

The Battle of Ideas

Economics and the
Struggle for a Better World

PETER J BOETTKE

THE SIR RONALD TROTTER LECTURE

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The Sir Ronald Trotter Lecture

SIR RONALD TROTTER was the first chairman of the New Zealand Business Roundtable in its present form, a position he held from 1985 to 1990.

Among his many other roles he has been chief executive and chairman of Fletcher Challenge Limited, chairman of the Steering Committee of the 1984 Economic Summit, a director of the Reserve Bank of New Zealand, chairman of the State-owned Enterprises Advisory Committee, chairman of Telecom Corporation, chairman of the National Interim Provider Board, a chairman or director of several major New Zealand and Australian companies, and chairman of the board of the Museum of New Zealand Te Papa Tongarewa.

He was knighted in 1985 for services to business.

This lecture was instituted in 1995 by the New Zealand Business Roundtable to mark Sir Ronald Trotter's many contributions to public affairs in New Zealand. It is given annually by a distinguished international speaker on a major topic of public policy.

The twelfth Sir Ronald Trotter lecture was given by Peter Boettke at the Museum of New Zealand Te Papa Tongarewa in Wellington on 8 August 2007.

Peter J Boettke

PETER BOETTKE is deputy director of the James M Buchanan Center for Political Economy, research director at the Mercatus Center, and a professor in the Economics Department at George Mason University, Fairfax, Virginia.

He is the author of several books on the history, collapse and transition from socialism of the former Soviet Union – *The Political Economy of Soviet Socialism: The Formative Years, 1918–1928* (Kluwer, 1990); *Why Perestroika Failed: The Economics and Politics of Socialist Transformation* (Routledge, 1993); and *Calculation and Coordination: Essays on Socialism and Transitional Political Economy* (Routledge, 2001). In 1998, Professor Boettke assumed the editorship of the *Review of Austrian Economics* (Kluwer Academic Publishers).

Professor Boettke is also the faculty director for the Global Prosperity Initiative, which is part of the Social Change Project at the Mercatus Center at George Mason University. In addition to his scholarly activities, he is a dedicated teacher and has won teaching awards, including the Golden Dozen Award for Excellence in Teaching from the College of Arts and Sciences at New York University.

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Introduction by
Roger Kerr
executive director
New Zealand Business
Roundtable

IT IS MY VERY PLEASANT DUTY to introduce our guest speaker, Professor Peter Boettke, to give the 2006 Sir Ronald Trotter lecture.

This is the twelfth lecture in a series that was inaugurated in 1995 to recognise Sir Ron's role as the Business Roundtable's founding chairman and his many contributions to business and public affairs in New Zealand. We are delighted that Sir Ron and Lady Margaret Trotter are with us this evening.

The Business Roundtable's mission is to promote policies for a better New Zealand. We have done research and put forward ideas on many topics, and not just ones of narrow interest to the business community. Tonight's speaker will address a topic that we regard as central to our mission, namely economic growth, which is the essential foundation for prosperity, social progress and even environmental improvement.

Peter Boettke is the deputy director of the James M Buchanan Centre for Political Economy at George Mason University in Fairfax, Virginia. He is also the director of research at the Mercatus Center of that university, and a professor in its economics faculty.

Already Professor Boettke has had an impressive academic career. In his late 20s he was invited to lecture for a year at the Hoover Institution

at Stanford University, and in his early 30s he was appointed to one of the top economics departments in the world at New York University. He has lectured and taught courses at many American universities, and at the London School of Economics, Oxford University and the Max Planck Institute in Germany.

He is the author of three books on the history and collapse of the former Soviet Union and its transition from socialism. He is now also the co-author of the classic principles of economics text, Paul Heyne's *The Economic Way of Thinking*. He has a long list of publications to his name and has edited numerous academic journals. His fields of interest include the methodology of economics, economic history, the history of economic ideas, public choice, Austrian economics, economic sociology and economic anthropology.

More closely related to this lecture, much of Peter's recent work has focused on issues of economic development, including the collapse of 'development planning', entrepreneurship, and the role of institutions such as property rights and the rule of law in building prosperity.

Central planning, of which development economics was an offshoot, was not the only bad economic idea of the twentieth century. Others included much of so-called welfare economics, with its notions of pervasive market failures, and naive applications of Keynesian economics. And it was Keynes, of course, who famously remarked on the power of ideas for good or evil.

Peter's focus in this lecture is on the role of economics in the twentieth century, and how it led us down the path of government intervention. The discipline lost its way, and the consequences have been dire. Not only did many poor countries stay mired in poverty, but the standards of living in many advanced countries grew at well below their potential rates.

New Zealand is a case in point. For many decades, New Zealand was almost a laboratory for bad economic ideas: indicative planning, Keynesian fine-tuning, state ownership, protectionism and heavy-handed regulation of markets. Our relative living standards declined as a consequence. In the last 20 years, we have returned to some of the more time-tested ideas of

economics, with great benefits in terms of better economic performance. Yet New Zealand is still under-performing as a country, bad ideas are being floated in public debates, interventionist policies have been coming back, and the growth outlook is becoming weaker again.

The good news about modern economic growth, however, as Professor Boettke and other researchers have argued, is that the future of democratic societies is in their own hands. Good institutions and policies fundamentally determine the wealth of nations, not natural resources, size or geographical location. Some research suggests as much as 85 percent of the international variation in income per capita can be explained by the institutions and policies that countries adopt. In other words, the fault is in ourselves, not our stars, if we are underlings.

So our lecturer's subject is both topical and of great importance to the debates that will shape future public policy in this country. Economic ideas matter. Please join me in welcoming Peter Boettke to New Zealand and inviting him to deliver the 2006 Sir Ronald Trotter Lecture on *The Battle of Ideas: Economics and the Struggle for a Better World*.

*The Battle of Ideas:
Economics and the Struggle
for a Better World*
Peter Boettke

In *An Inquiry into the Nature and Causes of the Wealth of Nations*, Adam Smith argued that there was a virtuous circle that led to increased prosperity. The source of economic growth and development was the gains from specialisation and trade realised through the greater division of labour and the expansion of the market economy. The division of labour was limited by the extent of the market. But, as the market expands, the division of labour is refined even further and the gains from specialisation increase productivity further again. There are, in other words, increasing returns to the expansion of the market arena. This Smithian virtuous circle counteracts any tendency toward being caught in the Malthusian trap of subsistence levels of production and represents, instead, the progressive march of modernity.

In the lectures and notebooks that he used in writing his great treatise, Smith summarised his position in the following manner: “Little else is requisite to carry a state to the highest degree of opulence from the lowest form of barbarism, but peace, easy taxes and a reasonable administration of justice: all the rest being brought about by the natural course of things” (1976a [1776], xl). Smith goes further and argues in the next passage that: “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” (*ibid*).

Evidence from the history of economic development supports Smith – both in terms of the path to successful development and the consequences of steering off that path.¹ But one must unpack the basic institutional infrastructure that serves as the background to Smith’s policy prescription. Smith’s system of natural liberty (or Hume’s of property, contract and consent) consists of a network of complementary institutions that all serve to minimise the threat of predation from both public and private actors.

Once stated in this manner, the ‘paradox of government’ becomes apparent. Government is called upon to ward off the threat of private predation, but, in the government being so empowered, the problem of public predation is created. As James Madison put it in *The Federalist Papers*:

If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: You must first enable the government to control the governed; and in the next place, oblige it to control itself (1788, 164).

Neither appeals to the wisdom of nobility, nor to romantic dreams of the perfectibility of mankind, address this paradox. Instead, institutional arrangements must be forged that will check the ambitions of some against the ambitions of others to ward off predation by private and public actors.

The systems that Smith and Hume built to understand the political economy of growth and development did not rely on behavioural assumptions to generate the conclusions concerning the beneficial consequences of the ‘invisible hand’. Self-interest is postulated as a universal aspect of human nature, but the pursuit of self-interest is not the causal factor that is relied upon to explain how beneficial social order can emerge. In Smith’s comparative political economy, the self-interest of

businesspeople (reflected in their special-interest pleading), the self-interest of the clergy and academics (reflected in the laziness demonstrated when in protected positions) and the self-interest of politicians (reflected in their arrogance and grabs for power) are all contrasted with situations where the self-interest of buyers and sellers produces a social order that is both unintended and desirable. To put it another way, both the 'invisible hand' and the 'tragedy of the commons' explanations of social phenomena utilise the self-interested motivational assumptions, but the driving force in the analysis is the alternative institutional context, not the behavioural assumptions.

The intellectual projects of Hume and Smith were to discover, through analytical inquiry and historical investigation, the institutional environment that could produce peace and prosperity despite the foibles of man. FA Hayek summed up the Smith project as follows:

[T]he main point about which there can be little doubt is that Smith's chief concern was not so much with what man might occasionally achieve when he was at his best but that he should have as little opportunity as possible to do harm when he was at his worst. It would scarcely be too much to claim that the main merit of the individualism which he and his contemporaries advocated is that it is a system under which bad men can do least harm. It is a social system which does not depend for its functioning on our finding good men for running it, or on all men becoming better than they now are, but which makes use of men in all their given variety and complexity, sometimes good and sometimes bad, sometimes intelligent and more often stupid . . . The chief concern of the great individualist writers was indeed to find a set of institutions by which man could be induced, by his own choice and from the motives which determined his ordinary conduct, to contribute as much as possible to the need of all others; and their discovery was that the system of private property did provide such inducements to a much greater extent than had yet been understood (1948, 11-13).

In the reading that Hayek provides, the classical political economy of Smith was grounded in comparative institutional analysis. It is my contention that this comparative institutional approach remained the method of political economy throughout much of the eighteenth and

nineteenth centuries, and it was only with the direction that economics as a discipline took in the early twentieth century that the institutional context of economic action ceased to be the primary focus. From about 1900 to the 1960s, the discipline moved away from a focus on institutional context, and, instead, concentrated on refinements of the behavioural assumptions. Whereas the late classical and early neoclassical traditions focused on the subject matter of economics as exchange and the institutions within which exchange takes place, the refinements of neoclassicism focused on the subject matter of economics as being the allocation of scarce resources among competing ends and the efficiency properties associated with an ideal allocation.

In this lecture I explain why this intellectual development occurred in the twentieth century and I outline the consequential shifts in scientific thought and public policy. The story begins simply enough and is at first isolated to intellectual debates as disciplines were striving to establish themselves within the pecking order of an emerging academic structure, but the consequences of this intellectual development were ultimately a contributory factor to why the twentieth century was arguably the bloodiest in recorded human history.² This statement might be dismissed as hyperbole, but that means I must accept the challenge of convincing readers that this position is more reasonable than it first appears, and that there are good reasons to remain deeply concerned that the lessons of the twentieth century relating to unconstrained government have yet to be learned, even though so many millions paid the ultimate price.

The culprits in my narrative are going to be scientism on a philosophical level, formalism and excessive aggregation at the analytical level, and the alliance of statism with Keynesianism and socialism at the public policy level. The solutions will be found in scientific humility and methodological dualism at the philosophical level, methodological individualism and the theory of the market process on an analytical level, and laissez-faire capitalism and limited government at the public policy level.

How did economics lose its way?

In the beginning, the discipline was called political economy and it was a branch of moral philosophy. But those who practised political economy did so by building arguments based on reason and evidence, and not necessarily moral intuition. The art of political economy was in the application of theory to address practical problems of public policy and, thus, the discipline was perceived as a guide to statesmen. However, from the beginning of the discipline, the advice it offered to those in power was routinely dismissed soon after it was heard. The reason for this is straightforward; it is extremely rare that those in power are willing to follow advice that minimises their ability to exercise authority over either domestic or foreign subjects.

Adam Smith warned that: “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” (1976a, Vol IV, 478).

The teachings of political economy were disregarded by an alliance of the sophistry of the businessperson engaged in special-interest pleading and the power-wielding preferences of politicians. The great French political economist Frederic Bastiat chose satire as his way to expose the sophistry when he penned his petition of the candlestick makers for protection against the unfair competition from the sun in 1845 (1996). And his countryman, Jean Baptiste Say, soberly discussed the problem of political power and economic efficiency that results from government sanctioned monopolies in his *Treatise on Political Economy* (1971 [1820], 146–147). As Say put it: “The public interest is their plea, but self interest is evidently their object” (*ibid*, 161). In so doing, he provides another example of how the assumption of self-interest is not what drove the classical analysis of the benefits of the invisible hand of

the market economy. The system of government privileges that sought to control trade was “pregnant with injustice” and created serious mischief throughout the economy (*ibid*, 164).

John Stuart Mill argued in his *Principles of Political Economy* (1967 [1848], 881–883) that the first principle of social order is the protection of persons and property. Without this protection, the social order breaks down into uncertainty and violence. Mill was quick to point out that government was not the only source of this protection, though a government that habitually violated these protections would destroy society. The prosperity experienced by the free cities of Italy, Flanders and the Hanseatic league in an age of ‘lawlessness’ demonstrates that a certain level of insecurity can be managed through means of self-protection. As Mill put it:

Insecurity paralyzes only when it is such in nature and in degree that no energy of which mankind in general are capable affords any tolerable means of self-protection. And this is a main reason why oppression by the government, whose power is generally irresistible by any efforts that can be made by individuals, has so much more baneful an effect on the springs of national prosperity, than almost any degree of lawlessness and turbulence under free institutions. Nations have acquired some wealth, and made some progress in improvement in states of social union so imperfect as to border on anarchy; but no countries in which the people were exposed without limit to arbitrary exactions from the officers of government ever yet continued to have industry and wealth. A few generations of such a government never fail to extinguish both. Some of the fairest, and once the most prosperous, regions of the earth have, under the Romans and afterwards under the Turkish dominion, been reduced to a desert, solely by that cause (1967 [1848], 882–883).

At the beginning of the twentieth century, Max Weber summarised these arguments to explain why capitalism had developed in the West but not in China. In his *General Economic History* (1927), Weber enumerated the defining characteristics of modern capitalism. Although there is no doubt that the value system in a society was a significant contributing factor, according to Weber, it was not, as so many have concluded,

just the existence or lack of the Protestant work ethic that provided the explanation as to why there was no capitalism in China. Weber, instead, put great emphasis on the arbitrariness in the law and the tax system that was practised in China and that was inconsistent with the development of a modern economy. Modern capitalism was, instead, characterised by rational accounting, freedom of the market, modern scientific technology, the rule of law, free labour, a rationalisation of the conduct of life consistent with market activity and the commercialisation of economic life. These factors all worked to provide a rational ethic for enterprise, and a political and legal environment that was predictable and that guaranteed market participants a semi-autonomous area in society. In short, the basic lesson was once again one that provided that peace, easy taxes and a reasonable administration of justice prevailed and that economic development would follow in the natural course of things.

When one reads these different authors' arguments, what is striking is the consensus that was evident on the fundamental question of the causes of the wealth and poverty of nations. But this consensus was extremely fragile. Classical political economy proved to be quite vulnerable to critiques that focused on (a) instability, (b) monopoly, and (c) inequality.³ Karl Marx was the most thorough critic along these lines, but several others contributed along the way by pecking holes in the classical system through emphasising the problems of recurring business cycles, the concentration of market power in the hands of a few or a single seller and the unequal distribution of income. To counter the perceived problems of capitalism, critics of the classical system argued that the role of government had to change from that of a 'nightwatchman' to the more active guardian of the public interest.

Even though John Stuart Mill saw an expanded role for government interference, he argued that: "Whatever theory we adopt respecting the foundation of the social union, and under whatever political institutions we live, there is a circle around every human being which no government, be it that of one, of a few, or of the many, ought to be permitted to overstep" (1967 [1848], 943). Violation of this principle ran the risk

of the loss of human freedom and dignity. As such, Mill argued that: “the onus of making out a case always lies on the defenders of legal prohibitions” (*ibid*). Mill even argued more forcefully when he stated later in this chapter that: “*Laissez-faire*, in short, should be the general practice: every departure from it, unless required for some great good, is a certain evil” (*ibid*, 950). Despite this line of argument, Mill made a case for government interference in the economy to address problems of unsafe work environments, consumer ignorance, education, collective action, and inequality and injustice.

Obviously, there were intellectual gaps in the classical presentation of *laissez-faire*, but eventually these would be addressed to a considerable extent by the emerging neoclassical theory of value and price. For example, the neoclassical theory of factor pricing challenged theories of exploitation. But, as Hayek has pointed out, by the time those theoretical revisions were made, the public mind had already been swayed to the other side.

It takes a long time to rebuild the structure of a science if one starts by revising the fundamental concepts. And the modern revision of theoretical economics has occupied sufficient time to allow what was at first the heretical view of a number of radical economists – who had to fight what was then the conservatism of the practical men who were still under the influence of economic liberalism – to pervade the thought of the public and to establish itself as the dominating doctrine, not only among advanced social reformers, but even among the most conservative businessmen. The public mind in all leading countries of the world is now completely under the domination of the views which spring from the revolt against the classical economics of seventy years ago (1931, 24).

Despite the fact that the early neoclassical economists increasingly came to the consensus that classical economists had arrived at essentially the correct conclusions with cruder instruments, the classical presumption toward freedom of choice gave way to a demand for government action, and the concern with the abuse of political power was dismissed as the groundless fear of a pre-democratic era. Theory and experience sided with the general thrust of the classical political economists, but the public

mind and the political elite resisted that conclusion and were, instead, under the sway of interventionism guided by democratic consensus.⁴ The classical presumption against interventionism was reversed, and now those who argued for laissez-faire were dismissed as anachronistic.

In addition to this intellectual development in economics, it is important to emphasise two critical developments that crystallised the intellectual and policy consensus in the twentieth century. First, institutions of higher education were growing in importance as sources for research and policy as the German model of the research university spread throughout Europe and the United States. At the same time, academic disciplines started to become professionalised. The great success in the physical sciences during this period was attributed to enhanced technologies of measurement. The idea evolved quickly that science was measurement, and any discipline that desired the status of science would have to entail measurement. The neoclassical economists who were striving to make the discipline of economics a scientific enterprise were no less enamoured with measurement than anyone else in the *zeitgeist* – political economy was renamed economics. No longer a branch of philosophy and a handmaiden to history, economics was now a branch of social physics and deployed higher mathematics to bring rigor to the analysis of social order.⁵

Mathematical reasoning would not come to dominate economic analysis until the 1940s and 1950s, but the basic justification was already in place in the intellectual world in the late nineteenth century. The problem with verbal reasoning, it was argued, was that ambiguity results from either using the same words to mean different things, or using different words to mean the same thing. Assumptions could remain hidden, and moral intuitions could sneak into the analysis. It was believed that, by putting arguments in mathematical form, all of this would be avoided. Formal presentation required all assumptions to be made explicitly, and definitions to be precise.

The formalist victory in economic science was secured with the publication of Paul Samuelson's *Foundations of Economic Analysis* (1947)

and reflected in the axiomatic presentation of the general competitive equilibrium theory in the work of Kenneth Arrow, Gerald Debreu and Frank Hahn. Even though Kenneth Boulding (who at the time was a recent John Bates Clark Award winner and not the iconoclastic thinker he would later become) sent an early warning signal when, in his *Journal of Political Economy* review of Samuelson, he wrote: “Conventions of generality and mathematical elegance may be just as much barriers to the attainment and diffusion of knowledge as may contentment with particularity and literary vagueness . . . It may be that the slovenly and literary borderland between economics and sociology will be the most fruitful building ground during the years to come and that mathematical economics will remain too flawless in its perfection to be very fruitful” (1948, 199). But the concerns of Boulding and others were ignored as relics of an unscientific age.

Boulding pinpointed something of great importance that was dismissed too quickly, in favour of the focus on whether or not a thinker was sufficiently skilled in higher mathematics. The mathematical method resulted in draining the institutional context from economic analysis. Von Mises and Hayek raised a similar concern about the shift of analytical attention away from the process of exchange and the impact of alternative institutional arrangements on that process. Human choice was reduced to an exercise in constrained optimisation, and the force of competition was redefined as a state of affairs rather than a set of active engagements. Core theory no longer addressed the adjustments made in the market “not by any accurate measure, but by the higgling and bargaining of the market” (Smith, 1976a [1776], 35–36). Instead, equilibrium properties – that state where all adjustments have been completed – came to dominate economic theory.

In general equilibrium theory, no trades outside of equilibrium were permitted, otherwise the ‘false trades’ could derail the theoretical attainment of equilibrium. Instead, plans were pre-reconciled prior to permitting trade and then the system of simultaneous equations could be constructed and a unique price and quantity vector that would clear

all markets could be discovered. Absent the pre-reconciliation of plans among agents the unique price and quantity vector could not emerge within the system. The only way to get the equilibrium solution was to presuppose one was already in equilibrium. No path to equilibrium could be constructed.

It is not that the equilibrium theory served no purpose. It did communicate the delicate interconnectedness that an advanced economic system exhibits. And it did demonstrate the characteristics of the end-state toward which economic activity would result in the absence of changing circumstances. But it clouded our understanding of the processes by which economic actors adapt creatively on the margin to changing circumstances and learn how to coordinate their plans better with others to realise the mutual gains from trade. Moreover, the theory eliminated from economic analysis how alternative institutional arrangements either impede or encourage that learning by economic actors.

The formal theory of the 1950–1970 time-period strove to be institutionally antiseptic, and succeeded to a considerable extent. The mantle of science was attributed to economists because of the form in which they presented their arguments, but the cost of obtaining that prestige was to ‘cheapen’ the content of economics. James Buchanan often challenged his students with the question: “What more do we know today about the nature of markets than Adam Smith knew in 1776?” If not much progress was evident, Buchanan concluded, then perhaps the formalist emperor has no clothes and someone needs to play the role of the innocent child and reveal the truth of the matter to our fellow economists.⁶

The problem would not be so troublesome if it just impacted on economics, but economic policy debates were greatly influenced by the changing nature of economics in the twentieth century. The debate over socialism among economists is perhaps the most obvious example, but market failure theory, in general, and the policy response through tax and regulation were equally impacted by a consensus among formal theorists that institutions of private property, freedom of contract and constitutional constraints cease to play a definitive role in economic outcomes.⁷

Scientism, formalism and statism dominated economic thinking in the twentieth century. In addition, the main generation of scientists and intellectuals in the twentieth century came of political consciousness during the Great Depression, finished their graduate education either during or after World War II, rose to professional prominence in the 1950s and 1960s and became elder statesmen of the profession in the 1970s and 1980s. This was a generation, save Milton Friedman, who had lost faith in unbridled capitalism, believed deeply in the ability of democratic governments to address the social ills of poverty, racism, sexism and other forms of social injustice, and took great pride in the new science of economics they had helped create, which could serve as a tool for social control to meet those challenges. This was a generation who defeated Hitler in their youth, and put a man on the moon by middle age. Only the most cynical and superstitious of that generation, it was believed, could doubt the progressive thrust of new science and democratically elected government, and, instead, demand a return to the older teachings of classical political economy that emphasised the institution of private property, freedom of contract and constitutional constraints on the power of government.

The counter-revolution in economic thought

By 1950, economic thought and policy was dominated by Keynesian demand management on the macroeconomic side, and market failure theory on the microeconomics side. During the period of 1946–1980, the intellectual consensus was collectivist, and the policy practice was not lagging far behind. Government spending as a percentage of gross domestic product (GDP) in the United States expanded quickly as action chased after thought. There was no intellectual resistance to the growth of government. Ideas and interests aligned to transform Western societies and also to build a policy consensus in the West's efforts abroad to address underdevelopment that was decidedly anti-market.⁸ The voices of economists born in the nineteenth century, such as von Mises and Hayek, that were raised to caution against this trend were dismissed.

But a growing counter-revolution that emphasised the institutional infrastructure and economic processes started to emerge within the profession to challenge the Keynesian and market failure hegemony.

The property rights economics of Armen Alchian, Ronald Coase and Harold Demsetz; the public choice economics of James Buchanan and Gordon Tullock; the new learning in industrial organisation associated with George Stigler and Yale Brozen; the theory of the entrepreneurial market process associated with Israel Kirzner; the new economic history associated with Douglass North; and the monetarist critique of Keynesianism associated with Milton Friedman, all emerged in the 1960s as a formidable opponent to the policy consensus from 1950–1970. By the mid-1970s, the presumption in thought had swung back decidedly in the direction of the classical political economy as the New Classical revolution of Robert Lucas challenged the Keynesian hegemony in macroeconomic research. Policy would lag behind and, unlike in the move from *laissez-faire* to statism, interest groups and politicians would block moves for policy to catch up to the new thinking. If the period between 1945 and 1975 was one of ‘galloping socialism’ in Western democracies such as the United States and United Kingdom as big government was called upon to serve as a corrective to economic ills (justified by market failure theory and Keynesianism), the period between 1975 and 2005 was one of ‘creeping liberalism’ in Western democracies, as the justification for the previous policies was soundly defeated on the intellectual level. However, the actual behaviour of government, in terms of spending, taxation and regulation, changed at a slower rate than would have followed from the intellectual victory.

Milton Friedman has argued that we have seen a victory in the realm of ideas, but a failure of implementation. In the move from rhetoric to thought, and from thought to action, the classical liberal movement has been tripped up at the second stage. The stumbling blocks have mainly been a consequence of the forces of inertia – the political resistance to change. Friedman explained this tyranny of the status quo as the alignment of intellectuals, interest groups and politicians (an ‘iron triangle’) who benefited from the existing array of policies and who

would block any proposed change.⁹ Still, it is important to recognise that a counter-revolution in economic thought had been successful and that the Keynesian and market failure dominance in economic education was defeated to a considerable extent by 1980 and thereafter.¹⁰ The justification for activist government in economic life needed to be grounded in an alternative microeconomic framework – at least at an intellectual level. The inertia in public policy, however, prevented the counter-revolution in economic theorising from realising the public policy consensus in economic policy to the same extent that the Keynesian consensus experienced between 1950–1980. *Laissez-faire* in rhetoric and dirigisme in practice is perhaps the more accurate description of the public policy consensus since 1980.

Path dependency in policy

During the Keynesian hegemony, various statistical metrics were developed for the task of social control. National income statistics were collected, and policy models of fine-tuning of the macroeconomic system were developed. The two would serve one another – the macroeconomic models dictated what data should be collected, and the data collected would then be employed in the models to transform the analytical model into a tool for policy. Economics so conceived ceased to be a way of thinking about exchange relationships and the institutions within which exchange takes place, and, instead, became a tool for social control.¹¹ The analytical focus was on models postulating a relationship between macroeconomic variables such as inflation and the rate of unemployment, and the empirical focus was on the statistical examination of these variables and the postulated relationships. Keynesian models raised Keynesian questions that were examined with Keynesian data to produce Keynesian answers.

An excellent illustration of this can be found in the ‘Washington Consensus’ of the 1990s. The Washington Consensus focused its rhetoric on privatisation, deregulation, fiscal balance, monetary restraint and free

trade. But it still suffered from a 'one-size-fits-all' approach to public policy, which paid little or no attention to the historical details of the institutions in the particular society under examination, and maintained a primacy on macroeconomic policy, rather than a microeconomic analysis of the economic situation. In other words, while the Washington Consensus expressed a certain sympathy with aspects of the counter-revolution in economic theory, in practice, it did not represent a major departure in public policy but was, instead, merely 'conservative Keynesianism' as opposed to the 'liberal Keynesianism' from the earlier era. As another example, if you engage in a careful reading of Jeffrey Sachs's discussion of the policies required for post-communism ('shock therapy'), it will reveal that Sachs was not offering a shift in the policy regime of Western democracies for East and Central Europe and the former Soviet Union, but a desire to establish a market economy so that the necessary regulatory regime and tools of macroeconomic management could be institutionalised and implemented as tools for social control.¹² A new era of laissez-faire was not ushered in with the breakdown of the Keynesian consensus and the collapse of communism. The 'creeping liberalism' of the 1975–2005 period began with the claim that government had grown too big when government spending represented 32 percent of GDP in the United States and ended with the claim that government had been drastically cut when government spending represented 31 percent of GDP. During that period, never once did that figure fall below 29 percent.

The creeping liberalism experience over the past 30 years is not limited to the United States. Consider the case of Russia after communism. In 1992, the rouble exchanged at 180R to US\$1.00, but in 1995 it exchanged at more than 5,000R to US\$1.00. This was during a period that was described by its critics as an era of 'monetarism'. During the 1990s, we heard repeatedly that Russia's citizens were subjected to the cruel consequences of market romanticism, yet a close reading of all media accounts reveals there was a growing 'black market' during the 1990s. Underground markets are not associated with liberalism, but, instead,

prohibitions. So, again, Russia's problems in the 1990s were a consequence of too much government involvement in the economy, rather than too little.¹³ The inertia in public policy that limited the pursuit of economic liberalism was true, even after a collapse of the previous policy regime. A similar story can be told of the so-called liberal reforms in Argentina in the 1990s, where market liberalism is blamed for failed policies, when a more subtle reading of the situation would reveal that the problems were caused by government distortions of the economic environment.

Liberal economic theory is not blameless in this confused intellectual and policy state of affairs. The academic defence of the liberal economic order has often portrayed the free market system as requiring hyper-rational individuals who interact in a mechanistic and impersonal system of ruthless efficiency. Demonstrations of deviations against the ideal of hyper-rational action by individuals and static efficiency as realised by the system would demand government action to address social ills. Given the ridiculous benchmark of hyper-rational individuals and ideal efficiency, the real world would, at every point, fall short and thus be in constant demand of, on the one hand, paternalistic intervention by government to save individuals from their alluring hopes and haunting fears (which produce 'irrational' choices), and, on the other, government activism in the economic system to curtail problems of monopoly, externalities, public goods and macroeconomic instability.

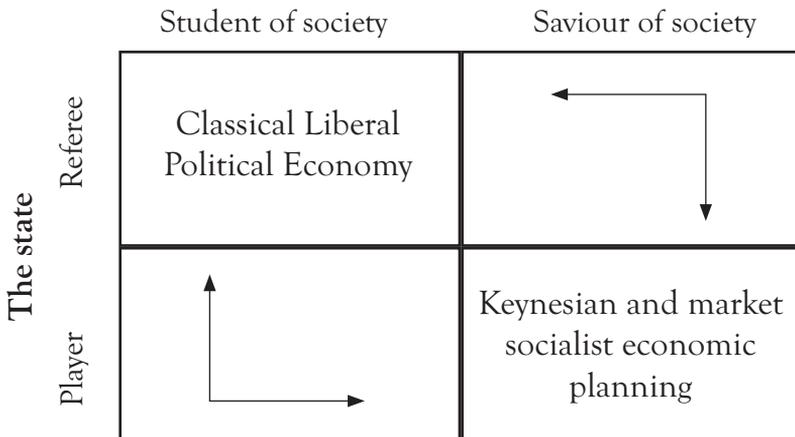
The inertia in public policy results in a recycling of the critique of *laissez-faire* and a tendency to ignore what was learned during the counter-revolution of the 1950–1975 period on the intellectual front because of the failure of implementation during the era of creeping liberalism between 1975–2005. It is inaccurate to claim that 'big government has returned' for the simple reason that it never really left us in the democratic West. However, it is important that we recognise that the defence of 'big government' now has new claims to our intellectual attention. The criticism of neo-liberal policy associated with the anti-globalisation movement (which focuses on inequality and questions of global justice), and the critique of economic growth and development connected with

the ‘happiness’ research (which focuses on how the preoccupation with per capita income does not address human well-being and thus serves as a poor guide for public policy), in combination, enhance the demand for government policy to move beyond questions of the institutional framework, and to play an active role within the economic process. In addition, the tension around the globe associated with the threat of terrorism is interpreted as evidence of the increased need for enhanced governmental powers to combat the current situation. Politics, in other words, moves from setting the legal and political framework to having an active role within the economy.

The following diagram tries to capture the economist’s role in society and the tension with which the economist is confronted:

As long as the economist is viewed as a student of society and the role of the state is limited to that of a referee, a classical liberal policy regime of laissez-faire can result and can be sustained. However, if the role of the state in the economic system is not limited, and, instead, is viewed as an important player in the economic game, then economists will gravitate to viewing themselves (and demanding that others view them in the same light) as saviours of society via the tools of social control provided by

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economic theory and statistical analysis. Therefore, the two stable positions are the economist as student/state as referee and state as player/economist as saviour (that is, the North-West and South-East quadrants). Outside of those stable relationships, the natural pull is toward either of these boxes because the other two situations are incentive incompatible.

Unfortunately, philosophical presumptions that envision economics as a tool for social engineering, rather than as a branch of moral philosophy, frame the debate in such a way as to bias the outcome in the direction of the state as player/economist as saviour quadrant. There is a natural alliance between scientism and statism that is extremely hard to resist intellectually.¹⁴ In addition, there are significant public choice reasons why the natural pull in the policy world is toward the state as player/economist as saviour quadrant. To agitate for the state as referee/economist as student quadrant is to forgo significant rents as an economist and to ask politicians to do the same.

Resistance of that natural tendency toward the state as player/economist as saviour quadrant is the task of classical liberal political economists. The role of the economist in a free society from the perspective of classical liberalism is much humbler, yet still one of vital importance. The economist in a free society is charged with three tasks. The first is to be a teacher and to communicate to students and interested citizens the basic principles of the discipline of economics (the logic of choice, the economic forces at work in alternative systems, the principle of spontaneous order and so on). The second is to be a student of society, to work hard as a scholar to understand the nature of economic processes through time. The third task is to be a social critic, to analyse policies and economic ideas critically for their logical coherence and their vulnerability to opportunistic behaviour. Through these roles, the economist can help fellow citizens to become informed participants in the democratic process. And, it is through pursuing these tasks competently that the economist can help break the policy inertia associated with the 'iron triangle' of interest groups, bureaucratic structures, and politicians.¹⁵

Conclusion

The great classical economist John Stuart Mill pointed out that:

Ideas, unless outward circumstances conspire with them, have in general no very rapid or immediate efficacy in human affairs; and the most favourable outward circumstances may pass by, or remain inoperative, for want of ideas suitable to the conjuncture. But when the right circumstances and the right ideas meet, the effective is seldom slow in manifesting itself (2006 [1845], 370).

Ideas do ultimately rule the world, as John Maynard Keynes (1936, 383) taught us, but they must conspire with circumstances for their influence to be felt in the world of public policy. Sometimes the changes that result from the conspiracy of economic ideas and political and historical circumstances can be for great good (for example, the alliance of economists and abolitionists in the nineteenth century to eliminate slavery) and at others for great evil (for example, the rise of communism and fascism in the first half of the twentieth century).

Economic ideas play a vital role in the struggle to realise a better world. The hope for the twenty-first century, after the bloodshed of the twentieth and the inauspicious beginning of this century in terrorism and militarism, resides in the liberal ideal of a free and prosperous cosmopolitan order. We need an ethic for strangers that transcends national borders, rather than an ethic of geopolitics that rewards allies and aggresses against perceived enemies. The civilising role of commerce and trade, a role recognised by the classics such as Voltaire, Montesquieu, Hume and Smith, must be appreciated once again.

The economic advancement of countries is a consequence of realising the gains from trade (associated with the insights of Adam Smith on the division of labour) and the gains from innovation (associated with the insights of Joseph Schumpeter on entrepreneurship and creative destruction). The economic retardation of countries, on the other hand, is a consequence of foolish government policies that hamper exchange relations and curtail creative efforts of individuals. Therefore, the fate of

humanity ultimately turns on the outcome of a 'race' between Smithian gains from trade, Schumpeterian gains from innovation, and government folly in terms of policies that attempt to thwart exchange and curtail innovation. Rather than thwarting exchange and curtailing innovation, good rules of the game will thwart the predatory proclivities of rent-seeking actors and unleash the creative potential of mankind.

Vote of Thanks

Paul Bevin

SIR RONALD AND LADY MARGARET TROTTER, distinguished guests, ladies and gentlemen, I have been given the honour of thanking our speaker on your behalf.

One of the first things I learned about Peter Boettke is that he is a basketball fan, and coach in particular, which appeals to me as a former player. I note, too, that he takes great pride in his economics teaching and sees this role as akin to a coach. He has even written about 'Entrepreneurship in the Coaching of Basketball'! He sounds like a good teacher and he has demonstrated that in his lecture.

When I studied economics at Victoria University of Wellington, I don't recall learning about Professor Boettke's branch of economics. Keynes was still the man then. It may also reflect the fact that I didn't learn much economics, in university anyway: there were too many competing interests, basketball not least.

Instead, I learned my economics in the mid-70s and early 1980s at the Treasury. It was an environment where the preoccupation was with economic 'fine tuning' - the stuff of Keynes. Muldoon, the finance minister and prime minister of the time, made economic pragmatism an art form.

With an arrogance about the role of government and what it could do, Muldoon led New Zealand into a socialist style command-and-

control economy that was almost bankrupted by a foreign exchange crisis in 1984.

We all know what followed in response to the crisis. A renewed faith in competitive markets underpinned the sweeping deregulation and institutional economic reforms of the Lange Labour government in the 1980s and the succeeding National government in the early 1990s. It propelled New Zealand to the forefront of economic reform in a global context and established a platform for faster growth in living standards. Key parts of those structural reforms remain in place today.

This radical shift in policy in New Zealand toward more faith in market solutions and a more limited role of government was supported by thinking that had been going on in the Treasury for a few years. That work built on the revival of market economics but it was greatly enriched by a deeper understanding of how markets really work on the one hand and the dangers of government intervention on the other. There was a recognition that markets were not perfect but that governments were often worse. Much of this improved understanding is attributable to the names to which Professor Boettke refers – Hayek, Buchanan, Coase, Demsetz.

About that time, my son decided to study economics, but when I saw his course outline and texts I despaired. They were still dominated by Keynesian macroeconomics and apparently unaware of the newer thinking. It seemed our universities were behind the times. Fortunately, I found him a great book by Henry Hazlitt titled *Economics in One Lesson*. Although first published in 1946, it was still relevant then and remains so today. That book echoed Peter Boettke's thesis: older ideas about economics are now back at centre stage, and deservedly so.

Since the early 1990s, however, economic policy in New Zealand has been ignoring the lessons of time-tested economics and reverting to pragmatism. The role of the government versus private markets is steadily expanding again. New Zealand is losing ground in the battle of ideas and the struggle for a better world. The policy slippage may have been masked by a long period of strong growth in the world economy but we had better take note, or we will keep losing ground.

Professor Boettke's message is also that the economist's role is not to be the guiding hand for the macroeconomy. It is to understand and explain the lessons of history and the value of voluntary exchange in private markets in improving outcomes. This implies economists should challenge policy makers openly and vigorously when they promote poor policies. We all know that the price of freedom and of sound policies is eternal vigilance. Please join me in thanking Professor Boettke for his excellent, topical and ultimately positive address.

Notes

- ¹ See, for example, McCloskey (2006) for a full discussion of the history of economic growth.
- ² See RJ Rummel's work *Death by Government* (1994). Rummel estimates the death toll as a result of direct government action against citizens in the twentieth century to be 169,202,000 people. Also check Rummel's website at the University of Hawaii: <http://www.hawaii.edu/powerkills/welcome.html> (last accessed February 2007).
- ³ See Buchanan's (1991) insightful essay 'The Potential and the Limits of Socially Organized Humankind'. As Buchanan points out: "The great scientific discovery of the eighteenth century, out of which political economy (economics) emerged as an independent academic discipline, embodies the recognition that the complementary values of liberty, prosperity, and peace can be attained" (244). But while the historical experience provided empirical evidence of the ability of the classical liberal project to simultaneously achieve liberty, prosperity and peace, the project failed to capture the intellectual imaginations of leaders. "Why did social philosophers", Buchanan asks (245), "from the middle of the nineteenth century forward lose interest in the classical teachings? Why did the socialist century emerge, and with the active support of social philosophers?" Buchanan argues that the classical liberal vision proved vulnerable to claims about justice, and, in particular, claims about distributive justice. The fact that justice-driven moral purposes were exploited by interest-driven actors to produce undesirable outcomes in terms of liberty, prosperity, peace and justice is beside the point for the critique of classical liberal political economy. The challenge today for political economists is to focus attention again on political structure (not political intervention) and to develop a concept of constitutional justice grounded in a realistic (not romantic) notion of politics that can resist the false claims of the welfare state and realise a social order that simultaneously achieves liberty, prosperity, peace and justice.
- ⁴ Ludwig von Mises (1949, 692) points out that once the state was attributed both benevolence and omniscience: "Then one could not help concluding

that the infallible state was in a position to succeed in the conduct of production activities better than erring individuals. It would avoid all those errors that often frustrate the actions of entrepreneurs and capitalists. There would no longer be malinvestment or squandering of scarce factors of production; wealth would multiply. The ‘anarchy’ of production appears wasteful when contrasted with the planning of the *omniscient* state. The socialist mode of production then appears to be the only reasonable system, and the market economy seems the incarnation of unreason”.

- 5 See Roy Weintraub (2002) where he discusses Marshall’s role in the establishment of economics as a discipline at Cambridge. The classic critical reference on ‘scientism’ is Hayek’s *The Counter-Revolution of Science* (1952). Philip Mirowski’s *More Heat than Light* (1989) and *Machine Dreams* (2003) explain how the formalistic aspirations of economists impacted on the development of economic thinking in the late nineteenth and twentieth centuries. See also Michael Bernstein’s *A Perilous Progress* (2001) and Robert Nelson’s *Economics as Religion* (2001) for a discussion of the discipline of economics and its relationship to public policy in the twentieth century.
- 6 In his essay ‘Cost, Choice and Catallaxy’ Buchanan (2005) provides an excellent discussion of how a slight revision to our understanding of the content of core theory can radically alter the framework for policy evaluation. In this instance, Buchanan is focusing on opportunity-cost reasoning and the idea of cost-benefit analysis in law and economics. In Boettke, Coyne and Leeson (2006) ‘High Priests and Lowly Philosophers: The Battle for the Soul of Economics’, we argue that, when it is demanded of a discipline by the scientific establishment and public policy decision makers to provide results that it is constitutionally unable to achieve, the ‘soul’ of the discipline and the intellectual integrity of its practitioners is what becomes at risk as those in the discipline strive to provide the results demanded. Science can quickly turn into nonsense, even if nobody wants to admit it.
- 7 Ronald Coase (1988, 185), in response to a criticism by William Baumol of his work, where Baumol defends the ‘impeccable logic’ of the traditional Pigovian approach to welfare economics with its calculation of taxes and subsidies to address the problems of externalities, states satirically that: “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”.

- ⁸ For instance, consider the dismissive intellectual treatment that the work of PT Bauer on the economics of underdevelopment and the failure of foreign aid received in the 1960s and 1970s. My colleague, Chris Coyne, and I attended a conference in 2004 at Princeton University in honour of PT Bauer, and Amartya Sen, in response to a question, described the biggest difference between the intellectual state of play in 1964 and 2004 by stating that in 1964 the basic idea was that market economies were zero sum games while politics represented opportunities for positive sum games, whereas in 2004 politics were viewed as zero sum games and markets as positive sum games.
- ⁹ See Friedman and Friedman (1984).
- ¹⁰ Consider the recognition by the Nobel Prize committee as weak evidence of this shift in thought: Hayek (1989), Friedman (1976), Stigler (1983), Buchanan (1987), Coase (1992), Becker (1993), North (1994), Lucas (1996), and Smith (2003). However, in the 1990s and this first decade of the 2000s a resurgence of Keynesian-sympathetic political economy can be found in the works of Paul Krugman and Joseph Stiglitz, so there has been a counter-counter-revolution.
- ¹¹ It should not be surprising that Abba Lerner's classic work was entitled *The Economics of Control* (1944). However, see Milton Friedman's (1953) early critique of Lerner's work for a foreshadowing of the institutional emphasis that became a hallmark of the counter-revolution.
- ¹² This is strikingly revealed in a comparative reading of Poland's *Jump to the Market Economy* (1993) and *The End of Poverty* (2005). Sachs's basic perspective of the 'economist as saviour' does not change, though the policy tools of salvation get different emphasis.
- ¹³ See Boettke *Why Perestroika Failed* (1993) for a discussion of the inconsistent reform efforts under Gorbachev and the difficulties in the policy changes initiated in the early Yeltsin years, and Boettke *Calculation and Coordination* (2001) for a further discussion of the general pattern of half-measures and inconsistent policies through the 1990s in post-communist Russia.
- ¹⁴ This was Hayek's theme in *The Counter-Revolution of Science* (1952) and it constituted, in many ways, his most difficult intellectual challenge in trying to win acceptance of his ideas. For a discussion of the role of Hayek's 'Abuse of Reason' project in his life-work see Bruce Caldwell's *Hayek's Challenge* (2004, 232-260).

- ¹⁵ Henry Simons argued in his University of Chicago economics syllabus that the primary function of economic study was as a “prophylactic against popular fallacies” (1983, 3). Following this line of argument, the reader is encouraged to look at WH Hutt’s *Politically Impossible . . . ?* (1971), which challenged economists to speak the truth about economic policy rather than worry about the pragmatic concern of ‘political feasibility’.

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