human variety to produce peace and prosperity. The classical political economists of the 18th and 19th century discovered that the private property market economy provided the basis for just such a system.

Smith had argued in *The Theory of Moral Sentiments* that the "man of systems" was wise in his own conceit, but perhaps his most biting passage on the arrogance of the politician is found in *The Wealth of Nations*. In the paragraph after the famous "invisible hand" passage, Smith argued the following:

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[6] The emphasis on institutional filters and equilibrating processes is developed in Robert Nozick's discussion of "invisible hand" explanations in *Anarchy, State and Utopia* (1974, pp.18–22).

> What is the species of domestic industry which his capital can employ, and which the produce is likely to be of the greatest value, every individual, it is evident, can, in his local situation, judge much better than any statesmen or lawgiver can do for him. The statesmen, who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would no-where be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it (Smith, 1776, Bk. IV, p.478).

This passage anticipates, by my reading, the calculation/ knowledge argument about government planning associated with Mises and Hayek, as well as the problem of arrogance and power that Hayek identified with the "pretense of knowledge" or "fatal conceit." Elsewhere I have argued that David Hume's dictum that when we design institutions of government we must assume that all men are knaves, implies that we must watch out for both hubristic knavery of the kind that Hayek has emphasized as well as the opportunistic knavery of the kind that Buchanan and Tullock have emphasized in the development of public choice theory. Smith, in this passage, anticipates the core ideas in those modern critiques of government control over economic life and reveals another element of what is enduring in economics.

III. What Is Enduring and What Is Not

When we teach principles of economics to our students, most teachers of economics introduce the concept of scarcity quickly. Individuals choose within constraints and do not make unconstrained choices. As a result, our choices always involve the assessment of trade-offs, and as such we need some tools to help us make those assessments. The price system provides those tools for us. More importantly, the price system translates our private assessment of trade-offs into publicly useful information for others to utilize in their own private assessment of trade-offs, and thereby establishes the terms of exchange on the market.

Economics explains exchange and the institutions within which exchange takes place. As Frank Knight often stressed, economic analysis must always begin with the recognition of the fundamental point that an exchange is an exchange is an exchange, and exchange is mutually beneficial, otherwise the trade would not have taken place. Economics is elementary, but the persistent and consistent application of the economic way of thinking to all walks of human life requires discipline and creativity. Economics is a deadly serious discipline about deadly serious topics, and economics is a joyous exploration of man in all his endeavors. In our capacity as teachers of economics, it is our responsibility to introduce our students to both sides of the economic way of thinking.

But one of the most valuable applications of the economic way of thinking may very well be in explaining why good economics more often than not conflicts with good politics under democracy. An economic analysis of democratic politics reveals that the process pits a vote-seeking political entrepreneur against rationally ignorant voters and specially interested voters. The logic of this situation produces a bias in which the vote-seeking political entrepreneur will seek to secure votes and campaign contributions by promising to concentrate benefits on the well-informed and well-organized specially interested voters while dispersing costs on the unorganized and ill-informed rationally ignorant voters. Moreover, the election cycle will impact the timeframe and produce a shortsightedness bias to compound the concentrated benefits/dispersed cost logic.

This is good politics. To do otherwise risks not gathering the required votes to win election. A vote-seeking politician that cannot garner votes eventually is weeded out of the political marketplace. But do shortsighted policies that concentrate benefits on special interest groups and disperse costs on rationally ignorant (or rationally abstaining) voters produce good economics? We must conclude NO; they instead produce political externalities. Good economics instead would concentrate costs on decision makers but disperse the benefits widely on the population. This is, again, one way to think about the implications of Adam Smith's invisible hand postulate – individuals pursuing their self-interest within a system of private property and the competitive market system will bear the costs of their decisions but possess the opportunity to reap the benefits from mutual exchange, and these exchanges produce more generalized benefits to the society as a whole. As we can see in the spread of trading opportunities and gains from technological innovation, these benefits of modern commercial life are the gift that keeps on giving. In other words, the benefits are not short-term gains, but long term in nature and at the core of the explanation of the wealth of nations (and their poverty when the benefits from trade and the benefits from innovation are not regularly realized).

Good economics concentrates costs on decision makers in the short run and disperses benefits to the society as a whole in the long run, whereas good politics concentrates benefits on well-organized and well-informed interest groups in the short run, while dispersing costs on the ill-organized and ill-informed mass of voters (both rationally ignorant and rational abstainers) in the long run. Since the beginning of the discipline, economists have recognized the conflict between good economics and good politics.

In the wake of this realization, we must remember that our job as economic educators and scholars is neither to steer the ship of state in one direction or another, nor to provide pleasant and popular news to the ears of politicians and the public about the possibility of enlightened government policy to provide a corrective to the social ills of this world. Instead, our job is the twofold task of: (1) the pleasant job of presenting the basic principles of our discipline to our "students" and deploying those basic principles to make sense of the world around us, and (2) the unpleasant one of playing the social critic who demonstrates logically and empirically how the best intentions of policy makers go astray and produce outcomes that are worse than the conditions the policies intend to eradicate. As Knight (1951, p.365) stressed, we should not underestimate our role in providing *negative knowledge*. Economics puts parameters on people's utopias, and the teachings of the principles of economics should inform as much on what *not* to do, perhaps even more than providing a guide to public action.

Implicit theories of post-scarcity worlds, or theories that do not see a role for property, prices, and profit and loss, or theories that assume that the decision makers in policy are omniscient eunuchs (or more traditionally benevolent despots) should not endure in economic education. The vulnerability of such fragile analysis must be exposed and subjected to harsh criticism in our scientific journals, in our classroom lectures, in the policy papers we write or testimony before committees that we provide, and in our effort to reach the everyman with magazine articles, newspaper opinion editorials, Twitter and blog posts, and radio and television appearances. Arthur Marget supposedly used the analogy to the netman in the days of the gladiator to describe his intellectual endeavor. Carrying a net and a trident, the fighter would entrap his adversary in the net and then use the trident to strike the death blow. Marget reportedly described his massive tome, *The Theory of Price* (1948–42), as his effort to entrap all the Keynesian fallacies in his net, after which he would strike the death blow with his analysis.

Amazingly, Keynesianism as a system of *political* economics displays resilience in the face of repeated efforts (intellectually successful from my perspective, I should add) to be ensnared in the net of economics as fallacious doctrine. I contend that political, rather than analytical, reasons explain its appeal, and so we must continue to fight this battle and expose the intellectual bankruptcy of politicized economics. Keynesianism is indeed a disease on the body politic in democratic society. An economic doctrine of technocratic arrogance, it suffers from the "pretense of knowledge" and gives scope to the opportunistic behavior of politicians who become unconstrained by Keynesianism in practice.

I have referenced J.B. Say as stressing the role of the price system in the self-regulation of the market, but his fellow Frenchman, Frederic Bastiat, should not be forgotten. His infamous "petition," the classic economic satire, exposes the silliness of special pleading. What differs between the candlestick makers' petition and the calls for bailouts, for protection from foreign competitors, for the establishment of public unions whose members are exempt from the vagaries of the marketplace, and so on? Not only must cold heads prevail over warm hearts; the arrogance as well as the loose reasoning must be continually exposed – no doubt first by careful theoretical and empirical analysis, but don't forget that ridicule and satire are also effective teaching tools.

IV. Conclusion

It is an amazing honor for me to earn this award from APEE. I am truly humbled to receive this award, and to be listed among the past winners of this award such as Armen Alchian, Harold Demsetz, Douglass North, Vernon Smith, or my teachers Gordon Tullock and James Buchanan. To be honest, I am more comfortable viewing myself as someone who studies the work of these past winners and teaches their works to my students, rather than someone who is on any list with them. But I will gladly and humbly accept this honor from our society.

I hope my discussion of what is enduring in economics captured elements of the thinking exhibited in the great work of these previous award winners, and I hope it can serve as a rally call for all of us who view our primary professional duty as that of economic educators. We have a job to do; we have to teach the basic principles of economics and cultivate an appreciation among our students of the teachings of the great political economists from Adam Smith and David Hume to F.A. Hayek and James Buchanan. Their message was clear: Not only is the private property market economy a self-regulating system guided through relative price adjustment and profit and loss calculus, but the market society forms the basis for a political order of free people. Efforts to intervene in the market order should always be checked for knavish efforts of either hubris or opportunism (or both). Even as we are staring the current situation of anti-economics knavery gone amok squarely in the face, let us, as economic educators, never lose sight of the core message and communicate it simply and clearly: When it comes to realizing the mutual gains from social cooperation, prices work, politics doesn't. The central message of the superiority of economic freedom compared to the tyranny of government control is what emerges from the study of the economic thinking that is valid for yesterday, today, and tomorrow.

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