Economists as social engineers

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August 2010

Institute of Public Affairs
Free people, free society

> "Why, practically every nonsense that has ever been said about capitalism has been championed by some professed economist".[1]

In this paper, I make the argument that modern "mainstream" economic thought is inclined towards government intervention and social engineering.[2] To the extent that economic analysis is seen simply as a tool it is likely that economists will recommend greater intervention in the marketplace. Largely, the damage is caused by an ever-increasing emphasis on "short-term" analysis and social discussion. As Joseph Schumpeter wrote "any pro-capitalist argument must rest on long-run considerations. In the short run it is profit and inefficiencies that dominate the picture".[3] Mainstream economists have a theory that indicates that these inefficiencies cause markets to "fail" and government intervention can improve upon market outcomes. This feeds into the policy recommendations that economists make and also what they teach in the classroom. As an ever-increasing cohort of the population is exposed to these teachings, it is likely that public support for markets will be eroded.

The Perversion of High Theory

Economics has come a long way since Adam Smith, the founder of modern economics, wrote these words,[4]

> Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice; all the rest being brought about by the natural course of things. All governments which thwart this natural course, which force things into another channel or which endeavour to arrest the progress of society at a particular point, are unnatural, and to support themselves are obliged to be oppressive and tyrannical.

In fairness to modern economists, one may quibble over the definitions of "opulence", "easy taxes", and "tolerable". The problem with this observation is that it doesn't leave much scope for economists. Indeed, Ronald Coase has argued that economists have spent much of the past two hundred years filling in the details of Smith's vision and

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[1] Joseph A. Schumpeter, 1942, *Capitalism, Socialism and Democracy*, Harper & Row, p. 144.
[2] Daniel B. Klein makes a similar, and far more elegant, argument in his paper "The Smith-Hayek Economist: From Character to Identity", available at www.econlib.org/library/Columns/y2007/Kleinidentity.html
[3] Schumpeter, ibid, p. 145.
[4] Adam Smith, 1776, *An Inquiry into the Nature and Causes of the Wealth of Nations*, University of Chicago Press, p. xl. This quote is from Edward Cannan's Editor's Introduction.

correcting the errors he made.[5] This is probably right. Modern economic theory, however, has a very different perspective about the workings of the market than were held by its founder.

Adam Smith sets out some very important yet basic concepts. First, he recognises the importance of the division of labour and trade. Second, he understands the power of self-interest.

> Whoever offers to another a bargain of any kind, proposes to do this. Give me that which I want, and you shall have this which you want, is the meaning of every such offer; and it is in this manner that we obtain from one another the far greater part of those good offices which we stand in need of. It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.[6]

Self-interest is as out of fashion today as it was then. Smith, however, tells us that it is possible to “do good” without actually “being good”. Trade in an anonymous market enhances “civilised society”. As Friedrich Hayek tells us, “It is not good intentions or needs but doing what in fact most benefits others, irrespective of motive, which will secure the best reward”.[7] Self-interest leads to Smith’s famous invisible hand theorem.

> As every individual, therefore, endeavours as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good.[8]

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[5] Ronald Coase, 1991, ‘The Institutional Structure of Production’, The 1991 Alfred Nobel Memorial Prize Lecture in Economic Sciences, Reproduced in, *Essays on Economics and Economists*, University of Chicago Press. p. 4.
[6] Smith, ibid. p. 18.
[7] Friedrich A. Hayek, 1976, *The Mirage of Social Justice: Law, Legislation and Liberty vol 2*. University of Chicago Press. p. 72.
[8] Smith, ibid. p. 477 – 478.

This all seems fairly straightforward and uncomplicated. People trade in their own best interests and by doing so expand the market, leading to more trade and greater wealth in the society. Compare how modern economic theory purports to make that same point.

> If the utility functions U_i are strictly increasing, any equilibrium is efficient: if $(p^*, (x_i^*)_{i=1,...,I}, (y_j^*)_{j=1,...,J})$ is a competitive equilibrium, then the allocation $((x_i^*)_{i=1,...,I}, (y_j^*)_{j=1,...,J})$ is a Pareto optimum.[9]

Writing in the *New York Review of Books*, the 1986 Economics Nobel Prize winner Robert Solow translates this into English in this way: "a perfect free market system – and months of study go into the precise meaning of "perfect" here – will achieve a Pareto-optimal outcome. [That is to say] no feasible reallocation can make anyone better off without making someone else worse off".[10] This expression is known as the "First Theorem of Welfare Economics" – it is based on assumptions, and has a rigorous mathematical proof. There is a second welfare theorem that suggests that Pareto-optimal outcomes are independent of the distribution of wealth, in other words it is possible to redistribute wealth (or income) and the market will still be efficient. This too has a number of assumptions, and a mathematical proof.

The assumptions that underpin the mathematical proofs of both welfare theorems are quite onerous. In addition, the proofs themselves are fragile. In other words, the violation of any assumption leads to the proof failing. Modern economists interpret the proof failing as justification for corrective intervention.[11] What are the assumptions? The first assumption is that "complete" markets exist. This assumption is easily violated when uncertainty, transactions costs, and asymmetric information exist. The second assumption is that no so-called market failures exist. In other words, there are no public goods, no externalities[12], and no increasing returns. The third assumption is that there is no monopoly or monopsony[13] in the economy. If all of these assumptions are met, then the market will function as Adam Smith predicted. In any event, it may still be possible

[9] Bernard Salanie, 2000, *Microeconomics of Market Failure*, The MIT Press, p. 3.
[10] Robert Solow, 'How to Understand the Economy', *New York Review of Books*, Nov. 16, 2006.
[11] I thank Alex Robson for clarification on this point. The assumptions are sufficient but not necessary; the precise nature of the violation is important in determining whether the market is efficient or not.
[12] James Buchanan and Craig Stubblebine, 1962, 'Externality', *Economica*, 29: 371 – 384, however, show that externality violates equilibrium in very specific instances. By not considering these instances clearly economists are likely to overstate the impact of externality on the economy. See also the articles contained in *The Collected Works of James M Buchanan* Vol. 15.
[13] Monopsony is a single buyer, while monopoly is a single seller.

to redistribute wealth and income and the market would work well.[14] Each and every one of these assumptions is violated in practice – economists tend to interpret this as meaning markets fail. Robert Solow is worth quoting in this regard.

> … Adam Smith claim[ed] that unfettered competitive markets guide the consequences of self-interest to a socially beneficent outcome. Modern students learn that this "beneficence" has to be carefully interpreted. … So the free market outcome is not "better" that its starting distribution of wealth. It can be described as socially desirable only if the allocation of initial endowments was socially desirable. The theological free marketeer likes to omit that proviso. A good student should not.[15]

Theoretical economics – or at least, the mainstream version of economics – has no theory explaining why markets actually work well in practice. It is logic such as this that leads to the economists' quip "that is all very well in practice, but it could never happen in theory". Hayek has referred to this attitude as "constructivist rationalism".[16]

Modern economists have a theory that indicates that free markets are unlikely to work well in practice.[17] This, of course, invites proposals for improvement – particularly in the area of wealth distribution. This is especially problematic. What sort of wealth distribution should there be? Economists often speak of "equity", but struggle to include it in their formal models. This problem is not trivial. Fred Argy, for example, has written

> Economists are very good at advising on the best means of achieving given policy objectives – so long as the social objectives are clearly and fully laid out for them by the politicians. But most of the time the social goals are not specifically defined and so economists inject their own value judgments into the public policy debate.[18]

Two interrelated problems immediately arise. The first is a behavioural problem. James Buchanan tells us "economists, along with other social scientists and social philosophers, enjoy playing God".[19] By this he means that economists take it upon themselves to set out their own personal utopias, but not how it might be achieved nor

[14] Even Hayek can be quoted supporting this notion. "A free system can adapt itself to almost any set of data, almost any general prohibition or regulation, so long as the adjusting mechanism itself is kept functioning" F.A. Hayek, 1960, *The Constitution of Liberty*, Routledge, p. 200.
[15] Solow, ibid.
[16] Friedrich A. Hayek, 1973, *Rules and Order: Law, Legislation and Liberty Vol. 1*. University of Chicago Press. p. 9. See generally chapter one of *Rules and Order* and chapter two of *The Constitution of Liberty*.
[17] Strictly speaking, economists tend to interpret their theory as indicating that markets do not work well in practice.
[18] Fred Argy, 'Ideology and Economic Policy', Posted at Club Troppo, August 2006. www.clubtroppo.com.au/2006/08/29/ideology-and-economic-policy-fred-argy-2/
[19] James M. Buchanan, 1977, 'Democratic Values in Taxation', Reproduced in *Debt and Taxes: The Collected Works of James M. Buchanan, Vol. 14*, pp. 36 – 45.

how it might be reconciled with existing democratic society. The second problem is the "standard" economic model of government. Bernard Salanie explains: "As is generally the case in microeconomics, this book will content itself with describing the government as a "benevolent planner" that takes into account the preferences of agents for determining the social optimum and then attempts to make use of it". [20]

Economists deduce from their theoretical model that the real world can be improved by intervention from a "benevolent planner". Harold Demsetz has described this as being the "nirvana approach" to economics. Economists who use this approach "seek to discover discrepancies between the ideal [world] and the real [world] and if discrepancies are found, they deduce the real is inefficient."[21] In other words, reality must conform to the economists' imagined ideal world. Demsetz indicates three logical fallacies associated with the nirvana approach – the grass is always greener, there can be a free lunch, and people could be different. Economic policy advice in such circumstances becomes very problematic. As James Buchanan warns, "[s]o long as the economist proffers his advise as if some benevolent despot is listening to him, he may be more willing to devote his efforts to persuasion based ultimately on his own personal, private scale of values, even if the argument is couched in quasi-philosophical terms."[22]

Economic Social Engineering

Fred Argy has described a series of bipartisan policy goals as seeking "to promote a fairer society … These policy goals, founded on a set of normative social beliefs and values peculiar to Australia, were not always achieved in practice but the *intent* – to temper the effects of markets on income and wealth inequality and to promote greater equality of opportunity – was clearly there."[23] Before any of these policies are investigated (or even identified)[24], it is worth noting that these policies were *intended* to work, but he seems to imply that in practice many did not. Argy is most concerned however, not with the outcome of the policy but its actual intent. Immediately, this is at

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[20] Salanie, ibid. pp. 8 – 9.
[21] Harold Demsetz, 1969, 'Information and Efficiency: Another Viewpoint', *Journal of Law and Economics*, 12, 1 – 22.
[22] James M. Buchanan, 1975, 'Public Finance and Public Choice', Reproduced in *Debt and Taxes: The Collected Works of James M. Buchanan, Vol. 14*, pp. 3 – 24.
[23] Fred Argy, 2006, 'Equality of Opportunity in Australia: Myth and Reality', The Australia Institute, Discussion Paper Number 85, p. 7 (emphasis original).
[24] I intend to discuss only two of the six policies.

odds with Smith's vision. Yet nothing Argy says is inconsistent with modern mainstream economics.

The first policy Argy identifies is "full-time employment for anyone who wanted it". This policy is hardly unique to Australia and forms the basis of many macroeconomic policy recommendations. The problem with a policy such as this, is the "for anyone who wanted it" component. What about those individuals who do not want employment or is willing to work but not for the wage others are offering to pay? Mainstream economics has no "work ethic" associated with it. In fact, a work ethic violates the convexity assumption leading to "market failure".

James Buchanan suggests that individuals in an economy would be better off if there were a strong work ethic than if there were a weak work ethic.[25] Most people would agree with this proposition. Mainstream economists, however, would not. Buchanan's argument revolves around Adam Smith's insight into the division of labour. Smith had argued that the division of labour is limited by the extent of the market. As individuals work more, so they increase the size of the market and enable greater specialisation and trade. This process would see new job descriptions appearing, greater employment, and increased wealth in society. In other words, a work ethic is associated with increasing returns, while the standard economic model of the economy has constant returns.[26] Buchanan tells us "my argument suggests that individual voluntary adjustments need not generate results that are optimal or efficient, as defined in the conventional Pareto way."[27] In other words, suggestions for improvement can be made for employment in the absence of a belief in a work ethic.[28] Of course, many economists themselves may believe in the work ethic and work very hard themselves.

In Australia, much is made of high effective marginal tax rates (EMTR). These rates result from the interaction of the (progressive) tax system and the means-tested welfare system. Argy defines a "means-tested, community-based and dignified social transfer safety net" as one of his six policies. He also includes a "strongly progressive tax system". These two policies, however, do not interact well. The EMTR is described as the change

[25] James M. Buchanan, 1994, *Ethics and Economic Progress*, University of Oklahoma Press, p. 5.
[26] Buchanan, ibid. p. 25.
[27] Buchanan, ibid. p. 24.
[28] The federal government has often been criticised for its 'Work for the Dole' programme and the notion of mutual obligation. Yet this is a work ethic notion. The federal government has been criticised for its policy to encourage people to work past retirement age. This too is a work ethic notion.

in after-tax total income that results from a change in earned income. Total income arises from the combination of wages and welfare. As wages increase so the tax payable on those wages increase and welfare payments decline. The "logic" of EMTRs then is that it does not pay low-income individuals to work harder, or unemployed individuals to get a job. This conclusion, however, entirely ignores the value of a work ethic.

Another policy that Argy tells us was intended to work is a "strongly progressive tax system". In this regard, at least, Australian policy has been a glorious success. In particular, under the Howard government, the tax burden (contribution to net income tax) on the top 25 percent of taxpayers increased from 60.8 percent in 1996-7 to 64.2 percent in 2003-4.[29] The overall tax burden is also very progressive. It only appears less progressive as a consequence of (high) alcohol and tobacco taxes that due to the incidence of consumption are regressive.[30] The question needs to be asked why a strongly progressive tax system is preferred. Friedrich Hayek writes that "progressive taxation is today the chief instrument of income redistribution".[31] Recall that economic theory suggests that income and wealth can be redistributed and economic efficiency will be re-established by market forces. This result, of course, invites proposals to redistribute income and wealth. Hayek tells us that redistribution as an explicit policy had been rejected in the nineteenth century, so progressive taxation had to be "smuggled in under false pretences". These two pretences involve economic theory: first, equality of sacrifice and second diminishing marginal utility to income. Both of these notions have been severely criticised in the economic literature, yet many economists and most economics texts continue to justify progressive taxation on these grounds. Clearly, the objective is income redistribution. Argy gives the game away when he writes, "there is no cause for great social concern: Australia's income distribution has been remarkably stable over the past twenty years, despite accelerating economic and structural reform."[32]

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[29] These numbers are from my book chapter 'Who's not paying their fair share of income tax?' in Peter Saunders (ed), 2006, *Taxploitation: The Case for Income Tax Reform*, CIS. p. 58. Data for 2003-4 are calculated in the same way from the Australian Tax Office.
[30] See my paper 'Taxation with misrepresentation: Australia's revenue lobby in denial', *Policy*, 20(4): 31 – 37, Summer 2004-05.
[31] Hayek, *The Constitution of Liberty*, p. 267.
[32] Argy, ibid. pp. 7 – 8. Argy goes on, however, to suggest that income distribution is a narrow focus on the problem of inequality and that "passive redistribution" does not correct "market-based inequalities".

Egalitarianism is *not* a logical successor to Adam Smith's vision of markets.[33] Ludwig von Mises is emphatic on this point; "The inequality of incomes and wealth is an inherent feature of the market economy. Its elimination would entirely destroy the market economy."[34] It is inequality that gives rise to the division of labour, specialisation, and trade. This should not be confused with the notion of equality before the law. Mises also makes the point that those societies which embrace egalitarianism (in intent, although not always in practice) do not prosper. Those societies that have adopted Marxist principles have not achieved their stated objectives. Similarly, Islamic economies have struggled to reach their full economic potential. Any ideology or religion that brands "acquisitiveness as immoral and erect[s] institutional barriers to check it" will not prosper economically.[35]

Mises is not only scathing of egalitarianism as a philosophy, he is also scathing of welfare "propagandists".

> They intentionally employ a term the generally accepted connotation of which precludes any opposition. … Their terminology already implies that all opponents are ill-intentioned scoundrels eager to foster their selfish interests to the prejudice of the majority of good people.
> The plight of Western civilization consists precisely in the fact that serious people can resort to such syllogistic artifices without encountering sharp rebuke. There are only two explanations open. Either these self-styled welfare economists are themselves not aware of the logical inadmissibility of their procedure, in which case they lack the indispensable power of reasoning; or they have chosen this mode of arguing purposely in order to find shelter for their fallacies behind a word which is intended beforehand to disarm all opponents. In each case their own acts condemn them.[36]

These are particularly harsh words, yet it is difficult to see how Mises is incorrect in his assessment. Mises is the successor to Smith's vision, and not modern welfare economics.

> The welfare propagandist, it is true, raises two objections. First, that the individual's motive is selfishness, while the government is imbued with good intentions. … But what counts in life and reality is—in spite of what Kant said to the contrary—not good intentions, but accomplishments. What makes the existence and the evolution of society possible is precisely the fact that peaceful cooperation under the social division of labor in the long run best serves the selfish concerns of all individuals. [37]

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[33] Bernard Salanie, ibid. pp. 14 – 15 explains how egalitarianism is the only wealth distribution that mainstream economic theory can accommodate as being "fair".
[34] Ludwig von Mises, 1949, *Human Action: A Treatise on Economics*, Fox & Wilkes. p. 840.
[35] Mises, ibid. p 841. The entire section consists on a comparative analysis that is well worth reading. Modern readers should not be put off by the terms "Asiatics" and "Mohammedans".
[36] Mises, ibid. p. 834.
[37] Mises, ibid. p. 845.

Blackboard Economics

Ronald Coase complains that economic analysis has become too narrow; "What is studied is a system which lives in the minds of economists but not on earth. I have called the result "blackboard economics"."[38] In essence, economists are able to practice their trade without "a detailed knowledge of the actual economic system or, at any rate [having] managed to proceed without it". This is a vital omission. Mainstream economists can demonstrate the conditions whereby theoretical market can operate, and then make real-world policy prescriptions without any understanding of real markets. This results in real costs to the economy. Deirdre McCloskey is scathing of this approach; she writes that economists believe "that Truth comes from a piece of chalk".[39]

Economists have discovered a range of factors that can cause their theoretical market to fail, yet have a poor understanding of how real markets resolve these failings. Ronald Coase has described how firms evolve to reduce transactions costs, and how the legal system interacts with markets. Coase practises a form of economics now known as the comparative institution approach. Many economists, however, practice the nirvana approach, and many teach the nirvana approach.

A substantial portion of the nirvana approach consists of identifying so-called externalities. Externalities occur when an economic transaction has an effect on a non-participant to the original transaction. Positive externalities occur when third parties gain from a transaction and negative externalities occur when third parties incur a loss from the transaction. The standard economic solution to externality is either a tax or a subsidy. I briefly consider two examples.

Kenneth Arrow published a classic paper in 1962 arguing that competitive markets would under-invest in research and development. The reason being that "three of the reasons given … for a failure of the competitive system to achieve an optimal resource allocation hold in the case of invention".[40] In other words, the market fails because

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[38] Ronald Coase, ibid. p. 5.
[39] Deirdre N. McCloskey, 1996, *The Vices of Economists – The Virtues of the Bourgeoisie*, Amsterdam University Press. p. 63
[40] K J Arrow, 1962, "Economic Welfare and the Allocation of Resources for Invention", In *The Rate and Direction of Inventive Activity*. Princeton University Press. Reproduced in N. Rosenberg (ed). 1971. The Economics of Technological Change: Selected Readings. Harmondsworth: Penguin Books.

economists say it must. This paper contains not a single shred of empirical evidence. Yet the conclusions drawn are remarkable. Richard Romano is worth quoting in full: "In the frictionless perfectly competitive market, with no barriers to the use of information, *the market will provide no R&D investment.*"[41] Anyone with eyes in their head must know that this conclusion is false, but not mainstream economics. As Keith Pavitt argues, economists spend too much time referring to the "the standard theorems of welfare economics" with "progressively fewer references … to the empirical evidence".[42]

Examples of a negative externality would be environmental degradation and traffic congestion. The solution to negative externalities is the imposition of a tax. This has been the standard economic solution since the days of A.C. Pigou. In the US, for example, Professor N. Gregory Mankiw has created the Pigou Club – this "club" consists of all those individuals who have called for a greater gasoline tax in the US. Politicians like negative externalities because they provide revenue opportunities. Indeed, many social problems are now described in terms of externality, either to others (passive smoking) or to future versions of oneself (obesity). Mainstream economics as a discipline provides the tools and an intellectual framework supporting government intervention and control over many aspects of human behaviour.

Of course, not all economists are mainstream. Yet a major puzzle needs to be addressed. How did this state of affairs come about? Both Joseph Schumpeter and Hayek provide a theory of intellectuals. Schumpeter argues that intellectuals are forever questioning and attacking social institutions. It is a great irony that modern capitalism creates the wealth to support a large intellectual class that subsequently attacks and undermines that very system. Schumpeter's is a theory of incentives.[43] Hayek provides a psychological argument – intellectuals are *rationalist* and require detailed explanations of all phenomena. It is not enough that something should work in practice; it also need work in theory. Hayek makes the prediction that the more intelligent an educated person is the more likely they are to hold socialist views.[44] After all, while Adam Smith's view of the world is incompatible with socialism (or even massive government intervention),

[41] Richard Ramano, 1989, "Aspects of R&D subsidization". *The Quarterly Journal of Economics*. 104: 863 – 873, p. 863 (emphasis added).
[42] Keith Pavitt, 1993, 'What do firms learn from basic research?' In Dominique Foray and Christopher Freeman (Eds) *Technology and the wealth of nations*. London: Pinter Publishers, p. 31.
[43] Schumpeter, ibid. pp. 145 – 155. See especially, p. 151.
[44] F.A. Hayek, 1988, The Fatal Conceit: The Errors of Socialism, University of Chicago Press. pp. 52 – 54.

modern mainstream economics believes that market failure is ubiquitous and government intervention is required to maintain economic efficiency. While Hayek provides a theory explaining why intellectuals hold the views they do, he does not let them off unscathed. "It is hard to believe that anyone accurately informed about the market can honestly condemn the search for profit."[45]

Conclusion

"The results speak for themselves. The market economy needs no apologists and propagandists."[46] The human condition has improved dramatically since 1776 when Adam Smith published his magnum opus.[47] Adam Smith did not start that process, and indeed had nothing to say about the early industrial revolution that was occurring around him. He described the process whereby human wealth has increased. That understanding, however, has not survived in modern economic theory and is not taught in our schools and universities. Indeed, the results do not speak for themselves. Both Hayek and Schumpeter explain why.

For a free market to survive, its friends need to speak up. Capitalism and market forces have generated sufficient wealth to provide a higher education for an ever-increasing proportion of the population. Mises tells us "[w]hat determines the course of a nation's economic policies is always the economic ideas held by public opinion. No government, whether democratic or dictatorial, can free itself from the sway of the generally accepted ideology."[48] Public opinion cannot be expected to favour free-markets when economists continually argue that market can and do fail and that government can correct those failures.

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[45] Hayek, ibid. p. 105.
[46] Mises, ibid. p. 854.
[47] History is taught so badly, if at all, that many students may be unaware of this improvement.
[48] Mises, ibid. p. 850.