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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 19th century agricultural reality (law of diminishing returns).

Nonetheless, many economics faculties and major journals still cling to the neoclassical paradigm, for 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 advisers, 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 skepticism'.

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 which 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.

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Introduction: Assumptions Behind the Neoclassical Paradigm

Business practitioners, jurists, psychologists, economic historians and general observers of social affairs are invariably astounded when they discover what assumptions – often made implicitly – 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 present-day econometricians – assume perfect knowledge when 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. An economy where all is perfectly known already, without discovery and innovation, of course has no room for innovating engineers and entepreneurs, whom the brilliant Austrian-American economist Joseph Schumpeter (1883-1950) placed at the centre of economic development. Most neoclassical textbooks relegate the entrepreneur to the fringe of the discipline, if he gets a mention 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 model to an evolving, complex world, where thousands of people, who have never met, interact to fill the shelves of a department store which carries several hundred thousand different items, a world where computer programs are often updated on a weekly basis, a world where services are often tailor-made and a world, in which causation is circular. Can we be surprised that non-economists are bemused?
- ❏ *Homo* certainly-not-always-so *sapiens* is rarely able to master all the knowledge necessary to choose what will bring the *maximum* utility or profit next week, next month, next year (Hayek, 1945, esp. p. 530; Dolan, 1976; Kasper-Streit; 1998, pp. 44-52)! When speaking of optimising utility, as neoclassical analysts do, they imply that there is a stable spectrum of positively known human satisfactions (represented by indifference curves), which can be attained by varying combinations of given resources and known production techniques and which can be assessed rationally. I have never seen an indifference curve, not even my own. If I have one, it is utterly unstable: my indifference curve between lunch and an interesting chat at 12:30 looks quite different from the one at 2 pm. 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 or optimise utility, because expected benefits change and are interdependent and anticipated costs are subjective — everyone's opportunity costs differ and change when available alternative opportunities change (Buchanan, 1969, Foreword). I may sometimes be able to optimise the use of my time this evening, but can we make a decision where to relocate our family in order to optimise our life opportunities for the remainder of our lives? Besides, when we pursue our own diverse, ever-changing purposes, we are often satisfied with less than the optimum or maximum. We are not mere atomistic, passive re-actors faced with given means, ends and constraints, as the neoclassical paradigm depicts humanity (Mises, 1966). The mental model of neoclassical economics has therefore rightly been labeled utopian, reflecting a 'nirvana approach' to the real world (Demsetz, 1969).

- Outsiders, who are not brainwashed by standard 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 rationality is to optimise ends by means — presents a psychologically stunted image of humanity. At best, *homunculus oeconomicus* tells only half the story of human action. In reality, human endeavour is often motivated by love, guile, laziness, forgetfulness, fear, sheer entrepreneurial curiosity or a determination to prove a point. For example, it is simply unrealistic to consider the risk-taking 'Schumpeterian' entrepreneur, who pursues an untested idea that no one else has yet had, as irrational. A more realistic conception of economic rationality should by all means comprise utility maximisation as analysed by neoclassical economists, but it must also embrace entrepreneurial drive as described by Joseph Schumpeter, and mere satisficing behavior as described by Herbert Simon (Schumpeter, 1961; Simon, 1976; Kasper-Streit, 1998, pp. 53-64).
- Another implausible aspect of the neoclassical orthodoxy is the implication, if not even the assertion, that 'equilibrium' – 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 in Britain called a situation, when net capital formation stops (MPC = r) 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 through arbitrage. This promotes greater equilibrium. These are the Kirznerian entrepreneurs who are alert for such opportunities (Kirzner, 1973). Dare I say that neoclassical equilibrium amounts to the end of economic life?

- The DNA of neoclassical economics is intrinsically permeated by the concepts of diminishing returns and equilibrium. The theory of diminishing returns points to the widely shared, superficially plausible insight that economic growth cannot go on forever and that systems tend towards entropy. According to 19th century economists, such as David Ricardo (1817) and Thomas Robert Malthus, 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). Even today, some introductory textbooks explain this 'production function' with diminishing returns by referring to yields of wheat on a field in response to additional fertilizer inputs. Karl Marx made this theorem the basis for predicting the collapse of the capitalism. But modern economies do not tend towards an equilibrium. Rather, they move dynamically forward. When we speak of national economies, equilibrium is an unrealistic abstraction, which we should delete from our textbooks. (Neo)classical economists were correct when — looking at resource exhaustion and tipping points – – they foretold that certain places would run out of timber, emmer wheat and whale oil, but that did not matter for the economy ads a whole. Before long, entrepreneurial ingenuity mobilised coal, GMO crops and mineral oil. Economic progress simply keeps changing horses! After peak oil, we may get nuclear fusion or bio fuels from algae, and so on.[1].
- Textbooks and models also tend to assume transaction costs to be zero. In reality, over half of all 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). Much entrepreneurial effort is invested into reducing the costs of transacting business, and the legal and financial professions, too, are working

[1] For a slightly different take on the classical and Marxian error of assuming diminishing returns see Ridley (2010), pp. 193-212.

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. Therefore, lawyers embrace Hayekian institutional economics. He explicitly speaks about the "role of the lawyer in political evolution" (e.g. 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. The new discipline of Law and Economics, which we owe to the generosity of the *private* John M. Olin Foundation, has sprung from Austrian roots to highlight how the rule of law advances justice and prosperity.

- Ever so often, economists exclude unforeseen side effects by 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 doesn't stand still and things don't 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, in Hodgson *et al.,* vol. 1, 1994, p. 223). The general public has learnt from biology, medicine 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 interventionists. 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? We must conclude that *ceteris paribus* cannot serve as a legitimate substitute for our lack of knowledge; we must recognise that economists ever so often only pretend to have knowledge, as Friedrich Hayek spelled out so insistently in his Nobel Prize lecture (Hayek, 1978).
- The *ceteris paribus* assumption of neoclassical theory also induces the economics profession to think short term. And short-termism is of course an inherent trait of electoral politics. The time horizons of political pragmatists typically stretch only as far as the next election, and bureaucrats look no further than their next posting. If you have a short time horizon, you are more easily instrumentalist, i.e. given to interventions, which are the business of political and bureaucratic elites. This is why

[2] Money is a device to save transaction costs (Menger, 1981/orig. 1871). If everyone had 'perfect knowledge', we would – strictly speaking – not even have to bother with a means of payment and store of value.

ceteris paribus models meet with such high demand. Just recently, we have again seen how avidly politicians and bureaucrats welcomed the orthodox idea of Keynesian demand management. In the downturn of 2007-08, Keynesian 'stimulus' offered them an easy political escape from the need for a 'cleansing crisis' and from the arduous task of reforming intractable structural inconsistencies on the supply side. How often did we hear Keynes' silly quip: "In the long run, we are all dead"? But that was 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 leave the reader with the impression that the political and administrative elites are tireless, selfless agents who do the people's will, serving the general good of society. In other words, neoclassical authors assume that there is no principal-agent problem and no agent opportunism. This is patently untrue (at least outside New Zealand!). 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 all of us. This skeptical, but realistic view of political and bureaucratic behaviour is still often dismissed as cynical and misanthropic. It cannot be easily fitted into the neoclassical paradigm and is certainly not taught in schools. Nonetheless, the 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 that all these assumptions of neoclassical orthodoxy are absurd. Yet, neoclassical economists tend to work with them, though not always explicitly. At best, the assumptions are hastily mentioned up-front at the beginning of Economics 1.01, but later they are rarely dropped. Much econometric modeling is based on this paradigm, for models have to be closed, so that they can be solved mathematically. Alas, the world is open-ended. Nothing is pre-ordained. 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*, i.e. those aspects that constitute the essence of what we wish to understand. The point was

once made graphically by Hayek with reference to the study of ballistics: When predicting the trajectory of a projectile, it may well make sense to abstract from humidity and air 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 beginning with 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 endeavour; our knowledge is never perfect. This is a fundamental aspect, which 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 taken you deep into a controversy that became first known in Continental Europe some 130 years ago as *Methodenstreit*. Loosely translated from German that means 'dispute over the correct method to analyse economic phenomena'. The dispute began in 1871 when Carl Menger, a professor of economics at Vienna University in Austria, published his path-breaking book *Grundsätze der Volkswirtschaftslehre* (English: *Principles of Economics*, 1981). Menger (1840-1921) 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, rivaling entrepreneur, who acts subjectively, may get it wrong, and will correct his actions in the light of experience in the market (Huerta de Soto, 1998; also Bostaph, 1994). What matters is not only objective (explicit scientific) knowledge, but also the diverse tacit, subjective knowledge, which differs from place to place and period to period. 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 entrepreneurial creativity or the continual evolution of the division of labour. His was an attack on the nascent mathematical models of Léon Walras (1824-1910) and Vilfredo Pareto (1848-1913), which were built on constant information about ends and means that reached equilibrium, i.e. a state in which the plans of all individuals were compatible with each other. Economists of the 'Austrian School' have never ceased to dispute that this is the proper method of

economic study[3]. For a long time, they remained a small minority in Western countries, 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 with the result of impressive and sustained economic growth (Kasper-Streit, 1993). The fraternity of neoclassically-minded Anglo-Saxon economists and journalists considered it 'miraculous', 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 a number of seminal publications and by translations into English of 'classical' Austrian works, which had so far 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.* (eds.), 1994, vol. 1, p. 218). Austrian 'guiding ideas' have by now become increasingly influential in policy making in many parts of the world.

In contrast to Austrian economists, who focused on ignorance, dynamic change and open-ended evolution, neoclassical economists assumed 'perfect knowledge', constant parameters and static equilibria. They talked about rational decision making by a standard type of rational individual, *homo oeconomicus*. He and his wife, *femina oeconomica*, are presumed to have constant, complete information on costs and benefits, to engage in 'perfect competition' and accept given constraints. Their decisions can be

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[3] There has been a succession of polemics about the essence of economics: Menger against the model builders like 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), Mises and Hayek against Keynes and the neoclassical school (on the impossibility of socialism and on the misconception of macroeconomics), and the Neo-Austrians versus the mainstream, including the Chicago School (see Huerta de Soto, 1998, pp. 88-98).

Readers who want to familiarise themselves with the Austrian approach to economics might begin with Dolan (1976), O'Driscoll (1977), O'Driscoll-Rizzo (1985) and Kasper-Streit (1998), before delving into the original writings of Ludwig von Mises, Friedrich Hayek and Israel Kirzner, 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.

[4] The 'German economic miracle' carried within itself the germs of its own destruction, because the free-market design was coupled with a measure of political redistribution ('social market economy'). Through opportunistic and populist political 'auctions' for the vote, successive parliaments eroded private property rights and engaged in redistribution that destroyed the originally highly productive market order. It may be noted in passing that Germany's MMP-style electoral system contributed over time to fosterthis political populism and opportunism.

captured in mathematical models, so that specific outcomes can be predicted and corrective policy interventions can be designed.

This is not the place to get involved in fundamental philosophising. Let me instead elaborate on the most durable bone of contention by returning to the very beginning: Every introductory economics textbook and every first lecture in Economics 1.01 begins with a definition of the discipline. Twenty-eight out of thirty bestselling textbooks that I surveyed a few years back spoke of economics as the discipline that deals with scarcity, i.e. an innate and near-universal tendency for human wants to exceed available resources to satisfy them. The texts then normally speak of the linguistic origin of the term 'economics' in *oikos* (*οικος* – the household), evoking the idyllic 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. It is about rationing scarcity – a dismal pursuit.

Only a small minority of textbooks and teachers speak of the tendency of people to invariably discover more wants than they are able to mobilise resources, in other words as a discipline that deals with the dynamics of discovery and knowledge – a much more cheerful pursuit. These economists tend to speak of *catallaxy*. 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 a Greek or Phoenician merchant arriving in a foreign port, mixing with the locals to seek new opportunities to truck and barter, in the process discovering what people find useful. This dynamic-commercial view of economic life focuses on active knowledge search, entrepreneurial risk taking and testing ideas in markets in order to discover – partly by skill, partly by chance – what individuals want, as well as the rules of the game which govern such discovery procedures. This school of thought focuses on the interaction of individual competitors, in contrast to the central, fully informed decision maker at the start of a possibly harsh winter. It focuses on what I am speaking about: the assumption of 'perfect knowledge' versus the assumption that humans continually search for, and find, more useful knowledge.

Let's take note of the fact that an economy, in which conflicts and transactional frictions are assumed away, requires no law and no lawyers. And in a world of (already) perfect knowledge, scientific discovery, invention and technical innovation play no

role. Little wonder that lawyers, engineers and entrepreneurs have lost interest in neoclassical mainstream economics!

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 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 (Mises, 1966; Hayek, 1945; 1967; 1978b; Robbins, 1976). In this sense, economics is about knowledge (epistemology) and the endeavour to ceaselessly improve the human condition. This type of economics helps us to understand economic growth and development, whereas neoclassical theory had to come up with the vague concept of a 'third factor', which is estimated econometrically as a mere residual.

Although the conception of economics as an open-ended catallactic search process has a long history, the neoclassical mainstream was shaped by the more steady world of the 19th century: fairly static, repetitive agriculture and the mass production of a few standardised industrial products. This was a world with relatively slow technical change and a limited product range. In the 21st century, economic life is about a huge diversity of frequently tailor-made services and rapidly changing product qualities (think of the almost weekly updates of your computer software!). Can someone nominate an introductory economics textbook that introduces production and cost theory with examples from today's IT industry, or a just-in-time car-assembly plant with logistics covering tens of thousands of components? The economic reality of diverse, changing services, which now make up three quarters of the national product of mature economies, ceaseless innovation, just-in-time delivery and nimble reaction to global changes can only be understood through a theory that focuses on knowledge, coordination and never-ending, agile adjustment.

The Attractions of Neoclassical Economics

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

- ❏ 'Simplifying' assumptions — such as perfect knowledge, *ceteris paribus* equilibrium, constant preferences, and the unduly narrow conception of rationality —

make it easy to build models. They permit modelers to reduce the number of necessary variables and data to the number of equations in order to solve their models and produce esthetically pleasing results. Models then create the impression that new knowledge is generated — as well as insights that no one could comprehend otherwise. How much more satisfying is it to have answers from an elegant model based on perfect knowledge than to operate with the confusing evolutionary diversity of reality?

- ❏ As a battle-hardened academic teacher and head of a university department, I know only too well 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 the fact that buyers and sellers have to incur fixed and variable 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 macro mechanics[5], one can discuss manifold situations and inspire confidence in students that they are learning something satisfying and real. Disclosure of the many tacit and explicit assumptions that underpin the IS-LM model would only confuse students and deprive cognoscenti of inspiring, 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 lecture theatres.
- ❏ By using mathematical tools and statistical estimates, one can easily 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 – after discovering that mathematics is a poor, artificial language, which cannot capture the full, rich flavour of the idiom of institutional and evolutionary

[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 an endorsement of this type of macro-mechanic modelling!

social science. I am one of those, who one day bitterly concluded that all my time-consuming efforts to learn Fortran, extract data series, understand Durbin-Watson and what not, had been part of my wasted youth! It is a bitter pill to swallow, if you want 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 role as a policy advisor that made me shred my lecture notes and start afresh.

- A closed, comparative-static model can easily produce impressive, seemingly 'scientific' analysis and 'objective' results to impress laymen 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 thus meet a ready demand, and model building remains profitable and influential.
- In countries like New Zealand and Australia, where most secondary and tertiary education in economics happens in nationalised establishments and where most economic research is produced for government agencies, there is limited demand for the critical scrutiny of implicit philosophical values, let alone the role of the state. Confident constructivism (social engineering), which neoclassical economics and econometrics support, is 'cool', as it gives eager political elites influence, importance and income. Who in the Beehive, United Nations agencies, the World Bank or the IMF really wants to know about the pros and cons of big or small government in furthering the people's fundamental aspirations? Who in the state-owned media will run a critical case against government programs on the grounds that they detract from individual freedom? Why promote Hayekian analysts or public-choice skeptics, who might only attack the opportunism of politicians and bureaucrats? From the viewpoint of political and bureaucratic elites, economists with the neoclassical approach can be much more relied upon to produce solutions that expand their influence. Let us be clear: Career politicians and bureaucrats act rationally when they favour consultants and academic teachers, who furnish reasons for interventions. Intervention is their business. And, besides, if certain policy interventions produce problems, these can always be addressed later by a new intervention. That is again good for the business of the political elites (Sowell, 2009).

- ❏ It is only natural that quantitatively-inclined neoclassical economists include what is quantifiable and exclude what is not. Advances in data processing and the greater availability of statistical data have of course facilitated the use of quantified models. One has to admit that neoclassical econometric models — though frequently no more than sophisticated rulers to extrapolate the past — are useful as long as conditions of steady-state development prevail; in other words, as long as we can be sure that no 'black swans' and other unexpected circumstances appear[6].
- ❏ Generations of neoclassically-blinkered lightweights have now been educated in the orthodox tradition. They now 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 social policy. It is good for one's career and comfortable to be part of the neoclassical tribe. And for the political elites and the commentariat, it is also safe to accept the conventional consensus.
- ❏ One odd psychological obstacle in the way of wider acceptance of Austrian economics and catallactics, which has been puzzling me for years, is that neoclassical economics, which embodies the pervasive 'gene of diminishing returns', appeals to a preference for pessimism and hubris, which seems particularly entrenched in Judeo-Christian societies. The past may have been a record of unimagined material progress, but most observers and policy makers nevertheless make pessimistic predictions about the future (Ridley, 2010, pp. 280-347)! This cannot alone be the result of a political intent to control the masses by fear or blatant rent-seeking. A deeply ingrained instinct for precaution makes us predict accidents, so that we avoid them. In addition, there may be guilt feelings that we have had it so undeservedly good. However, there is a deeply ingrained and understandable human resentment against all change. Prospective changes, including material progress, challenge our limited cognitive limits and are therefore perceived as uncomfortable. That is why it is popular to assume that the breathless change of the modern world cannot go on. Matters are different in poorer and especially the ascendant 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

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

futurophobic than the affluent Westerners or the adherents of conservative Islam. Maybe, that is why evolutionary Austrian economics is more readily accepted among the elites of East Asia than in Western civilisation.

All this explains why the neoclassical orthodoxy and economic modeling have been triumphant for so long in Western societies. However, turning away from reality and clinging to outdated modes of thinking was already lambasted by Adam Smith. He 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". 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 laymen do not share. As a result, they increasingly speak only to themselves and not to thinkers in other disciplines, with whom they should interact. Remember 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 gives 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 Anglosaxon countries has, by and large, been decided against Descartes' worldview, but not when it comes to economics.
- ❏ 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 from sociology, history, psychology, jurisprudence, entrepreneurship and so on. Most students, who have not yet had much real-life experience, remain unaware that they are often only acquiring pseudo-knowledge. That will be sufficient for their exams or a Ph.D., 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. In my opinion, undergraduate students in the social sciences should be challenged to think about freedom *versus* security, efficiency *versus* justice, freedom *versus* the preservation of a livable environment. But how many are?

- ❏ The simplifying neoclassical assumptions have the consequence that the twenty 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 static descriptions of atomistic or oligopolistic markets. These have little to do with the reality of dynamic global rivalry for world market share in rapidly changing technology markets. They tell you nothing about product innovation, advertising and after-sale services, only about price changes as an instrument of marketing.
- ❏ Anyone who has practiced the econometric art on the basis of neoclassical assumptions, myself included, will know that statistical data series are less than perfect or complete. People in the trade are not always inclined 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 statistical estimates uncritically and brushes aside footnotes full of caveats, in order to get to the exciting part of the exercise: deriving correlation coefficients and the many wonderful statistical tests that 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. Worse still, data may be manipulated for political ends. Think of 'Climategate'. Think of inflation measures that underestimate the price rises which people experience. The consequences of inputs of such bent data in complex models are frequently impossible to assess. The output is science fiction.
- ❏ Sophisticated computer models pretend to use objective methods to 'prove' certain points. However, practising econometricians very often use subjective judgments to 'tweak' or doctor the parameters so as to ensure that their results look reasonably plausible and do not deviate too much from what others are saying. Moreover, complex models combine interdependencies, evolutionary feedbacks and time lags that interact in ways that no human mind could ever understand and assess. Canadian

economist Herbert Grubel was right when he recently drew on this insight to criticise complex climate models to 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 for the UN-IPCC's 'consensus' model predicting global warming. Modeling can easily become an excuse for not observing reality and an excuse from the arduous task of collecting genuine observations.

- ❏ 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. Economists know that it is frequently the unseen that matters, or that hard-to-assess quality differences determine what happens. For instance, statistics on school performance, which are based on numeracy and literacy tests, do not tell about the moral values that are taught or not taught. Moreover, social relations are occasionally disturbed randomly and unpredictably. This cannot be covered in models (in other words: black swans appear). I recall a discussion I had after the Asian financial crisis with one of the foremost monetary econometricians of East Asian financial systems. I had seen labour unit 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 why he had not foreseen the coming crisis, he replied: "My model was not specified for such developments." What is the use of such a model?
- ❏ Correlation coefficients of 0.55 are often presented as 'proof'. Also, short series of observations are used in models, which might very easily tell a different story if a few more observations are added (for a telling and politically relevant example, see Davidson, 2010). Neither policy makers nor the critical press bother to look at the finer points of modeling. Because they lack the expertise, they are normally happy to swallow the results produced by the 'experts'. Problems only arise when two competing models contradict each otehr. A few years ago, I was asked by a despairing Australian parliamentarian what to do about two industry models. One proved that the car tariff should be upheld, the other that it should be abolished. He was greatly relieved when I told him that the models only were insidious sausage machines to convert clever assumptions into predetermined results. Rather, he should rely on common sense and opt for free trade.

- Models that blindly derive correlations from data series, often assume that correlation means causation. They can be awfully wrong and may misguide policy for years. Permit me to illustrate this point with reference to the 'Phillips Curve'. New Zealand-born economist Bill Phillips established a stable relationship between money wages 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 that they could choose 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 macro-mechanics. When the Phillips Curve was relied on for policy-making in the early 1970s, we soon learnt that the construct was not load-bearing. The curve shifted sideways or upwards. In other words, we got stagflation, i.e. accelerating inflation *and* rising unemployment, a 'Black Swan event'. Macro-mechanists mumbled something about supply-side shocks and the oil crisis, then dropped the concept. To economists of an Austrian inclination, it had been clear that 'a little inflationary stimulus' would produce rapidly rising inflationary expectations, because labour-market monopolies and union-friendly governments were pushing for rising real wages. The result was profit compression, recession and an explosion of joblessness. The Phillips Curve is just one example where a tested, neoclassical theory turned out to be costly, misleading humbug.
- More generally, *ceteris paribus* argument on the basis of narrow, neoclassical assumptions has induced the economics profession to adopt a managerialist-activist stance. All too often, they present a complex national economy, as if it were an organisation, which can be directed by command and control from the top down. For every emerging problem, there is a solution in the tool kit. Nor are there unforeseen side effects. But a political community is not an organisation; the citizens are the principals and free in their decisions. When neoclassical models encourage the proliferation of detailed policy interventions, these interact in unforeseen, deleterious ways to make markets dysfunctional. Consequently, a dense web of regulation is now strangling much innovative enterprise. In 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 should 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 more recently enforced ruthlessly by socialists from Lenin to Hitler – is nowadays postulated by democratic leaders, who have little regard for individual freedom. All too often neoclassical model builders eagerly serve as the hand-maidens of the anti-freedom forces — whether they realise it or not!
- I leave my major gripe to last: I noted before that neoclassical (and Marxian) economics suffer from a pervasive birth of the 'law of diminishing returns'. In a mostly agricultural age, it may have looked plausible to transfer the microeconomic observation of diminishing returns to the macro-economy level. This may still have seemed plausible to Karl Marx, whose prediction of the terminal crisis of capitalism rested on this dogma. They were all dead wrong! The experience of industrialisation notwithstanding, 20th 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 [1912]; 1947; Hayek, 1945; 1968a: Gilder, 1981). The national production function becomes a movable feast!

  Let's take a quick look at economic history: 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 mid-19th century. When these technologies reached their 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? Nanotech? New energy sources? In each growth wave (or 'Kondratieff cycle', as Joseph Schumpeter called it), modern production spread to new industrial locations: first Germany and North America, then Russia, in the post-war period the East Asian Tigers, and in the IT growth wave after the 1970s, first and foremost China.

It is simply a gross fallacy of aggregation to derive a national production function from individual production functions! As economic progress 'changes horses', so to speak, the knowledge economy powers on inexorably. This may appear counter-intuitive to natural scientists and ecologists, who know the Second Law of Thermodynamics and know that no trees grow into the sky. But Austrian economics is based on the insight that the production factor knowledge is unlimited (Ridley, 2010). The growth process can only be stopped by the proliferation of collective interventions or a breakdown of law and order.

The Austrians' criticisms of the neoclassical orthodoxy and their querying of the underlying, implicit assumptions are all too often angrily rejected. Some practitioners may well admit in private that their models prove nothing, but they will then hasten to add that 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, i.e. rules of coordination among the millions of participants in economic life, and they are unnecessarily pessimist about the future. Economists and lawyers of a neo-Austrian persuasion keep making this point, but they are often perceived as tedious and dismissed as unhelpful. However, what is really needed for prosperity and security is not a clever new policy every year and every election campaign, but a steady, confidence-inspiring framework of abstract, easy-to-understand universal rules. This fundamental point was long overlooked, until the Keynesian model and microeconomic interventionism were discredited after 1970. Then, some talked about economic order and reformers out of the Austrian corner gained influence in kitchen cabinets 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 seems to me to be still 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 Mises, Hayek, and Schumpeter much more comprehensively.

There are many in New Zealand — including maybe even some in the Key government — who are 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[7] (Taskforce 2025, 2009), the Austrian approach commends itself. The previous Labour government professed to a 'knowledge and innovation strategy', but I could not detect even a trace of 'Austrian-economics DNA' in its make-up. The Key government's economic policy position – i.e. not the declarations, but the actions to date, at least as seen by a casual observer in far-away Australia – also seems to lack essential Austrian genes. The government seems to have resisted even the modest gene-modifications suggested by the '2025 Taskforce' (2025 Taskforce 2009). I would appreciate being told that I am wrong.

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[7] Apart from the fact that centrally fixed growth goals smack of mechanistic social engineering, it seems odd and derivative (even insecure?) for a national government to define a growth target not in absolute terms, but in relation to the economic performance in another country. Equality in real per-capita income with Australians depends as much on Australian institutions and efforts as on those of New Zealanders.

Here is a little back-of-my-envelope calculation: If Australian living standards were to grow by a plausible 2.5% p.a. on average to 2025, New Zealand's productivity growth would have to average 4.5% every year for 16 years! And if Australian growth averaged only 2% p.a., New Zealand growth would still have to be 4%. But with 3% in Australia, New Zealand's economy would have to average nearly 5% for 16 years. –– I know of no *affluent* society in history where such high growth rates have not been maintained for such a long period. Catch-up growth in poor, new industrial countries without socialised welfare are of course another matter. (West German post-war growth from 1950 to 1966 – termed 'a miracle' by ignorant Keynesian economists – ran at 4.5% p.a., but this was from a base distorted by massive war-time destruction and was made possible by a high skills base, high marginal productivity of capital invested in repairs of infrastructures and industrial plants, and foreign aid under the Marshall Plan, see Kasper-Streit, 1993.)

The Taskforce might be advised to investigate whether the goal of income equality with Australia can be best achieved by Australian governments imposing masochistic growth obstacles, e.g. a combination of high, new mining and business taxes, an Emissions Taxing Scheme (ETS), the admission of masses of unskilled welfare seekers from the third world, civil war, and successions of debt-boosting 'stimulus packages'. It is conceivable – but of course highly improbable – that such a policy mix could shrink Australian per-capita incomes by 1.8% p.a. from now on, so that parity with a stagnating New Zealand would be reached by 2025….

The biggest obstacle to the fine goal of faster productivity growth is – in my view – that Kiwi minds have been thoroughly poisoned by the explicit or implicit assumption of diminishing returns, hence a timidity and a pessimism that appear irrational (Ridley 2010). The pessimism about the future probably has to do with a reluctance to face uncomfortable structural changes and the lack of experience with competing on the part of many. Yes, I hear Kiwis say, the past has been one of material progress, and other economies are powering ahead. But will the future not be less promising? We can risk bold innovations only when future success is proven first. Maybe, the Law and Economics Association should campaign that the preaching of neoclassical notions of diminishing returns be made a criminal offence. I am not advocating the cup of hemlock for academics and opinion leaders who mislead New Zealand youths, but offending economics departments and NGOs might be faced with funding cuts. That would demonstrate that the New Zealand push for growth is serious.

A Few Constructive Suggestions

Listeners and readers, whose patience may by now be stretched beyond the limits by my line of creative destruction, are entitled to ask for indications of constructive messages out of this *Methodenstreit*. Paying attention to the dynamics of knowledge evolution and the institutional conditions that either help or hinder it (epistemology) has much to offer to our discipline.

Maybe, the most important message to take on board is that constitutions and institutions matter (Berggren *et al.,* 2002). Institutions are the rules that coordinate the many independent actors, who work together in a complex modern economy (a) to produce the material means that make up our 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, is sometimes also misleadingly called 'institutions': banks, universities, insane asylums, etc. These are organisations, i.e. more or less permanent, formal arrangements of production factors to generate an output. As so often 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 make progress.

The institutions that matter most are so-called internal institutions. They have evolved within society in the light of experience, for example customs, ethical norms, work practices and professional standards. 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.

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-Streit, 1998, pp. 92-170).

The big question is: What sort of rule best serves to advance fundamental 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 livable environment? We need such objective measuring rods to judge the value of different institutions, because *a priori* everyone will insist that his community has the best institutions in the world. In a way, this is of course true. 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 assert that not all institution sets are of equal value. We must measure the effects against such generally accepted, universal standards.

We must also recognise that the institutions are the result of evolution, adjustments to evolving technologies and other circumstances. On this point, opinions tend to differ between conservatives and libertarians. Libertarians acknowledge that traditional institutions may often be worth conserving because people have become used to them and therefore interact smoothly. But they also acknowledge that evolving circumstances require social and political entrepreneurs to invent and test new rule sets (Hayek, 1960). Sometimes, old rules can therefore be bad rules. The fact that many communities have clung tenaciously to their familiar institution sets explains why most of humankind has stagnated materially for most of their history and why many violent conflicts have been fought over institutional disputes.

The Austrian approach to economics is shaped by the understanding that all humans suffer from cognitive limitations and have limited time. In the face of this, the

institutions are valuable, shared 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). They must be *general*, i.e. not case-specific, *knowable* (transparent, simple, not spelled out only in secret codes), *certain* (clear and with clearly defined, unconditional consequences for violations) and *open*, i.e. applicable to future situations. Universality is also promoted when the various institutions are compatible with each other. American jurist Richard Epstein put it clearly when he acknowledged humanity's pervasive knowledge problem and concluded that our complex world requires simple rules (Epstein. 1995). Let me note in passing 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 you just one example: Austrians stress the universal rule that individual property rights should not be restricted as long as their exercise 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 (dto), the control of labour markets (abridging one's right to use one's own labour as one sees fit) or zoning regulations (which often violate individual rights 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, we now have environmental legislation that puts the burden of proof on developers and energy users — guilty until proven innocent. This is a mighty step away from freedom abd prosperity. Transaction costs and obstacles to innovation are then higher, 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 etc.), 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. Instead, they will insist that universal, general rules be applied in adjudicating in specific conflicys.

As far as economic institutions go, they are simple: secure private property rights, the freedom to use them as the rightful owner sees fit, and the rule of law. Alas, these economic institutions are often not well understood and are rarely taught in 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 embraces an open-ended bundle of rights, some of which owners have not even discovered yet. Expropriation by salami tactics – prohibition of this use or that – is the modern, neo-socialist game of governments and parliaments. You are, for example, no longer permitted to harvest the rain water that falls on your property or cut down the trees you 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 actions 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 to deal with the consequences of matters such as expropriation and corruption. On that score, the continental European faculties of law and economics of yesteryear had much to offer, but they, too, seem to have now 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 UN's vacuous 'Millennium Goals'. Before considering short-term forecasts under *ceteris paribus* assumptions, 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 world realistically as subject to ceaseless change. Subjective judgments are being altered and may affect economic actions 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 descriptions 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 Mises predicted the inexorable advent — some time — of a great depression (Huerta de Soto, *op. cit.*, 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 Wall, the progressive convergence of the capitalist and the socialist systems.

The economics profession would, in my opinion be well advised to be more modest and abstain from specific predictions such as British econometrician Nick Stern's prediction of temperatures in 2100, even if that means that they do not influence policy interventions to the same extent as 'economist kings' used to in the past. And my plea to the public and the media is to always ask the economic experts: "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 such a purist. I see merit in looking at the positive evidence to induce insights of the positivist sort, as the neoclassical mainstream does. I do not believe that we should stand methodologically solely on the deductive leg. Instead, we should all the time examine and cross-check our Austrian theories with observed reality (Rosen, 1997). In practice, we must also always stand back and ask: Is the evidence plausible? Will individual actors act as is tacitly implied by this economic model or that assertion?

I would also commend to you another Austrian habit: Never speak of collectives as if they were 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%', Instead say: 'The Prime Minister yielded to government-funded pressure groups to cut Greenhouse gases'. Don't say: "The world must abolish hunger in Africa by 2020". Such goals and generalities – typical of UN communiqués – are meaningless cop-outs. You will soon discover that this habit is conducive to clearer thinking about policy and a good antidote against political hypocrisy.

Because Austrian economics is all about the search for, and the coordination of, knowledge, economists should pay more attention also to that great Austrian iconoclast, Joseph A. Schumpeter (1883-1950). He had much to say about entrepreneurs and innovation and about the dynamic role of profits. Neoclassical economics and jurisprudence need in particular to absorb the lessons of Schumpeter's evolutionary worldview, for example on advertising, on the regulation or otherwise of competition and the behaviour of financial markets. In recommending to you 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% pure! But who is attracted by 100% purity – other than New Zealand tourism promoters? I for one like optimal pollution: a bit of salt in my food; germs of contradiction and diversity in the arts, which I find stimulating and enjoyable. I therefore subscribe to the concept of optimal impurity, to what philosophers, 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 may also be conducive to developing a better understanding of complex social reality: a few minor contradictions may stimulate good insights.

It is no coincidence, that evolutionary-institutional economics of the Austrian hue has in recent decades begun a mighty renaissance in areas that are marginal to economics – in schools of law, business and engineering, and in academies that focus on third-world development!

The stultifying neoclassical straightjacket was also ruptured by public choice economics, which arose from neo-Austrian perceptions of mankind and which produced a more realistic view of political motivation, recognising that opportunism is rife among political agents. In addition, the straightjacket has been jettisoned by the neo-institutional school and by long-term economic history. It may seem odd that an organisation so centrally concerned with economic evolution and growth as the World Bank ignored the crucial role of institutions for such a long time. As recently as 1993 they labeled 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 World Bank 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 modeling has declined in the World Bank and that they indeed

look into the costs of running a business, tax and law reform, the control of corruption etc. The same now holds true of third-world government agencies, where most talk is now about institutional reform and liberalisation.

Last not least, it would be a big mistake to accuse Austrian subjectivist economics of being only about lonely, atomistic, isolationist individuals. Like neoclassical economics, it is individualist in focus, but it adds an understanding of communal cohesiveness and empathy for others. The great American social scientist, Elinor Ostrom, who deservedly got the Nobel Prize in Economics last year, has done much, together with other, Austrian-inclined social scientists, to show that it is not simply a matter of big government *versus* individuals, who compete relentlessly like lonely wolves in a cruel world. Freedom, evolution and happiness are often pursued through free, voluntary organisations that are ordered by their own institutions. The theory of clubs shows how open groups 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 basic precepts of institutional economics, in particular the sociology of customs and informal networks (Ostrom, 1990; Aligica, 2009; Aligica-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! Real-life experience with diffuse, dynamic evolution and in the modern service industries is shifting economics inexorably towards the Austrian paradigm.

There is one additional reason why I believe that the time for a paradigm shift has come, in particular in our part of the world. As mentioned, East and South Asians have in my opinion always looked at the world as something subjected cyclical, evolutionary forces, whereas the Judeo-Christian and Islamic aspiration has been predominantly to speculate about some utopian equilibrium — a static ideal end state, a ‘Golden Age’. No Chinese philosopher was ever able to understand why European Marxists, like Joan Robinson, called economic stagnation ‘a Golden Age’. The former Secretary General of the Communist Party of China, Hu Yaobang, is reported to have said that the Chinese could learn so much more from the ideas of Montesquieu (who wrote about institutions and a freedom-friendly social order) than the ‘outdated’ ideas of Marx. Numerous discussions with Chinese researchers and students have convinced me that this view

resonates throughout the East Asian region. The evolutionary, institutional approach looks simply more natural and appropriate to the Chinese aspiration to become rich before they become old.

However, I am leaving the – for me – most important reason for abandoning neoclassical orthodoxy to last: It is irredeemably transfused with the pessimistic, hubristic notion of diminishing returns. Yet, the evolution of economically useful knowledge and indeed the stories of how our material civilisation is evolving are most exciting. They encourage optimism. Economists should again tell the good news that prosperity can and will continue. Let's move on from the rather dismal, drab and depressing tale about rationing scarcity and coercing people! Instead, let us speak about creativity, growth, diversity and progress, about widening humankind's material horizons and our progressive achievements.

Let us work on economics, the cheerful science!

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