WHAT'S WRONG WITH NEOCLASSICAL ORTHODOXY?

An Overdue *Methodenstreit*

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Abstract

The neoclassical 'economist king' has tumbled from his pedestal. Enrolments in mainstream economics courses have declined the world over. Faculties of law, commerce, sociology, psychology, anthropology, history and engineering have removed conventional introductions to economics from their curricula. Moreover, the great policy reforms since the 1980s owed little to the neoclassical mainstream, which has been found wanting. The poverty of neoclassical economics becomes evident when one realises that key concepts – such as competition, enterprise, profit, the costs of transacting business, the need for law and other rules of coordination (institutions) – have simply been 'assumed away for simplicity's sake'. It is also imbued with a wrong-headed pessimism, derived from nineteenth-century agricultural reality (law of diminishing returns).

Nonetheless, many economics faculties and major journals still cling to the neoclassical paradigm, because it makes teaching and research easy, facilitates publication and builds on established professional networks. Neoclassical assumptions allow economists to build elegant models, to adopt a utopian posture, allege frequent market failures and urge policy makers to engineer specific outcomes (constructivism), thus helping to increase the sway of the visible hand.

Despite recent lapses into Keynesian (neoclassical) economics and re-regulation, an intellectual sea change is manifest. Jurists, business analysts, engineers and historians, as well as top-level policy advisors, now increasingly embrace the Austrian (evolutionary or institutional) approach to economics. And the wider public has long jettisoned the assumption of a benevolent, all-knowing state. Instead, electorates embrace a deepening 'public-choice scepticism'.

To understand these changes, we are well advised to revisit the *Methodenstreit* (dispute over the correct method to analyse economic phenomena), which excited Continental European economists one hundred years ago and has been maintained on and off ever since. At its core lie fundamental disagreements over the very subject matter of human

action, and specifically the admissibility of assumptions of 'perfect knowledge' and '*ceteris paribus*'. Methodenstreit also deals with aspirations to make economics 'scientific', similar to the traditional laboratory sciences (scientism), and with assertions that it can be conducted satisfactorily without reference to fundamental social values (normative economics).

If economics is again to become more realistic and relevant, economists must acknowledge the absurdity of basic assumptions that underpin the neoclassical paradigm. Economics – a child of moral philosophy – must again, in essence, be about the search for and use of knowledge for socially valued purposes. A focus on creativity, progress and enterprise also recommends itself, because that will turn the dismal science of rationing scarcity into a more cheerful and encouraging discipline.

Introduction

Assumptions behind the neoclassical paradigm

People with practical life experience in business, law, engineering and psychology, as well as economic historians and general observers, are invariably astounded when they discover what – often implicit – assumptions underpin standard textbook economics.

- How can anybody claim to have 'perfect knowledge' of the future (or even some probabilistic counterpart thereof)? Yet, mainstream economists – from Alfred Marshall to John Maynard Keynes, to most of the present-day econometricians – assume they have perfect knowledge about people's preferences, available resources and technologies. In reality, economic life is in perpetual, open evolution. Enterprising people and competitors are all the time staring into the fogs of an unknowable future. If the economist-observer already knows all, there is little room for innovating engineers and entrepreneurs, whom the brilliant Austrian–American economist Joseph Schumpeter (1883–1950) placed at the centre of economic development. Yet, most neoclassical textbooks fail to discuss the critical role of profits and losses in governing economic life and, instead, relegate entrepreneurs to the fringe of the discipline, if they are mentioned at all.

- How often are we treated to analyses of two actors who make passive, predictable choices between two known products made from two production factors? It is hard to take the step from this simplistic, static model to an evolving, complex world, where thousands of people, who have never met, interact to fill the shelves of a department store that carries tens of thousands of different items, a world where computer programs are updated every week, where services are often tailor-made and in which causation is often circular. Can we be surprised that non-economists are bemused?

- *Homo* certainly-not-always-so *sapiens* are rarely able to master all the knowledge necessary to choose what promises the *maximum* utility or profit next week, next month, or next year (Hayek, 1945, p 530; Dolan, 1976; Kasper and Streit, 1998, pp 44–52). When speaking of maximising utility, neoclassical analysts imply there is a stable spectrum of known human satisfactions (represented by indifference curves), which can be attained by varying combinations of given resources and

known production techniques, and assessed rationally. I have never seen an indifference curve, not even my own! Should I have one, it is utterly unstable. Indeed, there is so much inconstancy over time and such complementarity between various satisfactions that I am inclined to consider the whole concept nonsense on stilts. In reality, we cannot know enough to maximise utility, because expected benefits change and are interdependent and the anticipated costs are subjective – everyone's opportunity costs are different and change when available alternative opportunities change (Buchanan, 1969, Foreword). We may sometimes be able to optimise the use of our time for an evening, but can we confidently make a decision where to relocate our family in order to optimise our life opportunities for the remainder of our days? Besides, when we pursue our own diverse, ever-changing purposes, we are frequently satisfied with less than an imagined optimum or maximum, as Chicago sociologist Herbert Simon demonstrated (Simon, 1976). Nor are we mere atomistic, passive reactors to given preferences, means, ends and constraints, as the neoclassical paradigm depicts us (von Mises, 1966; Demsetz, 1969).

- Outsiders, who have not been brainwashed by orthodox economics, wonder how one can assume 'for simplicity's sake' that rational humans are motivated *only* by maximising utility and profit within the bounds of a narrow end-means rationality (Cordato, 1994, pp 131–137). The artificial construct of *homo oeconomicus* – whose only form of rational behaviour is to optimise ends by given means – presents a psychologically stunted image of mankind. At best, *homunculus oeconomicus* tells only a part of the story of human action. In reality, human endeavour is also motivated by love, guile, laziness, forgetfulness, fear, sheer entrepreneurial curiosity or a determination to prove a point. For example, risk-taking 'Schumpeterian' entrepreneurs, who pursue untested ideas that no one else has yet had, cannot be considered irrational. A more realistic conception of rational motivation should comprise the end-means rationality of neoclassical economics, but it must also embrace entrepreneurial drive, as documented by Joseph Schumpeter, and mere satisficing behaviour, as described by Herbert Simon (Schumpeter, 1961; Simon, 1976; Kasper and Streit, 1998, pp 53–64).

- Another implausible aspect of the neoclassical orthodoxy is the implication, if not even the assertion, that 'equilibrium' – everyone's expectations being mutually compatible, so there is no further change – is somehow an ideal state of affairs. In an extreme, but revealing, application of this view, the growth theorists of the Cambridge School called a situation when net capital formation stops, as the marginal productivity of capital equals the rate of return, and when there is no further economic growth, a 'Golden Age'. Stagnation as a 'Golden' ideal? Every practitioner of business knows that markets are incessantly disequilibrated by changing

circumstances and new entrepreneurial initiatives. Of course, yet other entrepreneurs find profitable opportunities in arbitrage, which promotes equilibrium. These are the Kirznerian entrepreneurs who are alert for such opportunities (Kirzner, 1973). Dare I say that a neoclassical equilibrium amounts to the end of economic life?

- The DNA of neoclassical economics is intrinsically permeated by the assumption of diminishing returns. The 'law of diminishing returns' derives from the widely shared, superficially plausible insight that economic growth cannot go on forever and systems tend towards entropy. Nineteenth-century economists, such as David Ricardo (1817) and Thomas Robert Malthus, said that additions of capital raise the output of a given plot of land, but each additional unit of capital comes with diminishing returns (falling marginal productivity of capital). Karl Marx then made this 'law' the basis for predicting the collapse of capitalism. But modern economies move dynamically forward. (Neo)classical economists were and still are correct when they foretell resource exhaustion and tipping points in certain places. Microeconomies have run out of emmer wheat, building timber or whale oil. But, before long, entrepreneurs found new, more fertile strains of wheat, imported timber or used steel for construction, and sold mineral oil to keep the lamps alight. Human ingenuity simply finds new resources and processes. The economy progresses, changing 'technology horses' – so to speak! After peak oil, we may get nuclear fusion or biofuels from algae, and so on. Running out of something or other is the story of economic development. The Ricardian–Marxist assumption therefore is unrealistic. For entire national economies, an eventual stationary equilibrium is an untenable abstraction, which has done much harm. I shall return to this point.

- Textbooks and models also tend to assume transaction costs to be zero. In reality, over half of all the costs of producing and distributing the national product in a complex modern economy with an ever-more refined division of labour consist precisely of such costs (Oi, 1990).[1] Much entrepreneurial effort is invested into reducing the costs of transacting business, and the legal and financial professions, too, are working towards this end.[2] Indeed, much of the rapidly growing service sector is occupied with the need to invent, modify, monitor and enforce laws and rules that help us to contain transaction costs. Lawyers therefore embrace

[1] In addition to the fixed and variable costs of transacting business (Kasper and Streit, 1998, pp 125–168), there are of course transport costs for production factors and products. The standard textbook assumption that all production and consumption takes place in one spot has at least been abandoned explicitly by spatial and transport economics.

[2] Money is a device to save transaction costs (Menger, 1981). If everyone had 'perfect knowledge', we could – strictly speaking – confine ourselves to barter and would not even have to bother with a means of payment and store of value. The theory of money has been one of the main roots of modern institutional economics.

the institutional economics of Friedrich August Hayek. He speaks explicitly about the "role of the lawyer in political evolution" (for example, Hayek, 1973, pp 65–67). Indeed, his entire trilogy on *Law, Legislation and Liberty* is about the important contribution of the legal profession to economic cooperation.

- Every so often, economists exclude unforeseen side effects by making the *ceteris paribus* assumption. They have us believe that one can intervene in the complex, interactive web of economic life without unintended consequences. But economic life never stands still and things never remain the same. The evolutionary Austrian paradigm "is quite a different way of perceiving and analysing economic phenomena, emanating from the science of life rather than the science of inert matter" (Hodgson *et al*, 1994, vol 1, p 223). The public has learnt from biology and other life sciences that one has to be extremely cautious when tangling with Nature, which is a complex, evolving web. Unforeseen side effects often punish interventionism. Is it then not bizarre and incongruous that many natural scientists and Greens accept the policy suggestions of neoclassical economists, who are given to advocating interventions in the equally complex web of economic life of a nation? The assumption of *ceteris paribus* cannot serve as a legitimate substitute for our lack of knowledge. We must acknowledge that economists can only pretend to have much relevant knowledge, as Friedrich Hayek spelled out so convincingly in his Nobel Prize lecture (Hayek, 1978b). Of course, there are general-equilibrium models that show second- and third-round effects, but they often do not allow for plausible parameter shifts.

- The *ceteris paribus* assumption of neoclassical theory induces the economics profession to think short term. If you have a short time horizon, you are more easily instrumentalist, that is, given to interventions, which are the business of political and bureaucratic elites. Combined with the 'know-all assumption' discussed earlier, short-termism is likely to make neoclassical economists and their followers feel select and self-righteous – 'economist kings' who are entitled to claim the moral high ground and leadership (Sowell, 2009). Austrian economics, with its focus on dollar-democratic markets, offers no such moral satisfaction. As short-termism is an inherent feature of electoral politics and bureaucratic action, *ceteris paribus* models of course meet with high demand. Recently, we have again seen how avidly politicians and bureaucrats welcomed the idea of anti-cyclical Keynesian demand management. In the 2007–08 downturn, Keynesian 'stimulus' offered them an easy escape from the need for a 'cleansing crisis' and the arduous task of reforming intractable structural inconsistencies on the supply side. How often have we heard Keynes' silly quip: "In the long run, we are all dead"? It was rightly rejected even by his great admirer and acolyte Joan Robinson, who observed: "… oh sure! But not all of us at the same time!".

- Dozens of introductory economic textbooks convey the impression that the political and administrative elites are tireless, selfless agents who do the people's will, serving the general good of society, the much-cited 'national interest'. In other words, neoclassical authors assume there are no principal–agent problems and no cases of agent opportunism. This is patently untrue. Public choice theory, inspired by neo-Austrian economics, has shown that political and bureaucratic decision makers are not white knights in shining armour. They are self-seeking knaves like most of us. This sceptical, but realistic, view of political and bureaucratic behaviour is still often dismissed as cynical and misanthropic, and it cannot be fitted easily into the neoclassical paradigm. It is certainly not taught in high schools and academies. Nonetheless, an understanding that our elected and appointed agents are self-seeking has gained wide popular acceptance in the mature democracies. More and more people therefore reject the neoclassical assumption of an all-knowing, well-intentioned government.

Anyone with real-life experience will think these assumptions, which underpin neoclassical orthodoxy, are absurd. Yet, neoclassical economists tend to work with them, if not always explicitly. At best, the assumptions are hastily mentioned up-front at the beginning of Economics 101, but are rarely dropped later. Much econometric modelling is based on the same assumption-constrained orthodox paradigm, because models have to be closed so they can be solved mathematically. Econometrics could serve much more useful purposes if so much of the practice of modelling was not centred on method and based on misleading neoclassical assumptions. Alas, the world is open-ended. Nothing is preordained. All evolves.

Of course, any analyst of complex reality has to work with abstractions and simplifying assumptions. Theories always resemble maps that depict only certain salient features of the landscape and eliminate others. The important point, however, is that we must not assume away what Friedrich Hayek called the 'constitutional conditions', that is, those aspects that constitute the essence of what we wish to understand. Hayek once made this point graphically with reference to ballistics: when predicting the trajectory of a projectile, it may well make sense to abstract from air humidity and temperature. But it makes absolutely no sense to assume gravity away 'for simplicity's sake'! Gravity is a constitutional condition of what is to be investigated. Who would argue for studying bridge construction on the assumption of zero gravity 'for simplicity's sake'? Likewise, I want to argue with Hayek (1945; 1976; 1978b) that limited, widely dispersed and changeable knowledge is *the* constitutional element in all economic endeavours; our knowledge is never perfect. This is a fundamental aspect that must never be assumed away.

Neoclassical economists who make that assumption do not simplify; they just build essentially unrealistic mental constructs.

Methodenstreit: Οικοξ versus καταλλατειν

In making these points, I have already dragged you deep into a controversy that first became known in Continental Europe some 130 years ago as *Methodenstreit*. Loosely translated from German that means "dispute over the correct method of analysing economic phenomena". The dispute began in 1871 when Carl Menger (1840–1921), a professor of economics at Vienna University in Austria, published his path-breaking book *Grundsätze der Volkswirtschaftslehre* (English: *Principles of Economics*, 1981). Menger saw economics as a science of dynamic process and human action, not of passive adjustment to fairly constant parameters and equilibrium. He focused on the creative, rivalling entrepreneur, who acts subjectively, may get it wrong and will correct his actions in the light of experience (Huerta de Soto, 1998; Bostaph, 1994). What matters here is not only objective (explicit scientific and engineering) knowledge, but also the diverse tacit, subjective knowledge, which differs from place to place and period to period and is often decisive to commercial advantage. Menger accepted mathematical formalism as appropriate to describe equilibria, but rejected it as too narrow a form of expression to deal with normally prevalent economic phenomena, such as the continual evolution of the division of labour. His book was an attack on the nascent mathematical method of Léon Walras (1824–1910) and Vilfredo Pareto (1848–1913), who built mathematical models on the assumption of constant information about ends and means. For Menger, Pareto-optimality was a nirvana that could never be realised.

Economists of the 'Austrian School' have never ceased to dispute that theirs is the proper method of economic study.[3] For a long time, they remained a minority with little influence on policy, as they were overwhelmed by the ascendancy of the neoclassical mainstream. The only major exception was post-war West Germany, where the 'Freiburg School', which shared most key assumptions with the Austrians, shaped economic policy. The result was impressive and sustained economic growth (Kasper and Streit, 1993), which

[3] There has been a succession of polemics about the essence of economics: Menger against the model builders such as Walras and Pareto and against the German Historical School (on deductive versus inductive reasoning), Böhm-Bawerk against John Bates Clark (on the nature of capital), von Mises and Hayek against Keynes and the neoclassical school (on the impossibility of socialism and misconception of macroeconomics) and the neo-Austrians against the mainstream, including the Chicago School (see Huerta de Soto, 1998, pp 88–98). Readers who want to familiarise themselves with the Austrian approach might begin with Dolan (1976), O'Driscoll (1977), O'Driscoll and Rizzo (1985) and Kasper and Streit (1998), before delving into the original writings of Ludwig von Mises, Friedrich Hayek and Israel Kirzner, who may be considered the founding fathers of modern Austrian economics. They will also find that two Elgar Companion essay collections (Boettke, 1994 and Hodgson *et al*, 1994) contain useful and comprehensive material. See also Boettke, 2006, *The Battle of Ideas: Economics and the Struggle for a Better World*, The Sir Ronald Trotter Lecture 2006, New Zealand Business Roundtable, Wellington.

the fraternity of neoclassically minded Anglo-Saxon writers considered 'a miracle', a phenomenon that cannot and need not be explained.[4]

Matters began to change in the 1970s and early 1980s when the 'Austrian way of thinking' was revived by several seminal publications and translations into English of 'classical' Austrian works, which had previously been available only in the German original. British academic Geoffrey Hodgson was right when he remarked that "… evolutionary ideas in economics have enjoyed a remarkable revival in the 1980s" (Hodgson *et al*, 1994, vol 1, p 218). By then, Austrian 'guiding ideas' had become increasingly influential in policy making in many parts of the world.

The most durable bone of contention in the Methodenstreit is the definition of the discipline. Every introductory economics textbook and first lecture in Economics 101 begins with a definition of economics. Twenty-eight out of 30 bestselling textbooks that I surveyed a few years back spoke of economics as the discipline that deals with scarcity, that is, an innate and near-universal tendency for given human wants to exceed available resources to satisfy them. The inspiration for the perception of economics is the rather stationary agricultural world of the eighteenth and early nineteenth centuries. In the twenty-first century, economic life is fundamentally different. It is about a huge diversity of frequently tailor-made services and rapidly changing product qualities. Can someone nominate an introductory economics textbook that introduces production and cost theory with examples from today's information technology industry or a just-in-time car-assembly plant whose logistics covers tens of thousands of components? Today's economic reality can only be understood through a theory that focuses on knowledge and the coordination of independent, specialised actors who change ceaselessly and with agility.

Neoclassical textbooks normally go on to the linguistic origin of the term 'economics' in *oikos* (*οικος* – the household), evoking the picture of a patriarch who surveys the harvest and available resources for the winter and then rations what can be consumed by whom, when and how. In other words, economics is a problem of known resources, known wants and benevolent decision making in a static and completely known context. This sort of economics is about rationing scarcity – a dismal pursuit!

[4] The 'German economic miracle' carried within itself the germs of its own destruction, because the free-market design was coupled with a commitment to political redistribution ('social market economy'). In opportunistic and populist political 'auctions' for the vote, successive parliaments have eroded private property rights by more and more dirigiste regulations, thereby destroying the originally highly productive market order. It may be noted in passing that Germany's mixed member proportional-style electoral system contributed over time to foster this sort of political populism and opportunism.

Only a minority of textbooks and teachers seem inspired by modern commerce and finance and by the customs and laws that facilitate specialisation and innovation. They describe the tendency of people to invariably discover more wants than they are able to mobilise resources to produce, in other words they present scarcity in a dynamic context of discovery of diverse and changing knowledge (epistemology). People are seen as active, enterprising doers, who sometimes know enough to maximise their utility, sometimes are satisfied with less, sometimes take risks to achieve what may look impossible – it is a much more cheerful pursuit! These economists tend to speak of 'catallaxy' (καταλλατειν). The word is derived from the Greek verb 'katallatein', which means "to exchange knowledge and assets and thereby turn potentially inimical strangers into friends". This evokes the image of the Greek or Phoenician merchant who arrives in a foreign port, mixes with the locals to seek new opportunities to truck and barter and, in the process, discovers what people find useful. This dynamic-commercial view of economic life focuses on active knowledge search, entrepreneurial risk taking and testing ideas in markets to discover – partly by skill, partly by chance – what individuals want. The approach also focuses on the rules of the game, which govern such discovery procedures. This school of thought deals with the interaction of individual competitors, in contrast to the central, fully informed decision maker at the start of a possibly harsh winter. It perceives the human species as curious and enterprising. In such a world of competition and discovery, there is a demand for conflict resolution by lawyers and technical solutions by engineers.

The concept of catallactics and economics as the science of exchange and knowledge search was first described in 1831 by Richard Whateley in his *Introductory Lectures on Political Economy*. The concept was later popularised by Ludwig von Mises, Friedrich Hayek and Lionel Robbins as the spontaneous market order, in which human purposes are *discovered*, as distinct from an economy, which organises available resources to serve *prescribed* objectives (von Mises, 1966; Hayek, 1945; 1967; 1978b; Robbins, 1976). In this sense, economics is about the ceaseless endeavour to improve the human condition. This brand of economics helps us to understand economic growth and development.

Attractions of neoclassical economics

In view of the implausible assumptions of the neoclassical paradigm, one has to ask: Why do so many professional economists and econometric model builders persist with the neoclassical paradigm? The reasons are transparent and obvious, though not necessarily respectable.

- The 'simplifying' assumptions make it easy to build models. They permit modellers to reduce the number of necessary variables and data to the number of equations needed to solve their models and produce aesthetically pleasing results. Such models create the impression that new knowledge or at least

insights are generated that no one could comprehend otherwise. How much more satisfying is it to derive answers from an elegant model based on perfect knowledge than to operate with the confusing, diverse evolutionary reality?

- By using mathematical tools and drawing on easily available statistical estimates, one can churn out publications and earn academic degrees that advance one's career. Should the data be insufficient, one can always conjure up a proxy, insert a 'dummy variable' or rely on other tricks of the econometric trade. I know from personal experience how reluctant one is to jettison one's hard-won econometric knowhow – part of one's human capital – when one discovers that mathematics is a poor, artificial idiom that cannot capture the full, rich flavour of institutional and evolutionary social science. It is a bitter pill to swallow, if you wish to make a career in which the professional establishment and academic appointment committees rate you by publications in neoclassically dominated journals. In my case, it was my experience as a policy advisor to governments and industry that made me shred my lecture notes and start afresh with the more realistic and broader theory that I have labelled here 'Austrian' and others call 'institutional' or 'evolutionary economics'.

- Generations of neoclassically blinkered lightweights have now been trained in the orthodox tradition. They occupy university chairs, editorial committees of professional journals, government offices, research outfits and the media. In other words, they have gained sufficient weight to mutually reinforce each other and promote a certain consensus about how the economy works and people ought to behave. To be part of the neoclassical tribe is comfortable and good for one's career. And for the political elites and commentariat, who lack a deeper understanding of economics, it is also safe to accept the conventional consensus.

- As a battle-hardened academic teacher and long-term head of a university department, I also know that neoclassical abstractions make it easy to teach economics. One can effortlessly fill hours of lecture time with the Marshallian '*ceteris paribus* cross' of supply and demand. If one were to acknowledge that buyers and sellers have to incur transaction costs, then the (ex ante) price for the seller differs from that of the buyer, and the neat Marshallian market model would be hard to discuss in class. Or using the IS-LM construct of Keynesian macromechanics,[5] one can discuss manifold situations and policy interventions and inspire confidence in students that they are learning something satisfying

[5] To simplify Keynes' neoclassical macroeconomics, it became customary to depict the compatibility between people's plans to accumulate monetary assets (savings) with other people's plans to borrow for investment (depending on the interest rate) by an upward-sloping 'IS-curve', and to depict the compatibility of supply and demand for cash (depending on the interest rate) by a downward-sloping 'LM curve'. The two curves are then said to determine a 'monetary equilibrium', a (real) income compatible with a certain interest rate. This clarification is not meant to be an endorsement of this type of macromechanical modelling!

and real. Disclosure of the many tacit and explicit assumptions that underpin the IS-LM model would only confuse them and deprive cognoscenti of clear-cut prescriptions for macroeconomic intervention. Neoclassical theory is thus not only easily taught, but also easily learnt by young students, who lack the life experience to do reality checks on what is said in the lecture theatre.

- A closed, comparative-static model can easily produce impressive, seemingly 'scientific', 'objective' results to impress laypeople and offer make-believe certainty to politicians. Economic advisors and economic research institutes are able to create the impression that their conclusions are empirically tested in ways similar to the laboratory sciences (scientism). Politicians, who have to make complex, risky decisions, develop a natural appetite for the certainties that models provide. Neoclassical models therefore meet a ready demand, and model building remains profitable and influential.

- In countries like New Zealand and Australia, most secondary and tertiary education in economics happens in government schools and institutions, and most economic research is produced for government agencies. Consequently, there is limited demand for the critical scrutiny of implicit philosophical values, let alone the role of the state. Confident constructivism (social engineering) of the neoclassical blend is 'cool': it gives eager political elites influence, importance and income. Who in the state-owned media will run a critical case against government programmes on the grounds they detract from individual freedom? Why promote Hayekian analysts and public-choice sceptics, who might only attack politicians and bureaucrats for their opportunism? Career politicians and bureaucrats act rationally when they favour consultants and academic teachers who furnish reasons for intervention. Intervention is after all their business. And, besides, should certain policy interventions produce a problem, it can always be addressed later by a new intervention. That is again good for the business of the ruling elites (Sowell, 2009).

- One odd psychological obstacle in the way of a wider acceptance of Austrian economics has been puzzling me for years. As noted, neoclassical economics embodies the pervasive 'gene of diminishing returns', which appeals to a preference for pessimism and hubris. The past may have brought unimagined material progress, but most are nevertheless pessimistic about the future (Ridley, 2010, pp 280–347). This cannot alone be the result of a Machiavellian intent to control the masses by inspiring fear or to facilitate blatant rent-seeking (Kasper, in press, 2010). A deeply ingrained instinct for precaution makes us predict accidents, so that we avoid them. In addition, there may be guilt feelings about past triumphs of progress and a wish not to tempt fate with optimism. Above all, there is a deeply ingrained and understandable human resentment against

change. Prospective changes, including material progress, challenge our cognitive limitations. Future changes are therefore perceived as uncomfortable. It is therefore comforting – I believe – to assume that the breathless change of the modern world will not go on. Perceptions are different in poorer and especially the emerging economies. I cannot prove it, but on my numerous travels and work experiences around the world I have found the pragmatic East Asians much less guilt-prone and futurophobic than the affluent Westerners or the adherents of conservative Islam. Maybe that is why evolutionary Austrian economics is more readily accepted by the elites of ascendant East Asia than by affluent Westerners.

All this explains why the neoclassical orthodoxy and economic modelling have been triumphant for so long. However, turning away from reality and clinging to outdated modes of thinking has already been lambasted by Adam Smith, who noted scathingly that certain universities have "chosen to remain … the sanctuaries in which … obsolete prejudices found shelter and protection, after they had been hunted out of every other corner of the world" (Smith, 1976, vol II, page 294). I second that!

Some creative destruction of neoclassical simplifications

The consequences of relying on facile neoclassical theory for dealing with real-world issues have gradually become clear.

- Economists are speaking increasingly in abstract models based on assumptions that other social-science disciplines and practitioners do not share. As a result, the economics profession increasingly speaks only to itself. Little wonder that lawyers, engineers and business people have lost interest in neoclassical mainstream economics and have deleted introductions to economics from their degree requirements. But let us also remember in this context that major blunders in management and policy are normally committed not because experts overlook something in their field of expertise, but because they have ignored something fundamental in an inter-related field.

- Admittedly, neoclassical simplification has given economics a kind of Cartesian clarity. But simple Cartesian logic is ill-suited to the messy, evolving and complex phenomenon of economic life. It seems odd that the philosophical discourse in the Anglo-Saxon countries has, by and large, decided against Descartes' world view, though oddly enough not in economics.

- The great economic reforms of the 1980s and 1990s in Thatcher's Britain, Reagan's America, Douglas' and Richardson's New Zealand – as well as in what used to be called the 'third world' and in the former communist 'second world' – were concerned with reforming the economic institutions. These reforms owed little to neoclassical orthodoxy and econometric modelling,

but almost everything to Austrian economists like Friedrich Hayek and Peter Bauer, and their public-choice colleagues in the Mont Pèlerin Society – an international academy dedicated to the promotion of freedom in economic life and beyond. Their influence may not (yet) have pervaded most academic departments and journals, but they have a firm place in influential think tanks and political kitchen cabinets. They are even beginning to be noted in the mega-bureaucracies of international organisations. If neoclassical economists persist with their assumptions, they will be increasingly bypassed in the market for ideas.

- The ease of teaching and learning prevents economics students from encountering and analysing an infinitely more complex, dynamic and challenging reality. Students miss out on acquainting themselves with highly relevant knowledge about sociology, history, psychology, jurisprudence and entrepreneurship, amongst others. Most students, who have not yet gained much real-life experience, remain unaware that they frequently only acquire pseudo-knowledge. That will be sufficient for their exams or a PhD, but will not be terribly useful thereafter. Most young economists fail to recognise that neoclassical theorising deprives them of exciting insights, which matter for the political economy of the real world. Later, when they confront their university knowledge with reality, at least some will discover that they were short-changed. They will not thank their academic teachers for having inculcated habits of neoclassical analysis, which they have to un-learn later. It seems already clear that many first-year students are turned off by sterile, abstract model building and a lack of moral content, so they move sideways to more satisfying academic subjects. In my opinion, undergraduate students of political economy become excited when they are challenged to think about normative issues such as freedom versus security, efficiency versus justice, or growth versus the preservation of a liveable environment. But how many present-day faculties stray into such philosophical terrain?

- The simplifying neoclassical assumptions have the consequence that the 30 most widely sold English-language introductions to economics are almost mute on core topics such as 'economic freedom', 'property rights', 'entrepreneurship', 'innovation', 'profit' and 'corruption'. If you look up 'competition' in the index, you are likely to be referred only to mechanistic descriptions of atomistic or oligopolistic markets. These have little to do with the reality of dynamic global rivalry for world market share in a rapidly changing world. They tell you nothing about product innovation, advertising and after-sale services, only about price changes as the one instrument of marketing.

- It is only natural that quantitatively inclined neoclassical economists include what is quantifiable and exclude what is not. Advances in data processing and

the increased availability of statistical data have of course facilitated the use of quantified models. To be sure, there is a use for neoclassical econometric models. But beware, these models are frequently no more than sophisticated rulers used to extrapolate the past, whereas real-world conditions may shift unexpectedly; in other words, no 'black swans' and other unexpected circumstances appear.[6]

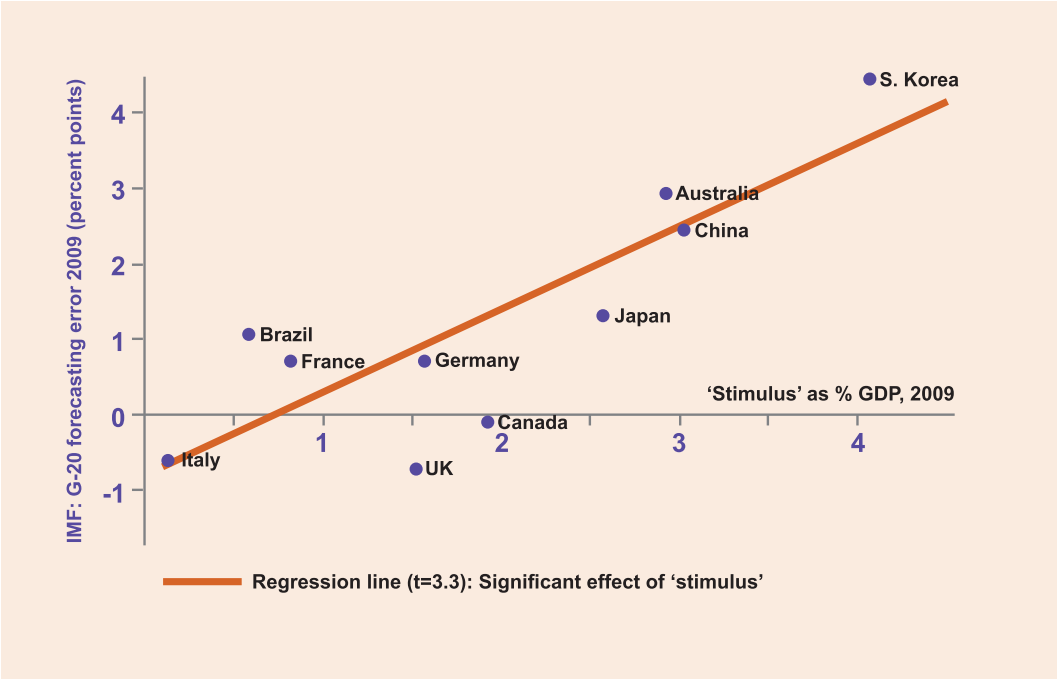
- Anyone who has practised the econometric art on the basis of neoclassical assumptions will know that statistical data series are less than perfect or complete. People in the trade are not always willing or able to follow Mark Twain's advice: "*First* gather the facts; *then* you can distort them at your leisure!". All too often, the econometric analyst copies dodgy statistical estimates uncritically and brushes aside footnotes full of caveats to get to the exciting part of the exercise: deriving correlation coefficients and the many wonderful statistical tests the trade has developed. If the coefficients are not 'satisfactory', one can always include a further variable, even a dummy variable, or try another trick to come to a desired outcome. Econometricians often rely on far-fetched substitutes for information that is unobtainable. Also, short series of observations are used in models, which might easily tell a different story if a few more observations were added. Worse still, data may be hand-picked to 'prove' a predetermined point. Think 'Climategate'. If the facts do not fit the theory, too bad for the facts! The consequences of cavalier empirical practices in shaping the inputs into complex, possibly unstable models are normally impossible to assess. The output is science fiction.

  A telling example of such fraudulent use of econometrics came to light in Australia in July 2010. The 2010–11 Commonwealth government's Budget Papers (No 1, Statement 2) showed a graph to underpin the politically important point that fiscal 'stimulus' had worked in Australia and other countries (Figure 1). The graph showed how the size of 'stimulus spending' in 2009 compared with improving macroeconomic output over original International Monetary Fund (IMF) forecasts. Alas, the Australian Treasury cherry-picked the data that suited a political hypothesis and omitted data that did not. A professor of institutional economics at RMIT University in Melbourne, Sinclair Davidson, included all 19 countries in the IMF's data on the Group of Twenty (G-20) and discovered there is no significant correlation.[7] The conclusion from the 2009 experience of all major countries is evident: Keynesian discretionary spending had no systematic effect (Figure 2). It is a sad reflection on the respect for economic analysis and truth that this attempt to

[6] Europeans used to be certain of an empirically proven correlation between swans and the colour of their feathers. A 100 percent correlation 'proved' all swans are white. And then someone imported an Australian swan. *Ooops*!

[7] Because the G-20 contains one non-country, the European Union, the complete IMF data set reports on the experience of 19 countries.

Figure 1: Stimulus and gross domestic product (GDP) expansion



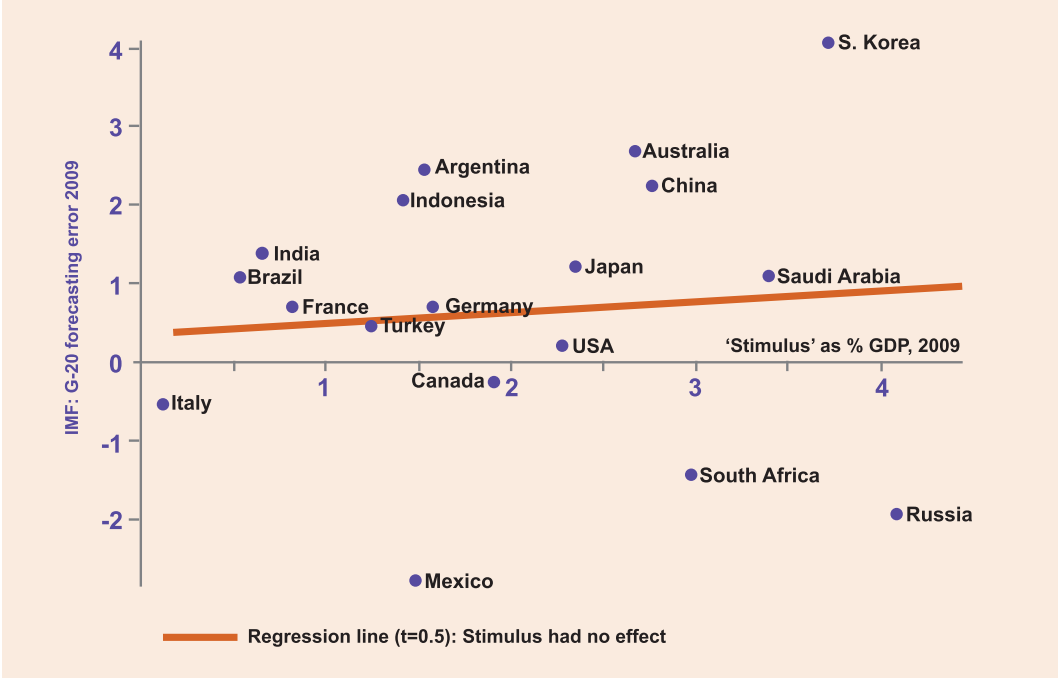
Source: Australian Treasury.

mislead the parliament ('Stimulusgate') raised hardly a ripple of public indignation (Davidson, 2010; Institute of Public Affairs, 2010).

- The providers of sophisticated computer models pretend to use objective methods to 'prove' certain points. In practice, econometricians often use subjective judgments to 'tweak' or doctor the parameters to ensure their results look reasonably plausible and do not deviate by too much from what others are saying. Moreover, complex models combine interdependencies, evolutionary feedbacks and time lags that interact in ways no human mind could ever understand and assess. Canadian economist Herbert Grubel was right when he drew on this insight to criticise complex climate models that predict global warming and global economic collapse (Grubel, 2010). I, too, wonder about the effects of 'black swans' – volcanic eruptions, unpredictable fluctuations in cosmic radiation and other random events of consequence – in view of the fact that the United Nations Intergovernmental Panel on Climate Change's 'consensus' model predicts global temperatures one hundred years from now. Modelling can easily become an excuse for not observing reality and from the arduous task of collecting genuine observations.

- Correlations are often presented as if they meant causation (as the Australian Treasury did in Figure 1). They can be awfully wrong and may misguide policy for years. Let me illustrate this point with reference to the 'Phillips Curve'. New Zealand-born economist Bill Phillips established a stable relationship between money wages

Figure 2: The proof: Keynesian economics did not work



Sources: IMF (complete data set); Davidson 2010.

and employment (Phillips, 1958). In the hands of neoclassical economists and policy advisors, the Phillips Curve soon morphed into an inverse, econometrically tested relationship between unemployment and inflation. Politicians were told they could choose between certain combinations of these two policy objectives. A bit more inflation would lower the unemployment rate. The theory was not underpinned by any understanding of individual human behaviour, labour-market monopolies, expectations and the like. It was pure macromechanics. When the Phillips Curve was relied on for policy making in the early 1970s, we promptly had to learn that the construct was not load-bearing. The curve shifted sideways or upwards. In other words, we got stagflation, that is, accelerating inflation and rising unemployment. The purveyors of macromechanics mumbled about supply-side shocks and the oil crisis, and then dropped the concept. To economists of an Austrian inclination, it had been clear all along that 'a little inflationary stimulus' could produce rapidly rising inflationary expectations, because labour-market monopolies and union-friendly governments were pushing up real wages. The result was profit compression, recession and job destruction. The Phillips Curve is just one example where a tested, neoclassical theory turned out to be costly, misleading humbug.

- It is frequently the unseen that matters, or hard-to-assess quality differences that determine what happens. An example is the Programme for International Student Assessment (PISA) studies of the Organisation for Economic Co-

operation and Development on school performance, which are based on numeracy and literacy statistics and have had a great influence on education policies in recent years. These studies, however, do not speak to moral values and education in independent, creative thinking that are taught or not taught.

- The model approach, which collapses history into a few parameters, easily lulls observers into uncritical confidence. They look only at what is repetitive, measurable and already included in their models. Alas, social relations are occasionally disturbed randomly and unpredictably, in other words: black swans appear. This cannot be covered in models. I recall a discussion I had after the Asian financial crisis with one of the foremost econometricians specialising in East Asian financial systems. I had seen unit labour costs rise and a lot of bad debts pile up, which had me worried long before the crisis. My econometrician friend had not predicted anything untoward. When I challenged him as to why, he replied: "My models were not specified for such developments". What is the use of such models?

- Correlation coefficients of 0.55 or less are often presented as 'proof' of something or other. Neither policy makers nor the media bother to look critically at the finer points of modelling, because they lack the expertise. They are therefore normally happy to swallow the results produced by the 'experts'. Problems only arise when two competing models contradict each other. A few years ago, a despairing Australian parliamentarian asked me what to do about two industry models. One proved the car tariff should be upheld, the other that it should be abolished. He was greatly relieved when I told him the models were only cunning sausage machines that converted clever assumptions into predetermined results. Rather, he should rely on common sense and opt for free trade.

- Narrow neoclassical assumptions have induced the economics profession to present the complex national economy as if it were an organisation that can be directed by top-down command and control. For every emerging problem there is a solution in the toolkit. But a political community is not an organisation. The citizens are the principals and free to pursue their own diverse purposes. When thinking in terms of neoclassical models, economists are encouraged to advocate proliferating, detailed policy interventions, which interact in unforeseen, deleterious ways making markets dysfunctional. A dense web of regulation is now strangling innovative enterprise in all mature, democratic polities. Manifold, contradictory prescriptions and prohibitions are stifling possible uses and combinations of private property rights, and hence economic growth. This is why observers demand reforms and political entrepreneurs promise them. But, in reality, rule systems are rarely overhauled comprehensively, let alone pulped altogether. One reason is political and

bureaucratic self-interest, another that mainstream economists have failed to make a convincing, comprehensive and irrefutable case for deregulation.

- While the neoclassical approach satisfies political demands, we must be clear about the wider context: we observe a ruthless worldwide tug of war between individual freedom and the 'primacy of politics'. The primacy of politics – first postulated by the Jacobins in the French Revolution and enforced ruthlessly by socialists from Lenin to Hitler – is nowadays postulated regularly by democratic leaders who display little regard for individual freedom. All too often neoclassical model builders eagerly serve as the handmaidens of these anti-freedom forces – whether they realise it or not.

- I leave my major gripe to last: I noted before that neoclassical (and Marxist) economics suffer from the pervasive birth defect of the 'law of diminishing returns'. In a mostly agricultural age, it may have seemed plausible to transfer the microeconomic observation of diminishing returns to the macroeconomy level. This may still have seemed plausible to Karl Marx. However, the experience of dynamic industrialisation notwithstanding, twentieth-century neoclassical economists have also worked with this assumption (Solow, 1988). While individual production processes and industries may be subject to falling marginal productivity, other processes embody new knowledge and innovations that raise the (marginal) productivity of capital and other inputs (Schumpeter, 1961; 1947; Hayek, 1945; 1978a: Gilder, 1981). As noted, modern civilisation catches a growth wave, rides it till it peters out and then, sooner or later, finds another (see Box 1).

It is simply a gross fallacy of aggregation to derive a national production function from individual production functions. The knowledge economy powers ahead inexorably. This may appear counter-intuitive to natural scientists and ecologists, who are thinking in terms of exhaustible physical inputs. But Austrian economics is based on the insight that the production factor knowledge is unlimited (Ridley, 2010). Much economic growth is not the result of exhausting natural resources, but rather of revaluing molecules. The conversion of a grain of sand through knowledge and energy into a computer chip constitutes a huge contribution to economic growth, but only the tiniest of reductions in the available sand and energy. When we measure national product, we think in dollar-valued quantities, not in tons of physical matter. The growth process can only be stopped by the proliferation of collective interventions or a breakdown of law and order. Both are common occurrences in human history. Indeed, sustained economic growth has been the exception and stagnation the norm since homo sapiens emerged.

Austrian criticisms of the neoclassical orthodoxy and querying of the underlying, implicit assumptions are all too often angrily rejected. Some economists may well admit in private that their models prove nothing, but they will then hasten to add that

Box 1: From growth wave to growth waves: A quick look at Kondratieff cycles

After the first industrial revolution – based on steam engines (solar energy stored in fossil fuels) and textile weaving – had lost momentum, spreading rail and shipping networks heralded a new wave of prosperity and progress by the mid-nineteenth century. When these technologies reached saturation points, they were complemented and partly replaced by motor transport. Electrical and chemical industries became the growth leaders that produced the boisterous Edwardian era. After the second world war, doomsayers predicted secular stagnation. Instead, motorcars, air transport, plastics and global free trade re-energised most economies. After the first oil shock and the global economic slowdown of the 1970s, electronics, containerisation and the liberalisation of capital markets propelled another fabulous growth wave. Who knows what will power the next growth wave. Biotechnology? Genomics? Nanotech? New energy sources? In each growth wave (or 'Kondratieff cycle', as Joseph Schumpeter called it), modern production also spread to new industrial locations: first Germany and North America, then Russia, in the post-war period the East Asian Tigers, and in the information technology growth wave after the 1970s, first and foremost China and then Taiwan.

they are useful devices to impress policy makers and to steer them towards certain preferred conclusions. I abhor such manipulative opportunism. My message is that we must liberate ourselves from being intimidated by models and spin doctoring that we cannot comprehend.

Reliance on neoclassical assumptions has high opportunity costs. People overlook the central importance of institutions, that is, the rules of coordinating the millions of participants in economic life, and they are led to be unnecessarily pessimistic about the future. Neo-Austrians keep making this point, but are often dismissed as unhelpful. However, commerce and industry require a steady, confidence-inspiring framework of abstract, easy-to-understand universal rules, not a clever new policy every election campaign. This fundamental point was long overlooked, until the Keynesian model and rampant microeconomic interventionism were discredited after the 1970s. Then, talk about economic order was taken seriously and reformers out of the Austrian corner gained influence in policy circles in London, Washington, Canberra and Wellington. What made Austrian economics palatable to policy makers after the sluggish 1970s was, above all, that it inspired hope and optimism. We got an enterprise-friendly overhaul of institutions and a more hopeful outlook on the future. Yet, a more comprehensive overhaul of the mainstream way of economic theorising still seems to be missing, at least in the Anglo-Saxon countries. Leading observers in many developing countries and indeed the formerly communist nations appear to have embraced the worldview of von Mises, Hayek and Schumpeter much more comprehensively.

Box 2: On catching up with the Western Isle in 16 short years

Many in New Zealand seem prepared to *seriously* pursue higher long-term productivity growth. To the extent that New Zealanders wish to catch up with faster-growing Australian living standards (The 2025 Taskforce, 2009), the Austrian approach commends itself. The previous Labour government superficially embraced a 'knowledge and innovation strategy', but it was hard to detect much of a trace of 'Austrian-economics DNA' in its make-up. The National government's economic policy position – that is, *not* the declarations, but the actions to date, at least as seen by an observer from Australia – also seems to lack sufficient Austrian genes. The government seems to have resisted even the modest gene modifications suggested by the '2025 Taskforce' (The 2025 Taskforce, 2009). I hope I am wrong.

To outside political economists with an Austrian pedigree, centrally fixed growth targets smack of mechanistic social engineering. Moreover, it seems odd and derivative (even insecure?) for a national government to define a national growth target not in absolute terms or with reference to past performance, but in relation to the economic performance of another country. Equality in real per-capita income with Australians depends as much on Australian institutions and efforts as on those of New Zealanders.

To make the point, let me offer a few back-of-my-envelope guesstimates. If Australian living standards were to grow by a plausible 2.5 percent per annum on average to 2025, New Zealand's productivity growth would have to average 4.5 percent every year for 16 years. An Australian growth rate of only 2 percent per annum would still require New Zealanders to power ahead at 4 percent per annum. And, since 3 percent average growth in Australia is not an impossibility, New Zealand's economy might have to average nearly 5 percent over 16 years, year after year through booms and busts. I know of no *affluent* welfare state where such high productivity growth rates have been maintained for such a long period.[8] Catch-up growth in poor, new industrial countries without socialised welfare is of course another matter.

The 2025 New Zealand Taskforce[9] might investigate whether the goal of income equality with Australia can be best achieved by Australian governments imposing masochistic growth obstacles, for example, a combination of high, new mining and business taxes, an emissions trading scheme (ETS), opening the borders to masses of unskilled welfare seekers from dysfunctional, strife-torn societies and a succession of debt-boosting 'stimulus packages'. It is conceivable – but of course highly improbable – that such a policy mix

[8] West German post-war growth from 1950 to 1966 ran at 4.5 percent per annum, but that was from a base distorted by massive wartime destruction and made possible by a high skills base, high marginal productivity of capital invested in repairing bomb-damaged infrastructures and industrial plants, and foreign aid under the Marshall Plan (Kasper and Streit, 1993).

[9] See www.2025taskforce.govt.nz for further information.

could shrink Australian per-capita incomes sufficiently for realising income parity in 2025 with a stagnating New Zealand economy.

The biggest obstacle to the fine goal of faster productivity growth is – in my opinion – that Kiwi minds have been thoroughly poisoned by the explicit or implicit assumption of diminishing returns, resulting in a timidity and pessimism that appear irrational (Ridley, 2010). This is why the discussion in this paper is not merely of academic relevance, and fighting the good fight for a realistic understanding of the economic basics is worth pursuing. Political leaders, the media and public will need to embrace a change in the shared economic paradigm, abandoning the eighteenth-century mentality of diminishing returns and embracing a proper understanding of the modern knowledge economy. What is required can be illustrated by present-day China, where nineteenth-century Marxism has been jettisoned in favour of a widely shared Schumpeterian 'can-do' paradigm. Should New Zealanders widely embrace a similar change in popular understanding of growth conditions, this would demonstrate to me that the New Zealand growth push is for real. After all, economic growth starts in the mind.

The growing stature of institutional economics has, in recent years, induced orthodox economists to partially vary their assumptions, or to attach Austrian insights to their models. This is easy because both the Austrian-institutional and neoclassical paradigms are individualistic in outlook and share numerous arguments against socialist collectivism. However, the individualist-collectivist dichotomy was the topic of last century. The task of the twenty-first century is to understand the diverse, dynamic life of service economies that interact on a global scale. It is about entrepreneurship and ceaseless innovation, phenomena for which neoclassical analysts are not properly equipped. Theories which one might call 'Austrian-hybridised orthodoxy' are halfway houses full of internal contradictions.[10] Different parts of the theory are developed from different and contradictory premises, whereas Austrian economics is developed from cohesive and plausible basic assumptions about human nature. Policy makers and the public are easily confused by internal contradictions. The understandable reluctance of neoclassically born-and-bred economists to rebuild their theories from realistic assumptions explains why the case for thorough policy reforms has rarely been made and why decision makers and their advisors flip-flop between reforms and reactionary relapses. New Zealand's labour-market reforms illustrate the case. One will only become confident of a steady and coherent policy design when the Austrian versus neoclassical debate in economics has been focused on the very roots, that is, the fundamental assumptions about human nature and social interaction.

[10] Examples of hybrid schools of thought are versions of the 'Chicago School', Posnerian law and economics, or textbooks such as that of EG Furubotn and R Richter (1997).

A few constructive suggestions

Readers, whose patience may by now be stretched beyond the limits by all this creative destruction, are entitled to ask for pointers to constructive messages that come out of this *Methodenstreit*.

The most important message is that constitutions and institutions matter (Berggren *et al*, 2002). Institutions are the rules that coordinate the many independent actors who interact in a complex modern economy (a) to produce the material means that make up our high living standard and (b) to find out new means to meet new wants that we are discovering all the time. Institutions in this sense have to be distinguished from what, in everyday English, are sometimes also misleadingly called 'institutions': banks, universities, prisons and so on. These are organisations, that is, more or less permanent, formal arrangements of production factors to generate an output. As so often occurs in the field of institutional economics, we have to begin with clear definitions. Confucius was right: We must call the phenomena by their correct names if we are to understand society.

The institutions that matter most are so-called *internal institutions*. They evolve within society in the light of experience, for example, the customs, ethical norms, work practices and professional standards that guide most of our behaviour. Institutions only have normative effect – constraining opportunism, tackling unavoidable conflicts and thereby saving transaction costs – if violations attract penalties. Thus, a bad conscience may punish us for violating an ethical norm. Opportunistic rule violations may also lead to immediate retaliation (tit for tat), social reprimand (tut-tut) or even ostracism (out!); an irresponsible member of a professional association may be handed a formal warning, and so on. These institutions create *spontaneous order* among the members of society, just as fish swarms in the sea or bird flocks in the sky are coordinated without a commander, or as traffic participants obey the rules of the road.

In addition, there are *external institutions*, which are designed and imposed from above by political agents: constitutions, legislation, regulations. Many external institutions derive from the codification and formalisation of internal ones. External institutions are enforced by coercive organs of the state – judges, the police, jailers, administrators (Kasper and Streit, 1998, pp 92–170). This kind of order is akin to rail traffic that operates under a centrally designed and enforced timetable (man-made order).

The big question is: What sort of rule best serves to advance universal human values, such as freedom, security (the intertemporal aspect of freedom, namely that we will be free to chose in the future), justice, peace, equity, prosperity and the conservation of a liveable environment? We need such objective measuring rods to judge the value of different institutions, because *a priori* everyone will insist that their community has the

world's best institutions. In a sense, this is of course correct. Once a community has got used to a particular institution set, it operates smoothly and at low transaction cost. Well-established institutions are therefore often furiously defended because they are the cement that binds societies together and indeed defines their identity. However, in these times of global mobility, international competition and prevailing value relativism, we must acknowledge that not all institution sets are of equal value, and must assess institutions against generally accepted, universal standards.

We must also recognise that the institutions are the result of evolution, adjustments to evolving technologies and changing circumstances. Conservatives and libertarians differ on this point. While libertarians acknowledge that traditional institutions are often valuable possessions, because people have become used to them, they also acknowledge that evolving circumstances require social and political entrepreneurs to invent and test new rule sets (Hayek, 1960). Old rules can sometimes indeed be bad rules. The fact that many communities have clung obstinately to their familiar institutions explains why most of mankind has stagnated materially for most of history and why many violent conflicts have been fought over institutional disagreements.

The Austrian approach to economics is shaped by the understanding that all humans suffer from cognitive limitations and act in limited time. Shared institutions are valuable cost-saving assets – some authors rightly speak of 'institutional capital'. Good institutions advance peace, prosperity and liberty, as long as they have what Italian jurist Bruno Leoni called 'universal quality' (Leoni, 1961). Economists should learn from the legal profession that the rules must be *certain* (clear and with clearly defined, unconditional consequences for violations), *general* (that is, not case-specific), *knowable* (transparent, simple, not spelled out only in secret codes) and *open* (that is, applicable to future situations). Universality is also promoted if the various institutions are compatible with each other. American legal scholar Richard Epstein put it clearly when he acknowledged humanity's pervasive knowledge problem and concluded that a complex world requires simple rules (Epstein, 1995). Let us also note that prohibitive rules (such as "thou shalt not steal") are much more likely to be universal than prescriptive rules.

The maxim of universality derives directly from the worldview of Austrian economics, but is habitually violated by neoclassical practitioners. To give just a few examples: Austrians stress the universal rule that the exercise of individual property rights should not be restricted as long as this causes no harm to others. Yet, neoclassicals have advocated 'optimum tariffs' (a limitation on the freedom to trade one's property rights), foreign investment controls (violation of the freedom to use one's capital wherever one sees fit), licensing and industry policies (ditto), the control of labour markets (abridging one's right to use one's own labour as one sees fit) and zoning regulations (which often

violate individual rights to develop what is theirs without evidence of harm being done to others). Modern governments habitually abridge private property rights, and modern parliaments spew forth a steady stream of prescriptive legislation, normally with little regard to individual freedom. They also reverse the burden of proof. Whereas, in a free society, the aggrieved parties must prove harm in court, environmental legislation now proliferates that puts the burden of proof on developers and energy users – guilty until proven innocent (Kasper, 2005). This is a mighty step away from freedom and hence prosperity. Transaction costs and obstacles to innovation are artificially raised, and freedom, justice, security and prosperity are diminished, often – alas – with the support of mainstream economists.

The maxim of universality has consequences for jurisprudence, too. Social engineering by legislation and judicial rulings is rife in most modern societies. In our diverse world, we should not have law codes specific to every specific activity (labour law, environmental law, financial-market law and so on), but general rules (the common law). Lawyers who subscribe to the psychology that underlies the Austrian worldview will be weary of their colleagues who try to reshape the world in predetermined, specific ways.

As far as economic institutions go, they are straightforward: secure private property rights, the freedom to use them as the rightful owner sees fit, and the rule of law. Regrettably, these crucial economic institutions are often not well understood and are rarely taught in mainstream economics courses. Thus, some economists still confuse property with mere possession; they see expropriation only when an asset is confiscated holus-bolus, as was done under old-style socialism. However, property confers an open-ended bundle of rights, some of which owners may not have even discovered yet. Expropriation by salami tactics – prohibition of this use or that – is the modern, neo-socialist game of Western governments and parliaments. Landowners in any Western countries are, for example, no longer permitted to harvest the rainwater that falls on their property or to cut down the trees they own. 'The authorities' all too often claim eminent domain without giving valid reasons or offering just compensation at market value. Traditional judicial tests for such government interventions are nowadays often dropped (Kasper, 2005; Ratnapala, 2007). Economics departments, who decry declining enrolments, would be well advised to build property rights and the rule of law into their syllabuses and deal with the consequences of matters such as expropriation and corruption. On that score, yesteryear's continental European faculties of law and economics had much to offer, but they, too, now seem to have fallen victim to sterile mathematical formalisation.

I would also recommend that economists embrace the Austrians' caution about predicting specific outcomes and planning for specific goals, such as the United Nation's vacuous

'Millennium Development Goals'. Economists ought to reflect on a pearl of wisdom from the Chinese sage Lao Tzu: "Those who have knowledge, do not predict. Those who predict have no knowledge". The reason for caution is that Austrians see the modern world realistically as subject to ceaseless change. Subjective judgments are being altered and may affect economic actions by others in hard-to-comprehend, unpredictable ways. Constant parameters – the keys in forecasting models – are therefore suspect. Austrians counsel us to confine ourselves to pattern predictions, general scenarios of the future that are not precise as to time, place and specific content.

To illustrate the point, let me mention two famously wrong neoclassical forecasts. A few months before the crash of 1929, Keynes and other economists of the Cambridge School asserted with great confidence that the exuberance of the 1920s would continue and stock market indices would boom indefinitely, whereas Hayek and von Mises predicted the inexorable advent – some time – of a great depression (Huerta de Soto, 2009, fn 64). The cause célèbre for the Austrian attitude to prediction has of course been their insistence since the 1920s that socialism is, in the long run, impossible, whereas neoclassical economists like Paul Samuelson extolled, up to less than one month before the fall of the Berlin Wall, the progressive convergence of the capitalist and socialist systems.

The economics profession would, in my opinion, be well advised to modestly abstain from specific predictions such as British economist Nick Stern's of world temperatures in 2100. That may mean economists do not influence policy interventions to the same extent as 'economist kings' of yesteryear used to. My plea to the public and media is to always think of ordinary citizens and to ask the economists: "Just *how* do *you* know?", instead of allowing themselves to be bamboozled by models they cannot understand.

Many neo-Austrian economists insist on methodological purity, starting from uncontestable (and plausible) assumptions about human nature to analyse economic phenomena by the deductive method. As someone who has spent a professional lifetime crossing the bridge to and fro between giving practical advice to industry and governments and academic theorising and teaching, I do not qualify as a purist. I see merit in looking at the positive evidence to derive insights of the positivist sort, as the neoclassical mainstream does. We should not stand methodologically solely on the deductive leg. Instead, we should all the time examine and crosscheck deductive and inductive insights against each other (Rosen, 1997). Econometric work should be confronted with Austrian insights to see whether the modelling plausibly reflects human action. In practice, econometric models and common sense are usefully complemented by the teachings of evolutionary Austrian economics. Will individual actors act as is tacitly implied by this economic model or that assertion?

I would also commend another Austrian habit: Never speak of collectives as if they were human actors. This is a misleading fiction that leads to sloppy logic. Only individuals with their own subjective attitudes are able to decide and act. Do not say: "New Zealand has decided to cut greenhouse gases by x percent". Don't say: "The world must abolish hunger in Africa by 2020". Such goals and generalities – typical of United Nations' communiqués – are meaningless cop-outs. You will soon discover that the habit of attributing all actions to subjective individuals is conducive to clearer thinking about policy, as well as being a good antidote against vacuous political hypocrisy.

Because Austrian economics is all about the search for, and coordination of, knowledge, economists should once again pay further attention to that great Austrian-American iconoclast, Joseph Schumpeter. He had much to say about entrepreneurs' evolution, for example, on advertising, the regulation or otherwise of competition, and the behaviour of financial markets. In recommending a brand of Austrian economics that is augmented by a dose of Schumpeterian economics, I, of course, reveal myself as an Austrian economist who is less than 100 percent pure! But I subscribe to the concept of optimal impurity, to what philosophers since Aristotle, medical researchers and system analysts call *hormesis* (Greek for 'rapid motion'; in modern medicine it refers to favourable responses to small doses of toxins and impurities). A little bit of methodological impurity is no doubt conducive to developing a better understanding of complex social reality.

It is no coincidence that evolutionary-institutional economics of the Austrian hue has in recent decades begun a mighty renaissance, not in the mainstream economics departments, but in areas that are marginal to economics – in schools of law, business and engineering, in academies that focus on third-world development and in non-government think tanks.

The stultifying neoclassical straightjacket was also ruptured by public choice economics, which recognises that opportunism is rife among political agents, as well as by long-term economic history. It may seem odd that an organisation so centrally concerned with economic development and growth as the World Bank ignored the crucial role of institutions for such a long time. As recently as 1993 it labelled the economic ascendancy of East Asia an 'economic miracle' – something that cannot and need not be explained (World Bank, 1993). As someone, who was marginally involved with this project, I can tell you that the lead authors were econometricians, with neoclassical blind spots for the evolution of knowledge, skills, transaction costs, political opportunism and corruption. I am glad to report that reliance on neoclassical modelling has since declined in the World Bank. Indeed, it now looks into the costs of running a business, tax and law reform, the control of corruption and so on. The same now holds true of

many third-world government agencies, where much talk is about institutional reform and liberalisation.

Last but not least, it would be a big mistake to accuse Austrian subjectivist-individualist economics of being only about lonely, atomistic, isolationist actors. Institutional economists have added an understanding of communal cohesiveness and empathy for others to our discipline. Elinor Ostrom, the great American social scientist, deservedly got the Nobel Prize in Economics in 2009 because she has done much – together with other, Austrian-inclined social scientists – to show that economics is not simply a matter of big government versus lonely-wolf individuals. Freedom, evolution and happiness are often pursued through voluntary organisations that are ordered by their own institutions. The theory of clubs shows how open, voluntary associations of individuals can benefit from economies of scale and scope and how they can use common assets sensibly without destroying them (tragedy of the commons). To understand why civil societies function, we should again look at the sociology of customs and informal networks (Ostrom, 1990; Aligica, 2009; Aligica and Boettke, 2009).

Finally: Economics – the cheerful science!

Let me end with a plea to economics teachers, model builders and policy advisors: Jettison the erroneous, outdated precepts of neoclassical orthodoxy! Modern diffuse, dynamic evolution and the dominance of the service industries are shifting economics inexorably towards the Austrian paradigm because these trends make the narrower neoclassical orthodoxy less and less realistic.

There is another reason why I believe the time for a paradigm shift has come, in particular, in our part of the world. East and South Asians have, in my opinion, always looked at the world as something subject to cyclical, evolutionary forces, whereas the Judeo-Christian and Islamic aspiration has been predominantly to pursue some utopian equilibrium – a static ideal end state, a 'golden age'. The former Secretary General of the Communist Party of China, Hu Yaobang, is reported to have said that the Chinese can learn much more from Montesquieu (who wrote about institutions and a freedom-friendly spontaneous social order) than has-been Marxism. Numerous discussions with Chinese researchers and students have convinced me that this view resonates throughout the East Asian region.

Finally, here is the most important reason for abandoning neoclassical orthodoxy: It is irredeemably transfused with the pessimistic, hubristic notion of diminishing returns. Yet, the history of how our material civilisation evolves encourages optimism. Economists should again tell the good news that prosperity can and will continue. Let

us move on beyond the rather dismal, drab and depressing tale about rationing scarcity and coercing people.

Instead, let us speak about creativity, growth, diversity, widening mankind's material horizons and progressive achievements. Let us work on economics, the cheerful science!

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