

## **High Priests and Lowly Philosophers: The Battle for the Soul of Economics**

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# High Priests and Lowly Philosophers: The Battle for the Soul of Economics

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Do not pry into things too hard for you  
Or investigate what is beyond your reach.  
Many have been led astray by their theorizing,  
And evil imaginings have impaired their judgments.  
Stubbornness will come to a bad end,  
And he who flirts with danger will lose his life.  
When calamity befalls the arrogant, there is no cure;  
Wickedness is too deeply rooted in them.

-- Ecclesiasticus 3: 21, 24-26, 28

God, grant me the serenity  
To accept the things I cannot change,  
Courage to change the things I can,  
and wisdom to know the difference.

---The Serenity Prayer by Reinhold Niebuhr penned in 1943

## I. Introduction

In his book, *Reaching for Heaven on Earth*,<sup>1</sup> Robert Nelson established that modern economics had indeed taken on a theological significance that was denied other social sciences and policy-relevant disciplines. This claim is worthy of serious attention, but Nelson's route to this conclusion is interesting in its own right. In writing about the role of economists in government, Nelson argued that economists do not limit their advice to

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<sup>1</sup> Robert Nelson. *Reaching for Heaven on Earth: The Theological Meaning of Economics*. Lanham, MD: Rowman and Littlefield, 1991.

technical expertise. Instead, they use their position as economic advisor to strongly advocate particular programs. In short, they don't just discuss the means-ends efficiency of this or that proposed policy independent of their own value assessment of that policy, but rather infuse their economic advice-giving with their own values. The economic way of thinking is a powerful tool for organizing and interpreting events, and may well be value neutral; but economists as advisors are definitely not value neutral.

This conclusion led Nelson to ponder why it is then that economists are given a privileged position in the policy arena. Why aren't other disciplines that also provide a useful framework for thinking about important problems afforded the same public hearing on issues of public policy? Nelson reasoned that since the economic way of thinking provides a way for us to understand and legitimate our modern world, perhaps economics has become the modern theology that has come to replace traditional theology as the set of doctrines that give meaning to our social reality and hope to our endeavors for improvement in our lives. At least that is what Nelson sought to explore in his 1991 book, and to amazing effect. Since economic progress was seen as the solution to social ills, the discipline of economics is awarded a special status as the harbinger of progress and its practitioners are transformed from lowly philosophers, who only study the world, to high priests of social control who are responsible for ushering in an age of unlimited progress and prosperity.<sup>2</sup>

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<sup>2</sup> Nelson's work should not be read as an indictment of economics in the least. All that he is attempting to show is that economists do not practice a form of value-free analysis, and in fact, cannot practice value-freedom when they offer policy guidance. Moreover, rather than a flippant critique of economics, Nelson actually engaged in historical research to demonstrate that many of the founding fathers of political economy and economics had deep theological commitments and used the intellectual constructs from their theology to construct their economics, and that they spoke of the discipline of economics itself and its policy advice in messianic terms. On the relationship between value-neutral economics, and value-relevant political economy see Peter Boettke. "Is Economics a Moral Science?," *Journal of Markets & Morality*,

In *Economics as Religion*,<sup>3</sup> Robert Nelson develops this line of argument even further and explores the theological underpinnings of such economic luminaries as Frank Knight and Paul Samuelson. The history of 20<sup>th</sup> century economics, in fact, could be read as how it came to be that Knight's Calvinistic economics was rejected in favor of Samuelson's secular religion of scientific management.<sup>4</sup> In fact, Nelson<sup>5</sup> demonstrates how Samuelson's claims to scientific value-freedom are merely rhetorical flourish. Instead, Samuelson's ideas are the logical outgrowth of the intellectual movement of American progressivism where government, in seeking to create the Kingdom of God on Earth, must act as a corrective to social ills such as unemployment and plan the social order. Guided by the teachings of scientific management, the practice of public administration promised not just efficiency in public affairs but to be morally uplifting as well. Thus, the liberal state would be transformed by science to become the administrative state with the goal of eradicating social ills. Samuelson, according to Nelson, must be seen as providing "the scientific blessing for the American welfare and regulatory state."<sup>6</sup>

Building on Nelson's analysis, we contend that the transformation of economics from a discipline that studies the economy to one that is entrusted with its control has threatened the very "soul" of economics. The false pretense of scientific management led

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1998, 1, 212-219 and Peter Boettke. "Why Are There No Austrian Socialists? Ideology, Science and the Austrian School," *Journal of History of Economic Thought*, 1995, 17, 35-56.

<sup>3</sup> Robert Nelson. *Economics as Religion: From Samuelson to Chicago and Beyond*. University Park, PA: Pennsylvania State University Press, 2001.

<sup>4</sup> Despite his severe criticism of religion, Knight could not escape his background in Christian thought. For Knight, as for earlier Christian theology, private property and the market economy exist because of original sin. Prior to the fall of man neither would be necessary and thus in an ideal world they wouldn't exist either. But in the imperfect world we live in, property and markets serve to counter the natural proclivity of fallen man to strive for power and advantage over other men. Property and markets may be an imperfect solution, but they are better than the alternatives. *Ibid.*, 136-137.

<sup>5</sup> *Ibid.*, 37-48.

<sup>6</sup> *Ibid.*, 263.

economists to promise to accomplish tasks that they cannot legitimately achieve. False theory combined with bad philosophy generated scientific claims that must now be rejected. But this doesn't mean that economics as a way of thinking about the world and organizing its facts must be rejected. Quite to the contrary, the teachings of economics are necessary for understanding the complexities of social reality. Perhaps its two most important public roles are: (1) to explain how within a specific set of institutional arrangements the power of self-interest can spontaneously generate patterns of social order that simultaneously achieve individual autonomy, generalized prosperity and social peace, and (2) through means-ends analysis, to provide parameters on people's utopian notions of economic policy.<sup>7</sup> The first captures the didactic role of the economist in teaching the nuances of Adam Smith's 'invisible hand' and the second captures the contribution that economics as a technical discipline can offer to public policy discourse. When we move beyond these roles and instead try to employ economics as the primary tool for social control, we run afoul and distort the teachings of the discipline.

We provide three cases where the scientific pretensions of economists got the better of them in the 20<sup>th</sup> century: Keynesian demand management, the practice of cost/benefit analysis by regulators and lawyers, and the debate over market socialism. If our argument is right, the role of the economist should move from high priest back to lowly philosopher. In taking this 'demotion', economists may find it harder to justify

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<sup>7</sup> See James M. Buchanan. "Economics as a Public Science," in *Foundations of Research in Economics: How Do Economists Do Economics?*, eds. Steven G. Medema and Warren J. Samuels, Cheltenham, U.K.: Edward Elgar, 1996, 30-36. Buchanan argues that the task of economics as a public science is to provide an understanding of the workings of an organized economy to citizens and the consequences of alternative interventions into that working economy in order that these citizens can be informed participants in the democratic process. In Buchanan's way of thinking, economists must differentiate between the analysis of what is, what could be, and what ought to be in performing their task of providing citizens with the information required to make intelligent democratic decisions.

their employment, but the discipline and those who practice it will also regain their ‘soul’ as they reject the false god of scientism and its pretensions of social engineering.

## II. Keynesian Demand Management

There has always been a subculture in the discipline of political economy that argued that the practitioner of political economy could be entrusted to devise schemes of social control that would outperform the “accidental” outcomes of *laissez-faire*. Thomas Malthus and J. B. Say exchanged words in the early 19<sup>th</sup> century over the issue of whether or not a market economy would generate “gluts” or whether the market is a self-regulating mechanism that would tend toward equilibrium where aggregate supply and aggregate demand are equated.<sup>8</sup> The majority of economists sided with Say and maintained that this self-regulating aspect of a market economy was one of the most powerful principles taught by the discipline of economics. However, the debate over self-regulation did not cease. Karl Marx’s writings on the inherent tendency of the capitalist system to lead to monopoly on the one hand, and suffer periodic crises on the other, were direct challenges to the vulgar teachings of political economy that taught self-regulation.

By the late 19<sup>th</sup> century, *laissez-faire* was increasingly under attack as both a scientific and public policy doctrine. Mill may have given theoretical presumption to the *laissez-faire* principle, but the exceptions to that principle that he articulated, which called for direct government action, were vast.<sup>9</sup> Political careers were built on the claim that monopoly power needed to be reigned in, and business fluctuations had to be

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<sup>8</sup> The letters from J. B. Say to Malthus were collected and published in 1821.

<sup>9</sup> J.S. Mill *Principles of Political Economy*. New York: Augustus M. Kelley, 1976 [1848], 941-979.

controlled through public policy. In the United States, anti-trust legislation was introduced, along with the establishment of the institutions of public administration to oversee the implementation and enforcement of this legislation. The banking system was also transformed in an effort to eliminate “panics.”

By the beginning of the 20<sup>th</sup> century, the dominant school of economic thinking in the United States was critical of the unrealistic political economy of classical economics and advocated an institutional economics that denied any universal laws of economics and demanded a more activist government to regulate and control the economy and promote efficiency and social justice. Of course, there were pockets of defenders of classical political economy, and even more practitioners of the new science of neoclassical economics; but the Progressive Era marshaled in the intellectual domination of the institutional school of economic thought. This domination was not limited to the teachings of economics, but permeated law schools and the budding discipline of public administration.

When the Great Crash of 1929 turned into the Great Depression of the 1930s, the remaining voices for *laissez-faire* were silenced. Economists who had held the classical position were either ignored or they changed their song to be more in tune with the times. Government had to do something to address social ills. Of course, some economic research argued that the Great Depression was caused by government policy failures --- a credit expansion of the 1920s generated a boom-bust cycle, and the government interventions in the 1930s (most notably trade restrictions) hampered the ability of the market adjustment process to work to eliminate the crisis. But this message was ignored. Instead, the message that resonated with policy makers, the public, and a new generation

of economists was that *laissez-faire* capitalism was prone to monopoly and business cycles as revealed in the Robber Baron age, the fraud perpetrated on consumers by poor products, the exploitation of workers in factories, and the indignity of unemployment as experienced in the 1930s. It was the job of the economists to address these social ills with the tools of the discipline and the expertise of public administration.

Keynesian economics filled this demand perfectly. John Maynard Keynes's work *The General Theory of Employment, Interest and Money*<sup>10</sup> provided a critique of the classical model of self-regulation of markets, a diagnosis of why the economies of Great Britain and the US had entered a depression, and policy advice on how to alleviate the problems of unemployment and instability. For the sake of this discussion what matters most is the general ideas behind this promise. Keynes argued that investment was unstable because it was based on the volatile expectations of investors and their moods of optimism and pessimism. In addition, Keynes argued that the introduction of money into an economic system repudiated the classical law of markets that maintained self-regulation. Prices were not linked to the supply and demand for money anymore than investment was determined by the interest rate in the modern economy according to Keynes. The introduction of expectations into economic analysis ruptures the old relationships that were established in classical economics. For example, during a recession, because of expectations that the economy is caught in a liquidity trap, attempts to get out of that trap through monetary policy stimulus will be ineffective. If investment is not rational, but instead based on 'animal spirits,' then private markets cannot be relied upon to assess the marginal efficiency of capital allocations among competing projects.

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<sup>10</sup> John M. Keynes. *The General Theory of Employment, Interest and Money*. New York: Harcourt Brace Jovanovich, 1964 [1936].



Finally, in the economy so described by Keynes, resources can remain idle and not be re-employed in alternative uses. The automatic adjustments that classical economics assumed do not come into operation because the economy can get stuck in an unemployment equilibrium. By definition an equilibrium is a point where no one in the system has any incentive or inclination to move from their current position. To move out of that equilibrium a force outside the system must be introduced. Keynes forcefully argued that government was the entity that could most effectively affect social change.

As Roger Garrison<sup>11</sup> has argued, Keynesian economics is the income-expenditure Keynesianism of basic textbook economics. This simple model served as the basic tool for understanding Keynesian public policy for a generation of economists. And it was a staple of Samuelson's presentation in his *Economics*.<sup>12</sup> In fact, the Keynesian hegemony from analytical perspective to social philosophy is embodied in Samuelson's classic textbook. In the 1948 edition, for example, Samuelson doesn't introduce basic supply and demand until page 447 precisely because of the notion that microeconomic principles only become effective after one has assured that the macroeconomic system is in balance. Left to its own devices, the capitalist system will suffer from aggregate demand failure and results in an unemployment equilibrium. It is the economist's task to engineer this full employment equilibrium, at which point the self-regulating tendencies of a market economy may be relied upon in situations where externalities are absent, production and exchange is limited to private goods (and not public goods), and the market structure is deemed competitive.

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<sup>11</sup> Roger Garrison. *Time and Money: The Macroeconomics of Capital Structure*. London: Routledge, 2001.

<sup>12</sup> Paul Samuelson. *Economics*. New York: McGraw Hill, 1998 [1948], 225-279.

For our story, the significant point to recognize is how Keynes's *General Theory* and later Samuelson's *Economics* reverse the presumption of Mill's *Principles*. With Mill the presumption was still with *laissez-faire* and the exceptions he enumerated justify the interventions of government into the economy. But by the time we get to Keynes and then Samuelson, the presumption is that government must intervene at all times to maintain economic civilization and that only in certain circumstances could the *laissez-faire* principle be relied upon.<sup>13</sup> In addition, it is important to realize the changing role of economists that this shift in presumption requires. At the time of Mill the economist could still take the stance of student of society, but by the time we get to Keynes and Samuelson the economist's task is to assume the role of society's savior utilizing the scientific tools of his craft to maintain societal balance and right social wrongs.<sup>14</sup> "Where the complex economic conditions of life necessitate social coordination and planning,"

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<sup>13</sup> To put a fine point on this Samuelson wrote: "No longer is modern man able to believe 'that government governs best which governs least.' In a frontier society, when a man moved farther west as soon as he could hear the bark of his neighbor's dog, there was some validity to the view 'let every man paddle his own canoe.' But today, in our vast interdependent society, the waters are too crowded to make unadulterated 'rugged individualism' tolerable." *Ibid.*, 142. Samuelson in the next paragraph admits that this system of "rugged individualism" led to rapid material progress, but he quickly adds that it also resulted in business cycles, the wasteful exhaustion of resources, income inequality, political corruption by moneyed interests, and the substitution of "self-regulating competition in favor of all-consuming monopoly."

<sup>14</sup> For an examination of the economist and the economic role of the state see Peter Boettke and Steve Horwitz. "The Limits of Economic Expertise: Prophets, Engineers and the State in the History of Development Economics," *History of Political Economy*, forthcoming. Though different terms are employed in this article, the basic idea is that there are only two stable intellectual equilibria --- economist as student and state as referee of the economic game, and economist as savior and state as active player in the economic game. The classical argument preached humility to economists and sought to constrain the abuse of power by the state and its agents; the modern argument preached activism and the need for agents of the state to use the power of the government to actively intervene on behalf of the people. The classical argument warned of the perversity of unintended consequences in government interventions, whereas the modern argument warned of the perversity of voluntary choice due to monopoly, externalities, public goods, and macroeconomic instability. The classical argument tends to push us to the student/referee equilibrium, while the modern argument tended to push us to the savior/player equilibrium. The puzzle for a contemporary of political economy that finds the humility argument of the classics persuasive is whether an argument that satisfies the modern mind can be made that leads to the student/referee equilibrium. This intellectual puzzle is separate from the material self-interest puzzle of how one would get economists to give up on an argument that privileges them in the public policy discourse.

Samuelson wrote, “there can sensible men of good will be expected to invoke the authority and creative activity of government.”<sup>15</sup>

Ludwig von Mises and F. A. Hayek were two of the strongest critics of this Keynesian transformation of the discipline of economics. Mises<sup>16</sup> tended to stress the logical fallacies committed by Keynesian economics, whereas Hayek<sup>17</sup> tended to stress the heroic assumptions made on behalf of economists put in the position of engineering social change through macroeconomic modeling. For the income expenditure model to work, the economist-engineer must know the aggregate level of current consumption, investment, and public spending, as well as what the full employment level of output would be, and the precise manner in which the multiplier effect will work to translate an increase in government expenditures into an increase in aggregate demand to achieve that full employment level of output. Each step of the analysis presupposes that the detailed knowledge of economic life is readily available to the macroeconomist and that each policy step advocated will result in the precise effect on economic activity that is intended to achieve economic balance at full employment levels. In short, the model assumes what it has to prove.

Moreover, macroeconomic theorizing tended to mask the real economic data that human actors use in forming their economic plans. Macroeconomic public policy is both mistaken and arrogant. Hayek argued that the “pretense of knowledge” evident in macroeconomic modeling resulted not in the solution of social ills such as unemployment, but instead in a pattern of resource employment that cannot be

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<sup>15</sup> Samuelson, 153.

<sup>16</sup> Ludwig von Mises. *Human Action: A Treatise on Economics*. New Haven: Yale University Press, 1949, 710-803.

<sup>17</sup> F.A. Hayek. *New Studies in Philosophy, Politics, Economics and the History of Ideas*. Chicago: University of Chicago Press, 1978, 98-100.

maintained. “What this policy has produced is not so much a level of employment that could not have been bought about in other ways, as a distribution of employment which cannot be indefinitely maintained and which after some time can be maintained only by a rate of inflation which would rapidly lead to a disorganization of all economic activity.”<sup>18</sup>

The collapse of the Keynesian hegemony in the 1970s reflected the intellectual victory of Hayek’s critique of Keynes. However, most economists have not followed Hayek’s plea for humility and the attempt to understand economic life in aggregate terms continues. The resurrection of Keynesian economics in the hands of Joseph Stiglitz<sup>19</sup> and Paul Krugman<sup>20</sup> requires the same heroic assumptions about the power of economists to fine-tune the world with the levers of economic policy that was evident in the Keynes/Samuelson error despite subtle shifts in the theoretical argument. As Robert Nelson<sup>21</sup> indicated, Stiglitz has pointed out that the theoretical underpinnings of Samuelson’s economics contained fundamental misconceptions that are now well understood. But Samuelson’s work established the scientific status of economics in American society and provided many economists with government jobs where they could use their scientific authority to influence public policy.

Even though Stiglitz understands the faulty foundations of Samuelsonian economics, he does not suggest that the revolution of information economics that he led, nor the institutional economics associated with Coase and North, nor the public choice revolution led by Buchanan and Tullock, should lead to a questioning of the position of economists in society that Samuelson’s work established. If anything, Stiglitz believes

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<sup>18</sup> *Ibid.*, 29.

<sup>19</sup> Joseph Stiglitz. *Globalization and Its Discontents*. New York: W.W. Norton and Co., 2002.

<sup>20</sup> Paul Krugman. *The Return of Depression Economics*. New York: W.W. Norton and Co., 1999.

<sup>21</sup> Nelson, 261.

that the contribution he has made to modern economics has made the role of the economists in society as redefined by Keynes and Samuelson even *more* justified than in their writings. The faith in the saving power of public administration guided by economic models does not die easily.

### III. Cost/Benefit Analysis

The new economics as embodied in Samuelson, was predicated on the following three propositions.

Prop. 1: The *laissez-faire* presumption has been reversed by the economics of Keynes and the development of economics since Keynes.

Prop. 2: Modern economics has provided the analytical toolkit for economists to assume the role of scientist *cum* social engineer.

Prop. 3: The analytical toolkit of modern economics is aided by new statistical measuring techniques which guarantee that abstract mathematical economic models can be accurately calibrated, generate clear predictions, be cleanly tested against the data, and thus provide the basis for successful economic policy initiatives.

In order for these propositions to work, we must assume that objective data exists and can be collected and analyzed in an economical manner. Obviously the development of computing power in the 20<sup>th</sup> century had a major influence on the manner in which economics is done, but that is not the side of the story we want to emphasize. The point we want to highlight is more subtle; economists have to *assume* that certain data exist for

them to manipulate, which we contend does not in fact exist.<sup>22</sup> In the case this section analyzes, the data assumed is the objectivity of cost and benefits.

Cost-benefit analysis permeates the field of public economics. It is not only the cornerstone of analyses of externalities, but also analyses of taxation, regulation, and alternative legal arrangements. The modern field of law and economics, for example, would be unrecognizable if cost-benefit analysis were rejected.

Conceptually, the economic way of thinking has no problem with the logic of cost-benefit analysis. The problem is when one tries to operationalize the analysis by assuming that costs and benefits are quantifiable entities that can be measured and compared. In standard Pigouvian welfare economics, deviations from the ideal allocation of resources result because of external economies. Private marginal benefits/marginal costs deviate from the social marginal benefits/social marginal costs. A positive externality is said to lead to an under supply of the good or service in question because the private marginal benefits from producing the good or service are less than the social marginal benefits it would produce. A negative externality generates the opposite

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<sup>22</sup> This is true for macroeconomics as well as the microeconomic questions we are going to address in this section. Gross Domestic Product, for example, attempts to measure the value produced in an economy in a given year by adding up the final good prices. There are sophisticated attempts made to avoid double counting, etc. But the entire enterprise faces an even more daunting problem. In order for the addition of these final good prices to have any meaning the analyst must assume they are in fact *equilibrium* prices that reflect the full opportunity cost of production for each good. But that would be true only if the conditions of general competitive equilibrium held true. First, the conditions of general competitive equilibrium are highly restrictive and one could argue are never approximated in the real world. Second, if the conditions of general competitive equilibrium were said to hold true, then the sort of policy designs advocated by Keynesian macroeconomist would be redundant, as the ideal equilibrium allocation of scarce resources would already be obtained. In short, by definition, the sort of idle resource argument of Keynesians presupposes the absence of general competitive equilibrium. But if that is the case then the price data would not be able to be added in any meaningful sense to provide the basis for public policy decisions. To get meaningful data, the Keynesian economist has to assume the existence of data which, if it did exist, would mean that Keynesian policy solutions are unnecessary. The fact that in the face of such a logical conundrum the Keynesian ascendancy occurred almost unchallenged demonstrates Nelson's point about the victory of faith over reason in modern political economy, and how once ideas and interests align how difficult it is to overturn a belief system.

problem. Undesirable goods and services are supplied beyond their ideal level because the private marginal costs of producing the good or service is less than the social marginal costs the good or service generates. In the standard drill, in the case of positive externalities the government should subsidize the production of the good and service so as to bring the private and social costs into alignment, whereas in the case of negative externalities the government should tax the activity so as to again bring about the alignment of private and social costs. Conceptually the logic of this approach is unassailable; but as a tool for public policy it is about as misguided as one could get and it has done tremendous damage to the way that economic discourses of public policy issues are conducted.<sup>23</sup>

Ronald Coase<sup>24</sup> and James Buchanan<sup>25</sup> pointed out the fundamental problems with Pigouvian welfare economics long ago. Their work was revolutionary, but the most radical implications of their work were ignored in subsequent years as the culture of economics became one deeply committed to the analysis and measurement of data. Science, after all, is measurement, as everyone likes to say. And if you cannot measure, measure anyway rather than threaten the scientific stature of a discipline. So despite the profound insights of Coase and Buchanan, cost-benefit analysis is far from being

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<sup>23</sup> The economic policy “think tank” world is divided into pro-market and anti-market forces and the dialogue between them is one of warring cost-benefit analysis. The pro-market groups show that the costs of this or that intervention will exceed the benefits and this is usually communicated by the cost to the average family of four. The anti-market forces, not to be outdone, respond by providing “evidence” that an unhampered market economy will generate costs to the average citizens well in excess of the benefits generated in the market. This is the way the discourse proceeds, but neither of them actually has the data to make the argument they want to make, so they make assumptions and guess. At best what we get is ideological commitments wrapped in numbers and disguised in the trappings of science. At worst all we get is the manipulations by vested interests to achieve their political goals at the expense of others.

<sup>24</sup> Ronald Coase. “The Problem of Social Cost,” *Journal of Law and Economics*, 1960, 1-44.

<sup>25</sup> James M. Buchanan. *Cost and Choice: An Inquiry in Economic Theory*. Chicago: Markham Publishing, 1969.

abandoned by practitioners of political economy --- many of whom actually profess allegiance to Coase and Buchanan.

The Coase/Buchanan critique of Pigou can be summarized in the following manner. Either Pigouvian solutions are redundant because private actors would negotiate away the conflicts (in the case of zero transaction costs), or the Pigouvian solution is non-operational (in the case of positive transaction costs, including information costs). If private actors aren't able to glean the costs and benefits and bring them into alignment, then how are government officials to do so? Rather than measure that which we cannot reasonably assume we can measure, both Coase and Buchanan advocate an opportunity cost approach to public economics. The comparative institutional analysis that such an approach leads to would, as Coase put it, "start our analysis with a situation approximating that which actually exists, to examine the effects of a proposed policy change, and to attempt to decide whether the new situation would be, in total, better or worse than the original one."<sup>26</sup>

The blackboard economics of Pigou, caught as it is in the logical contradiction of being either redundant or non-operational, remains hard to abandon.<sup>27</sup> William Baumol, for example, vehemently resisted the implications of Coase and Buchanan and argued that the Pigouvian tradition was "impeccable" even while admitting that "All in all, we are left with little reason for confidence in the applicability of the Pigouvian approach, literally interpreted. We do not know how to calculate the required taxes and subsidies and we do not know how to approximate them by trial and error." Baumol's intellectual dance led Coase to pen one of the most stinging indictments of modern economics when,

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<sup>26</sup> Coase, 43.

<sup>27</sup> For further elaboration on the contradiction of Pigouvian welfare economics see: Ronald Coase. *The Firm, the Market and the Law*. Chicago: University of Chicago Press, 1988, 157-185.



after summing up Baumol's position that the logic of the Pigouvian approach was "impeccable" if by "impeccable" one meant that "if its taxation proposals were carried out, which they cannot be, the allocation of resources would be optimal" Coase added: "This I have never denied. My point was simply that such tax proposals are the stuff that dreams are made of. In my youth it was said that what was too silly to be said may be sung. In modern economics it may be put into mathematics."<sup>28</sup>

#### **IV. The Debate Over Market Socialism**

The debate over market socialism in the first half of the 20<sup>th</sup> century provides another stark example in which economists let pretensions of scientism get the better of them. In the years leading up to 1920, Friedrich von Wieser, Joseph Schumpeter, Leon Walras, Vilfredo Pareto, Enrico Barone, Fredrick Taylor and Frank Knight all pointed out that if socialism was to rationalize production, it would have to succeed in satisfying the same formal requirements that capitalism was said to achieve under conditions of equilibrium.<sup>29</sup> In other words, if rationalization implied the most efficient use of resources, which is the meaning it would have to have, then socialist rationalization would need to satisfy the optimality conditions which are described using marginalist principles.

The Polish economist, Oskar Lange, rose to this challenge in 1936-1937 with a proposal for "market socialism" that not only satisfied the formal requirements of capitalism in general equilibrium, but was argued to actually perform better than the

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<sup>28</sup> *Ibid.*, 185.

<sup>29</sup> The papers on this "formal similarity" argument and the subsequent attempts to develop a marginalist economics of socialism can be found in Peter Boettke, ed., *Socialism and the Market: The Socialist Calculation Debate Revisited*. London: Routledge, 2000, volume 4.

market economy by wiping out monopoly and business cycles believed to plague real-world capitalism. In deploying the formal similarity argument, Lange provided the following blueprint. First, allow a market for consumer goods and labor allocation. Second, put the productive sector into state hands but provide strict guidelines for production to firms. Namely, inform managers that they must price their output equal to marginal costs, and produce that level of output that minimizes average costs. Adjustments can be made on a trial and error basis, using inventory as the signal. The production guidelines will ensure that the full opportunity cost of production will be taken into account and that all least-cost technologies will be employed. In short, these production guidelines will assure productive efficiency is achieved even in a setting of state ownership of the means of production.

Lange went even further in his argument for socialism. Not only is socialism, by mimicking the efficiency conditions of capitalism, able to theoretically achieve the same level of efficient production as the market, but it would actually outperform capitalism by purging society of monopoly and business cycles that plague real-world capitalism. In the hands of Lange, neoclassical theory was to become a powerful tool of social control.

Hayek's response to Lange's model for market socialism was multi-pronged and attacked its informational assumptions rooted in the neoclassical model of general equilibrium. First, Hayek argued that the models of market socialism proposed by Lange and others reflected a preoccupation with equilibrium. The models possessed no ability to discuss the necessary adaptations to changing conditions required in real economic life. The imputation of value of capital goods from consumer goods represented a classic case in point. Schumpeter had argued that once consumer goods were valued in the

market (as they would be in Lange's model), a market for producer goods was unnecessary because we could impute the value of corresponding capital goods *ipso facto*.

This "solution" was of course accurate in the model of general equilibrium where there is a pre-reconciliation of plans (i.e., no false trades). Hayek's concern, however, was not with the model, but how imputation actually takes place within the market process so that production plans come to be coordinated with consumer demands. This is not a trivial procedure and requires various market signals to guide entrepreneurs in their decision process on the use of capital good combinations in production projects. In a fundamental sense Hayek was arguing that market socialism could not answer this problem by assuming it away. Of course, if we focus our analytical attention on the properties of a world in which all plans have already been fully coordinated (general competitive equilibrium), then the process by which that coordination came about in the first place will not be highlighted.

This was Hayek's central point. Absent certain institutions and practices, the process that brings about the coordination of plans (including the imputation of value from consumer goods to producer goods) would not take place. Some alternative process would have to be relied upon for decision-making concerning resources, and that process would by necessity be one that could not rely on the guides of private property incentives, relative price signals, and profit/loss accounting since the socialist project had explicitly abolished them. In other words, the *ipso facto* proposition of competitive equilibrium was irrelevant for the world outside of that state of equilibrium. The fact that leading neoclassical economists (like Knight and Schumpeter) had not recognized this elementary

point demonstrated the havoc that a scientific preoccupation with the state of equilibrium, as opposed to the process which tends to bring about equilibrium, can have on economics.

In Hayek's view, the problem with concentrating on a state of affairs as opposed to the process was not limited to assuming that which must be argued, but directed attention away from how changing circumstances require adaptations on the part of participants. As we noted above, equilibrium, by definition, is a state of affairs in which no agent within the system has any incentive to change. If all the data were frozen, then indeed the logic of the situation would lead individuals to a state of rest where all plans were coordinated and resources were used in the most efficient manner currently known. The Lange conditions would hold—prices would be set to marginal cost (and thus the full opportunity cost of production would be reflected in the price) and production would be at the minimum point on the firm's average cost curve (and thus the least-cost technologies would be employed). But what, Hayek asked, do these conditions tell us about a world where the data are not frozen? What happens when tastes and technologies change?

Effective allocation of resources requires that there is a correspondence between the underlying conditions of tastes, technology and resource endowments, and the induced variables of prices and profit and loss accounting. In perfect competition the underlying variables and the induced variables are in perfect alignment and thus there are no coordination problems. Traditions in economic scholarship that reject the self-regulation proposition tend to deny that there is any correspondence between the underlying conditions and the induced variables on the market.

Hayek, in contrast to both of these alternatives, sought to explain the lagged relationship between the underlying and the induced. Economics for him is a discipline of tendency and direction, not a science of exact determination. Changes in the underlying conditions set in motion accommodating adjustments that are reflected in the induced variables on the market. The induced variables lag behind, but are continually pulled towards the underlying conditions.

Hayek argued that perfect knowledge is a defining characteristic of equilibrium but cannot be an assumption within the process of equilibration. The question instead is how do individuals come to learn the information that is necessary for them to coordinate their plans with others? In “Economics and Knowledge”<sup>30</sup> and “The Use of Knowledge in Society,”<sup>31</sup> Hayek develops the argument that how economic agents come to learn represents the crucial empirical element of economics and that price signals represent the key institutional guide post for learning within the market process. Traditional neoclassical theory taught that prices were incentive devices, which they indeed are. But Hayek pointed out that prices also serve an informational role, which is overlooked by modern economists preoccupied with models of equilibrium.

Hayek emphasized different aspects of the argument developed in these two classic articles over his career and came to place particular emphasis on the contextual nature of knowledge that is utilized within the market process. Knowledge, he pointed out, does not exist disembodied from the context of its discovery and use. Economic participants base their actions on concrete knowledge of particular time and place. This local knowledge that market participants utilize in orienting their actions is simply not

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<sup>30</sup> F.A. Hayek. “Economics and Knowledge,” *Economica*, 1937, 4, 33-54.

<sup>31</sup> F.A. Hayek. “The Use of Knowledge in Society,” *American Economic Review*, 1945, 4, 519-530.

abstract and objective and thus is incapable of being used by planners outside of that context to plan the large-scale organization of society.

Hayek's reasoning for why planning cannot work is not limited to the problem that the information required for the task of coordinating the plans of a multitude of individuals is too vast to organize effectively. The knowledge utilized within the market by entrepreneurs does not exist outside that local context and thus cannot even be organized in principle. It is not that planners would face a complex computational task; it is that they face an impossible task because the knowledge required is not accessible to them no matter what technological developments may come along to ease the computational task.

Market socialism requires a shift in the discipline of economics from understanding the workings of the economy to attempting to plan the economy. The scientific tools of neoclassical economics—most notably, general equilibrium—mislead socialist's proponents to believe they can effectively plan. Economists are no longer students of economy but become active players—engineers who plan economic activity. Of course, as both history and Hayek's work demonstrated, the position required by socialism is unsustainable in the long run. Hayek theoretically devastated the socialist program with the arguments discussed above. Most powerfully of all, however, the dramatic collapse of the Soviet Union at the beginning of the last decade revealed to the world the disaster wrought by economic hubris on the part of those who believed they could centrally direct economic life.

## V. Conclusion

Robert Nelson's *Economics as a Religion* is not only a fascinating read but also a profound work on the social role that economics has come to serve in modern times. As he writes: "The most vital religion of the modern age has been economic progress. If economists have had a modest impact in actually generating this progress, or even understanding the actual mechanisms by which it has occurred, they have had a large role in giving it social legitimacy. They have been the modern priesthood of the religion of progress, interpreting its forms, refining its messages, and assuring the faithful that progress would continue."<sup>32</sup> He goes on to state that we economists "like other priestly classes in history, live a secure and protected existence, often in the groves of the academy."<sup>33</sup>

Nelson limits his analysis mainly to the positive description of how economic growth has become the modern religion and economists its priestly guardians. We jump off from his profound analysis to look at the darker side of this transformation of our discipline. Using basic economic reasoning we would expect a protected priestly class to respond rationally to the incentives and abuse their privileged position and attempt to erect barriers to competitors. As economists, we ourselves are committed to the idea that economics as a discipline is vital to understanding the forces that shape our world. But we also believe that the priesthood status of our fellow economists has done severe

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<sup>32</sup> Nelson, 329.

<sup>33</sup> *Ibid.*, 332.

damage to our discipline and in the long run will delegitimize the teachings that economics offers.<sup>34</sup>

We have focused on three areas where economists in the 20<sup>th</sup> century sought to justify an expanded role for economists as social engineers. In each instance we have postulated that the argument given by economists was unjustified. Economics as a discipline would be better served by humility in the face of social complexity, than attempting to stretch the discipline beyond what it is capable of achieving. Our argument is simple: If we demand of a discipline something that it is incapable of doing, then intellectual resources will be wasted in the attempt to provide the unobtainable. Both type 1 and type 2 errors will be made in intellectual decision making as projects will be pursued that should have been rejected, and worthy projects will be foregone.

Can the situation of economics be reversed? We don't know. We know that if we argue that the situation is hopeless, we would in essence be admitting that the situation is ideal, as Frank Knight believed. On the other hand, we also recognize that change requires a bold intellectual entrepreneur to seize the opportunity and reorient the discipline. The reorientation we are calling for, however, is one that would reduce the prestige and power of the economists in modern society. Entrepreneurial action is usually not set in motion when the reward for the innovation is a reduction in relative status. On the other hand, we have argued that if economists give up their privileged position in society, they might regain their "soul." Perhaps the profit opportunity waiting to be seized by the economist *cum* intellectual entrepreneur is the long-term legitimacy of the discipline of political economy, and in order to seize it he must forego the false

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<sup>34</sup> And this delegitimation of the teaching of economics will have huge negative consequences for society by clouding the understanding of the principle of spontaneous order and the means/ends analysis that places parameters on utopian aspirations by political entrepreneurs.



promises of a pseudo-scientific enterprise of modern economics with its belief in efficient public administration guided by the techniques of model and measure that have characterized economics since Samuelson. Such an economist might face the wrath of his fellow economists in his own age. But one can hope that such an economist, by preaching the wisdom of humility, will be honored to be working in the tradition of political economy's intellectual giants such as Smith, Hume, Mises, Hayek, and Buchanan. It is only by rejecting his high priest status and embracing his position as a lowly philosopher that the economist has an opportunity to save economics from damnation due to arrogance. "For every one who exalts himself will be humbled, but the one who humbles himself will be exalted."<sup>35</sup>

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<sup>35</sup> *Holy Bible*. Luke 14:11.