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## What's Wrong with Economics? It Ignores the Pogo Principle: "We Have Met the Enemy and He is Us"

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**2011 History of Economics Society Presidential Address**  
by  
**Jerry Evensky**

Forthcoming: *The Journal of the History of Economic Thought* published by Cambridge University Press

## **What's Wrong with Economics?**

**It ignores the Pogo Principle:**  
**"We have met the enemy and he is us." <sup>1</sup>**

Or ... more classically, as it was put by Cassius:

"The fault (dear Brutus) is not in our stars,  
But in ourselves ...."  
*Julius Caesar*  
(Shakespeare, 2006, 16)

### **A. Laying Out the Problem**

Let me begin by giving credit where credit is due. Modern economic analysis is beautifully elegant and impressively powerful. I agree with George Stigler that "the systematic analysis of behavior of individuals pursuing their self-interest under conditions of competition ... is Newtonian in its universality." (Stigler, 1976)

But what is really unique about humankind is not the fact that we pursue our self-interest under conditions of competition. This applies to all species. Those that fail vanish.

What makes us unique is our capacity to reflect upon, understand, act upon, and significantly reshape the universe that surrounds us. That capacity has made possible the progress of humankind from the rude state of hunting and gathering to a level of material well-being amongst the privileged classes of the world today that the greatest kings and emperors of the past would envy.

This prospect of, as Adam Smith referred to it, "bettering their condition" (*Wealth of Nations* (hereafter *WN*), 341) has unleashed the energy and creativity of individuals wherever individuals are free to choose their own path in life. That energy and creativity has been directed most efficiently and effectively where market signals, prices, are free to adjust ... constantly signaling to each and all where the best opportunities lie in the next moment. And even as existing opportunities are seized by the energetic and the agile, the creative players among us lead the markets to new paths of opportunity

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<sup>1</sup> April 22, 1970 ... the first Earth Day. Cartoonist Walt Kelly's contribution was a single frame with Pogo Possum, namesake of Kelly's syndicated strip, standing among lovely flowering trees just beginning to collect the sea of trash that extends before him as far as one can see. (<http://en.wikipedia.org/wiki/File:Kellyposter1970.jpg> – Accessed 2 Nov. 2010)

that had heretofore been unimagined. The only limit to the fruitfulness of the market system seems to be our capacity for energy and imagination. Or so it seems if one is working in a world of Stigler's economic man, *homo economicus*: One driven solely and powerfully by a desire to better his condition.

But Stigler, and modern economics analysis more generally, miss one very essential point. "[T]he systematic analysis of behavior of individuals pursuing their self-interest under conditions of competition ... [may be] Newtonian in its universality", but we are not physicists studying stars or quarks, we are social scientists studying the human condition ... and as noted above, humans are unique in nature. Stigler focuses on the beauty of unfettered freedom to bring out the best of human capacities: When energy and imagination are unleashed in pursuit of self-interest, each individual is "led by an invisible hand to promote an end which was no part of his intention" (WN, 456). This is the engine of the progress of opulence for society, this is the cause in *The Nature and Causes of the Wealth of Nations*. But, freedom can also unleash the worst in human behavior. The energy and imagination that can be so constructive can also be employed in very destructive ways that freedom makes possible.

The slave trade that provided cheap labor to the sugar plantations of the West Indies and to the tobacco plantations of the American South was a complex free market in which many exercised energy and imagination in providing a valuable commodity to the market: Humans as chattel. One man's free to choose was another man or woman's slavery.

The system of apartheid in the Old South Africa was of great service to the market for commodities such as diamonds, providing cheap labor to energetic and imaginative men who certainly considered themselves entrepreneurs. In this case, one man's freedom to choose was another man or woman's quasi-slavery.

If there is a problem with economics today, it is that it models based on *homo economicus*, an abstract being that does not reflect the complexity of human nature. Adam Smith writes in his *Theory of Moral Sentiments*:

Human society, when we contemplate it in a certain abstract and philosophical light, appears like a great, an immense machine, whose regular and harmonious movements produce a thousand agreeable effects. As in any other beautiful and noble machine that was the production of human art, whatever tended to render its movements more smooth and easy, would derive a beauty from this effect, and, on the contrary, whatever tended to obstruct them would displease upon that account: so virtue, which is, as it were, the fine polish to the wheels of society, necessarily pleases; while vice, like the vile rust, which makes them jar and

grate upon one another, is as necessarily offensive. (*Theory of Moral Sentiments* (hereafter *TMS*), 316)

Smith's analysis of the human condition and of our collective prospect begins with a theory of virtue and vice in his first book, *The Theory of Moral Sentiments*, because it is the balance of these that determines the efficacy of the invisible hand in his second book, *An Enquiry into The Nature and Causes of the Wealth of Nations*.

Where is there room for the issues of virtue and vice in a world populated by *homo economicus*? What does it mean to be an ethical *homo economicus*? ... an unethical *homo economicus*? Wherein lay the norms for approbation or disapprobation of behavior if we are all simply maximizing utility? For *homo economicus* there are no norms, there is only self-referential motive.

In my introductory economics class I explain that markets are amoral – not moral, not immoral ... amoral. In that sense they are like computers ... incredibly powerful at processing immense amounts of information in useful ways, but totally agnostic as to the use. Computers can be used to educate, to elucidate, to heal ... or to develop weapons of mass destruction. They don't give a damn, nor do markets ... nor does *homo economicus*.

Well, there's a Catch-22 here. If no one gives a damn, then the market system doesn't work very well. As Hobbes appreciated in the 17<sup>th</sup> century, unfettered freedom is a dangerous and destructive environment. Somewhere, somehow, someone must give a damn about norms.<sup>2</sup>

If morals or ethics or virtue or justice or equality are terms that one would associate with a concern about and a conversation regarding norms, we would expect to see these terms reflected in that discourse. The published *Papers and Proceedings*<sup>3</sup> of the annual meeting of the American Economic Association is arguably the best source for examining the content of the discourse among modern mainstream economists, for this publication presumably reflects what the most significant Association of economists considers representative of and exemplary in its annual community discourse. An

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<sup>2</sup> Can't self-referential motives capture the same behavior as norms? No. As the complexity of society grows, so too does the weakness of representing *homo economicus* as exhibiting anything approximating norms: With growing social complexity nested utility functions become a modeling process akin to the Ptolemaic system builders resorting to epicycles upon epicycles. Genetically based altruism (Becker, 282) breaks down as a source of social cohesion because it suffers from an inverse square law with respect to genetic distance.

<sup>3</sup> Described as follows on the American Economic Association website: "*Papers and Proceedings* is published as the May issue of the *American Economic Review* each year. Selected papers and discussions of papers presented at the Annual Meetings are published along with reports of officers, committees, and representatives." (American Economic Association; <http://www.aeaweb.org/aer/papers.php>; Accessed 22 June 2011)

examination of the titles of sessions listed and papers published in *Papers and Proceedings* for the period covering the six annual meetings from 2006 to 2011 suggests that if the terms cited at the opening of this paragraph, morals ... ethics ... virtue ... justice ... equality, are indeed good proxies for norms as a subject of conversation, then norms are not a significant part of the conversation among those in the mainstream modern economics discourse.<sup>4</sup>

Table 1: Number of Times Each Term Appeared in the *Papers and Proceedings* of a Given Year<sup>5</sup>:

Term / Conf. Year	2006	2007	2008	2009	2010	2011
Ethic*	0	0	0	0	0	0
Moral	0	0	0	0	0	3****
Virtue	0	0	0	0	1***	0
Justice	0	0	0	0	0	1
Equality**	2	1	1	2	3	2

\* Captured possible cases: Ethics or Ethical

\*\* Captured possible cases: Equality or Inequality

\*\*\* Title: "Institutions, Factor Prices, and Taxation: Virtues of Strong States"

\*\*\*\* All in a session titled "Economics as a Moral Science"

## B. The Role of "norms" in Economics Analysis?

The term "norms" seems to make some economists nervous, so let me be clear. The issue here is not whether analysis should be normative or positive. The issue here is that norms matter in society, so any positive analysis of how human society works must factor in the role of norms.

Adam Smith writes, again in the *Theory of Moral Sentiments*:

Society ... cannot subsist among those who are at all times ready to hurt and injure one another. ... If there is any society among robbers and murderers, they must at least, according to the trite observation, abstain from robbing and murdering one another. Beneficence, therefore, is less essential to the existence of society than justice. Society may subsist, though not in the most comfortable state, without beneficence; but the prevalence of injustice must utterly destroy it. (*TMS*, 86)

Liberal society, and here I mean small – ℓ liberal ... liberal as in a society in which citizens enjoy freedom, is for obvious reasons especially vulnerable to the Hobbesian quandary of freedom: the

<sup>4</sup> In the "Centenary Symposium" of the American Economic Review (February 2011) there is a piece: "100 Years of the American Economic Review: The Top 20 Articles" (Arrow, et. al.). Among those 20, one article from 1955 relates to any of the norm related themes cited: "Economic Growth and Income Inequality" (Kuznets).

<sup>5</sup> American Economic Association

potential of a war of all against all. Liberty for all is only constructive to the degree that there is justice for all. Above, I cited American slavery and South African apartheid as examples of “free market” societies in which there were distortions of justice. In each case the injustice is clear and present to anyone who believes that individuals should “not be judged by the color of their skin but by the content of their character” (King, 85)

Structures of societal control such as slavery, apartheid, or segregation create a system of market power. The destructive consequences of power lie in the perverse alignment of incentives created by power. Power pays – in the vernacular ... it generates a “rent”, a return not to productive activity but to the advantage that power provides. Those who enjoy the power advantage are not challenged by the competition of the powerless. The powerful win the “race for wealth” because they control the race. They need not overly exert themselves, they need not call upon all of their creativity and imagination to win in the race ... because the race is fixed. Fat and happy, the only efforts that they must carefully and consistently attend to are those which preserve their power.<sup>6</sup>

And what of those on the down side of the power structure? They are competing too, but their competition is only with one another ... for a diminished set of prospects. They too desire to better their condition, but the best they can hope for is a “better” relative to the rest of the oppressed. There is little or no opportunity to nurture their gifts of creativity and imagination, and thus there is little incentive to do so because there is little prospect of being rewarded for those gifts. This untapped human potential is a significant loss to society.

Power is a “blessing” for the powerful because they enjoy a large slice of the social “pie”, of the social product, but it is a large slice of a very diminished pie because power distortions are inefficient for society.

Not only is much of the productive capacity that could spring from the imagination and creative energies of free individuals in fair, unfettered competition lost due to the perverse incentives created by power ... but power requires resources to be spent for its maintenance. Police, paddy wagons, guns, whips, jails, bullets, batons ... significant resources had to be expended to maintain the system of slavery or apartheid or segregation. These resources didn’t educate a child or cure a sick individual, they simply kept people “in their place” – to use an expression I grew up with.

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<sup>6</sup> This usage of the term “rent” is found in Adam Smith who writes in the *Wealth of Nations* that “the landlords, like all other men, love to reap where they never sowed, and demand a rent even for its natural produce” (*WN*, 67). This dynamic of pursuing power for the distributive benefit is referred to as “rent-seeking”, a term introduced by Kruger (1974). Rent-seeking and rent-maintenance, the expenditure of resources to sustain a power advantage, are explored at length by Buchanan, et. al. (1980).

I grew up in the 1950s in New Orleans. In those days the first level headings of the job-listing section of the daily newspaper were not, as they are today, work categories like professional, medical, food service, and so on. Back then, the first level headings of job listings were divided into two categories: “Help Wanted – Male” and “Help Wanted – Female”. So immediately we see the power structure of that society ... in that time ... in that place ... reflected in the gender demarcation under “Help Wanted”.

If you were a woman you might read a listing that said “Apprentice plumber wanted, starting pay \$5/hour. Will train. For information call TW1-0708.” But there was no point in picking up the phone. That listing was under the male column and you were not eligible. You might like the thought of \$5.00/hour but your options read like this: “Waitress wanted. Must be able to work flexible hours. \$1.00/hour + tips. Call UN6-5782.”

And imbedded in the structure of those job listings was yet another power structure – race based demarcations. An actual ad from the June 21, 1948 *New Orleans Times-Picayune* reads (all four of the following advertisements from that issue (Nicholson, 33))

WAITRESSES  
YOUNG ladies, white only, experience not necessary. Apply Worner’s Drug Store.  
706 Canal St.

Then four spots down on that page one finds:

Pantry Girl (colored), capable and experienced. Hours 12 noon to 9 p.m., 6 days a week. Meals and uniform furnished. ...

In the “Help Wanted – Male” section on that same page there are ads that read:

WHITE UPHOLSTERER  
5<sup>1</sup>/<sub>2</sub> days a week. Time and half for over 40 hours. Apply in person ...

and

COLORED PORTER  
If you are not lazy and want to work at a steady job with good pay, answer this ad. Pelican Bar, 301 S. Rampart. St.

In those days all the available jobs were listed in the paper. Abstracting from the market power created by “separate but equal” schools and assuming all could read – everyone had equal access to information. Anyone who bought a newspaper could see the available job options. But knowing the options is not enough to ensure a fair race. For the race to be fair, you have to have equal access to participate. But, access was not equal.

In those days in New Orleans and in many other places before and since (Antebellum South, Old South Africa, ...) this was not seen by those in power as a distortion. It was simply the norm, the natural order of things.<sup>7</sup> It was not seen as a violation of free market economics, it was simply the context of the “free market”: Blacks were inferior, after all they were “colored”, and women were frail, unless of course they were black and/or poor ... and both had their “place”<sup>8</sup>.

Power can be generated by political institutions backed by police and armies (e.g. slavery or apartheid or segregation), or by socially constructed norms that, inculcated through socialization, become tacit knowledge for all in that society (Berger and Luckmann). In New Orleans of the 40s and 50s gender based power was primarily established by socialization of norms with minimal need for political institutional reinforcement (There were restrictions on working hours and conditions for women that limited their options.). Raced based power also began with socialization, but it required significant political institutional reinforcement to sustain itself. Clearly, the political foundations of these power structures have been significantly eroded, but the social foundations ... the tacit understandings, the shared norms ... still have strength. Societal norms exert a very significant influence on economic processes. They are not as visible as political institutions<sup>9</sup>, they adapt much more slowly than political institutions ... and they don’t exist in the normless world populated by *homo economicus*.

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<sup>7</sup> Indicative of a divine natural order mentality is the assertion of Pastor Dwight Witherspoon in “a sermon to fellow Presbyterians at his Oxford, Miss. church [Dec. 21, 1860] that ... “[w]ere I speaking to abolitionists it would be my duty to defend the institution of slavery as an ordinance of God, to rebuke with all boldness and fidelity the folly and wickedness of their cause.” (cited in Coddington) Abraham Lincoln reflects his appreciation of this nexus between natural order thinking and faith when, in his second inaugural, he notes of the North and the South that “[b]oth read the same Bible, and pray to the same God; and each invokes His aid against the other.” (Lincoln) Each side believed that its understanding of the natural order was consistent with God’s will. Each side believed it was worth spending countless lives on bloody battlefields to defend its understanding of that will.

<sup>8</sup> Blacks who didn’t stay in their “place” were “uppity”.

<sup>9</sup> Girls growing up in the 50s read in the children’s books that “The doctor he and the nurse she ...”, “The executive he and the secretary she ...”, “The professor he and the elementary school teacher she ...”. They learned their sphere, along with the boys, and for most this norm was treated as the natural order of things. Thus, for most, challenging that order was not a consideration. For the few who may have questioned that order and considered such a challenge it was certainly a daunting challenge with a very small perceived probability of success (few examples of success, role models, existed), so most of those few who rejected the “natural order” were unlikely to challenge it because, in the vernacular of economics, the expected present value of such a challenge was extremely small.



This is a problem for economics if it aspires to represent the world as it is, as opposed to the world as it is assumed.

But for a moment, let's assume away this problem of norms that demarcate opportunities based on gender or race or some other observable difference.<sup>10</sup> Let's focus on process norms, the norms of the competition in the race for wealth. As noted at the outset, absent such norms *homo economicus* does not play well with others. And that can be very destructive.

### **C. Norms, the “race for wealth”, and “government”**

Consider some of the roots of the economic crisis that unfolded in 2008.

Thanks to the Fed in 2002, 2003, 2004 money was cheap, and the more you could move the more you could make. The government was focused on expanding homeownership. Mortgage finance companies acted like any red blooded entrepreneur would, they seized the day offering loans to any and all comers, and then they sold those mortgages bundled as securities. This location in the middle of the mortgage transaction was a wonderful place to play in this game.

You could dupe the mortgage recipient into believing she wasn't over leveraging with lines like “Hey, I wouldn't offer you a mortgage you can't afford ... come on, I want to be paid back. How stupid do you think I am? I've been in this business for years (Note: In many cases it was actually months), I don't make losing bets. It's a no lose situation for both of us. If you find you can't pay, we sell the house for a profit. I get paid back, you walk away with some extra cash. It's a no brainer.”<sup>11</sup>

What the mortgage recipient often didn't understand was that you weren't really going to share the risk because you weren't in this for the long haul ... soon after she signed the mortgage paper you

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<sup>10</sup> These “observable, unalterable attributes” are referred to as “indices” by Spence (357). This “observable” standard can lead to some bizarre situations when norms are in place and the typically observable indicators of “place” are unobservable. Consider Lize Venter: The following article that appeared in the July 26, 1983 Syracuse Post Standard, entitled “Found Baby's Future Dictated by Apartheid.” It reads in part:

“JOHANNESBURG, South Africa (AP) - Lize Venter is 4 weeks old and nobody knows who her parents are. In a society where the races are separated by law, that means the government will decide if she's black, white or of mixed race-and set the course of her life.... The decision on her race will determine who can adopt her, where she goes to school, what neighborhood she may live in, who she can marry, whether she can vote, where she can eat-what she can hope for in life.

“This is decreed by the Population Registration Act of 1950, adopted by the governing National Party two years after it took control of the White minority government.”

<sup>11</sup> “Complicated financial stuff was being dreamed up for the sole purpose of lending money to people who could never repay it.” (Lewis, 179)

were out of the transaction. You bundled this mortgage along with other mortgages into a security that you then sold.<sup>12</sup>

But alas, you're selling a security larded with risky mortgages and risk is clearly an issue for the potential security buyer so you "launder"<sup>13</sup> the risk: You, in effect, digitized the mortgages ... dividing them into micro pieces that were then recombined into bundles that homogenize lots of degrees of risk, so the risk seemed a mile wide (broadly spread) and an inch deep (not a problem).<sup>14</sup> But it was a problem, albeit not a transparent one. The security buyer was buying blind.

Imagine taking a family album, digitizing the pictures into pixels, then shuffling the pixels so that every new print has just a few pixels from each of the original pictures. These new prints would have no recognizable information. You'd have no idea what the underlying pictures looked like. And so it was with these mortgage backed securities. But, fortunately for the securities buyers they had the good work of the security rating agencies as a warrant for the quality of the securities. Unfortunately for the security buyers, these rating agencies were working for the security sellers.<sup>15</sup> The rest, as they say, is history.

There's a lot of imagination, energy, creativity ... a lot of good 'ol free market entrepreneurial activity going on here. And the consequence was a disaster that was almost catastrophic.

Most economists didn't see this coming because it all seemed to make sense. The free market was "doing its thing": Creative entrepreneurs were bettering their condition by using their imagination to create opportunities for homeownership, while others did the same by creating financial instruments that spread risk so broadly that no one had to worry. And hardly anyone did ... until it was too late.

What was missing? Norms, ethical norms ... Norms that would have constrained mortgage sellers from using asymmetric information to exploit the hopes and dreams of aspiring homeowners or the consumption addiction of folks that thought they could use their house as a piggy bank<sup>16</sup>. Norms that would have required security sellers to make the risk content of the securities clear so the transaction was transparent. Norms that would have made it incumbent upon ratings agencies to

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<sup>12</sup> "[T]he 'originate and sell' model" (Lewis, 24)

<sup>13</sup> "The whole point of the CDO was to launder a lot of subprime mortgage risk that the firms had been unable to place straightforwardly." (Lewis, 141)

<sup>14</sup> "Morgan Stanley had done as much as any Wall Street firm to persuade the rating agencies to treat consumer loans as they treated corporate ones – as assets whose risks could be dramatically reduced if bundled together." (Lewis, 208) Lewis refers to this as the "illusion of security" based on the perception that the "fates" of these mortgages were "uncorrelated". (Lewis, 74)

<sup>15</sup> "To judge from their behavior, all the ratings agencies worried about was maximizing the number of deals they rated for Wall Street investment banks, and the fees they collected from them." (Lewis, 157)

<sup>16</sup> Obviously there are other stories: Like those who knew what they were doing and figured they could flip the house, but a significant part of the problem was this subprime exploitation.

carefully assess and report the risk built into those securities ... their word being their bond. At every step of this transaction sequence, the actors seemed to be playing the part that economists assumed they would ... acting as *homo economicus*, as amoral beings who were simply doing what needed to be done to maximize their utility, to better their condition. In fact, however, they were not *homo economicus*. These individuals were human beings who, more often than not, understood society's ethical norms and chose to ignore them, and to act unethically in pursuit of their self-interest.

#### **D. Would Adam Smith have predicted the Great Recession?<sup>17</sup> Probably not, but ...**

As I tell my students in my introductory economics textbook<sup>18</sup>: The answer key as to how the world works is not in the back of the book. The value of a good analytical tool kit is not the answers it gives, but rather the questions it encourages us to ask and the tools it offers us to address those questions in a thoughtful, systematic way. So too Adam Smith's work ...<sup>19</sup>

Smith envisioned all of us as being made of the same "coarse clay" (*TMS*, 162). The properties of that clay include the capacity for self-love, or as we refer to it: self-interest ... the desire to better our condition. There is also beneficence ... the warmth of human kindness, and justice ... the capacity to bridle our self-love so that we don't trample upon others in our pursuit of a better condition. It is the balance of these "sentiments" – self-love, beneficence, and justice – that determines the content of our character.

That clay, and thus our character, is initially shaped by the social context into which we are born, for we have a desire for approbation ... we desire to be accepted by our social reference group. This gives that reference group the power to mold us. As children that reference group is generally a small and cohesive and enveloping family, and the norms of that group are taken to be the natural order of things and are inculcated as our "duty". To the degree we buy into and are committed to these norms, we develop the self-command to do our duty.

As we get older, the range of our references grows and competing norms are experienced. We develop a degree of autonomy for we each have the free will to make choices among these competing normative models. Indeed, given our imagination we even have the capacity to contribute our own

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<sup>17</sup> I at least recognized that there was something rotten in the state of Denmark. See my blog entry of Jan. 22, 2008, "Reflections on the Current Economic Conditions": <http://supa.syr.edu/blog/econ/?m=200801>

<sup>18</sup> Evensky (2008)

<sup>19</sup> The analysis of Smith I offer here is laid out in detail in Evensky (2005).

adaptations to the norms of our society, and to advocate for these adaptations. Each of us has a unique biography ... each of our journeys through life is different, so we each emerge as an autonomous individual initially shaped by but ultimately shaping, to different degrees, the institutions of our world.

This dynamic, the socially constructed being developing autonomy and reconstructing society, lies at the heart of Adam Smith's vision of the dynamic of humankind's progress, for he does believe that the course of humankind's history is a story of progress. ... Not an inexorable, uninterrupted story of progress, Smith is keenly aware of the horrors of human history and the failures of once grand societies ... rather a progress strewn with failures but nonetheless ... progress. For Smith, any given society is a natural experiment. It emerges through the intended and unintended consequences of human action and sustains itself to the degree that it solves the challenges of progress more effectively than those challengers that surround it.

Smith envisions humankind's progress as proceeding through four stages, each one more fruitful than the last: Hunting and gathering followed by pasturage then agriculture and finally commercial society. Growing complexity is an inevitable part of this progress, for the increased material well-being that each successive stage offers is based on an expanding market nexus. It is, after all, an increasingly extensive market that makes possible the ever finer division of labor that gives rise to increasing productivity. This growing complexity is characterized by more autonomy of individual action and extended forms property. This combination is fertile ground for destructive behavior of unbridled self-interest, for property is "the grand fund of all dispute ...." (LJA, 208)<sup>20</sup> Here again we face the Hobbesian challenge: How does a liberal society capture the fruits of freedom? For Smith the key to a society's progress lay in its capacity to address the challenge of social cohesion, and for Smith that key to social cohesion is civic ethics.

In Smith's story of humankind's progress, institutional big-G Government emerges and grows as a guarantor of individuals' security. But in Smith's analysis, the real blossoming of humankind's potential, the stage of free individuals and free markets ... a commercial society, requires that much of the policing role of government be taken on not by institutional Government, but by individual citizens in the form of shared civic ethics ... shared norms of self-government. In his analysis of humankind's progress, institutional Government plays an essential instrumental role. It facilitates progress to the degree it develops rules of justice that are fair and effective constraints on self-love. Smith's *Lectures on Jurisprudence* reflect a deep admiration for the British Common Law as a product of intended as well as

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<sup>20</sup> There are two sets of *Lectures on Jurisprudence* from Adam Smith. The earlier of these is referred to as "Report of 1762-3" and the other as "Report dated 1766". Following standard usage I reference the first as LJA and the second as LJB.

unintended consequences of human action that, he believed, had made Great Britain the most mature example of human society to his day.

To the degree that these institutional standards of behavior become accepted as civic duty ... as shared norms ... by individual citizens of society, the policing role of institutional Government can be reduced because ethical citizens are self-governed.<sup>21</sup> In a mature free-market society, the many are good citizens guided by their shared standards of civic ethics, and institutional Government is a community instrument for enforcing those rules on the few who do not willingly choose to play fair, to play by the rules.

Smith's hope for free market society growing ever more mature lay in the dynamics of commerce itself. Growing commerce would, he believed, progressively improve the lot of the least among the working class ... giving those citizens a stake in the society, and thereby building an ever broader base of citizen commitment to society's shared civic values.<sup>22</sup> Indeed, Smith's standard of a good commercial society is the condition of the working class. In *The Wealth of Nations* he writes:

Servants, labourers, and workmen of different kinds, make up the far greater part of every great political society. But what improves the circumstances of the greater part can never be regarded as an inconveniency to the whole. No society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable. It is but equity, besides, that they who feed, clothe, and lodge the whole body of the people, should have such a share of the produce of their own labour as to be themselves tolerably well fed, clothed, and lodged (*WN*, 96).

Smith believed that in a maturing free-market economy the well-being of the working class would be constantly enhanced and the distance between that class and the elite would be constantly diminished. He believed the very dynamic of market system drives this.

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<sup>21</sup> "Smith believes that the British experience reflects the salutary effect of more mature positive law on the character of the citizenry. As he makes the case for Roman civic maturity by contrasting it with Greece, so Smith makes the case for British civic maturity by contrasting it with France. In particular he contrasts the safety of London and Paris, asserting that the necessity of police to insure personal security in these two cities is not proportional to population but rather to the 'nature of the manners of the people' (*LJA*, 332)." (Evensky, 2005, 62)

<sup>22</sup> Clearly, in the opposite case, the more alienated the working class from the ruling principles of their society the more corrosive that alienation. Government would have to expend significant resources to enforce those values on an unwilling working class and this would be a perpetual drain on the society. Such societies, in Smith's analysis, are doomed to stagnation and decline. This is akin to Marx's alienated working class as an "internal contradiction".

In his analysis, the stock of capital grows in the course of a continuous circular flow that expands that stock with each circuit.<sup>23</sup> This growth of capital stock happens faster than labor force growth – so the competition among capitals becomes progressively more intense and the return to capital diminishes ... even as the competition for labor from an ever deepening capital stock drives up wages.<sup>24</sup>

Thus, for Smith, two leading indicators of progress in a free market society are the broadening acceptance and adherence to a shared system of civic ethics, and a diminishing distance between the top and the bottom of society's income distribution. It follows that a growing gap in income distribution is a *prima facie* case for a distortion somewhere in the system ... e.g., a distortion caused by market power enjoyed by those who, not concerned with shared norms, exploit their control over access to capital to their advantage.

This perverse case was not a hypothetical for Smith. Even as he published *The Wealth of Nations* in 1776 he was concerned with, and subsequently became consumed with, the distortions caused by what he referred to as the mercantile interests. "Like an overgrown standing army" (WN, 471)<sup>25</sup> these energetic and imaginative entrepreneurs had used their political influence to manage the flow of trade to their advantage, routing much of it through the one favored artery of trade that served their interests, the colonial trade. As a consequence this favored artery, "artificially swelled beyond its natural dimensions" (WN, 604), was a crisis waiting to happen ... which indeed it did.

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<sup>23</sup> It is in reference to his analysis of these circuits of capital flow that Smith introduces his most famous usage of the "invisible hand" image. (WN, 456) See (Evensky, 2005, 162-3).

<sup>24</sup> "In the course of this progress, distribution becomes more just: With each circuit, as the stock of capital deepens more capital competes for the available labor. As a consequence wages rise and the rate of profit falls. Thus the natural progress of opulence brings workers a better life and in a nation that has 'acquired its full complement of riches ... the ordinary rate of clear profit ... is very small, so that usual market rate of interest which could be afforded out if it, would be so low as to render it impossible for any but the very wealthiest people [among 'the monied interest' (WN, 351)] to live upon the interest of their money' (WN, 113)." (Evensky, 2005, 163)

<sup>25</sup> "This monopoly has so much increased the number of some particular tribes of them, that, like an overgrown standing army, they have become formidable to the government, and upon many occasions intimidate the legislature. The member of parliament who supports every proposal for strengthening this monopoly, is sure to acquire not only the reputation of understanding trade, but great popularity and influence with an order of men whose numbers and wealth render them of great importance. If he opposes them, on the contrary, and still more if he has authority enough to be able to thwart them, neither the most acknowledged probity, nor the highest rank, nor the greatest publick services can protect him from the most infamous abuse and detraction, from personal insults, nor sometimes from real danger, arising from the insolent outrage of furious and disappointed monopolists" (WN, 471).

While not every economic contraction can be accounted for as a crisis brought on by a rupture of an artery that has been engorged by excessive flows of capital,<sup>26</sup> such distortions may help us understand some such crises.

Consider for example the Great Depression or the Great Recession. There is evidence that these crises were preceded by a widening of the income distribution consistent with power advantages: In Tables 195 and 197 of “Income Payments – Annual Changes in Percentage Shares of Total Income Payments in Current Prices (Kuznets) 1919-1938”, we see that the “[u]pper 1 percent[’s]” share of total income payments went from 12.3% in 1920 to 14.5% in 1929, while the “Lower 95 Percent[’s]” share went from 77.9% to 73.9% during the same period. (United States Department of Commerce, 15). Similarly, Diaz-Giménez, et. al. write in “Facts on the Distribution of Earnings, Income and Wealth in the United States: 2007 Update”: “Overall, ... there has been a substantial increase in most measures of inequality since 1998 ....” (Diaz-Giménez, et. al., 3) If Smith had been around in the years leading up to the Great Depression or the Great Recession, he might not have forecast these events, but the skewing of income distribution in the 1920s and in the 2000s would have given him a sense of foreboding, and his analysis would have encouraged us to ask some very instructive questions about market distortions.<sup>27</sup>

I study Adam Smith because his work can inform our modern discourse. I was introduced to Adam Smith in a History of Economic Thought class I took as a Ph. D. student. My teacher in that course was an excellent scholar and a wonderful human being named Jesse Burkhead. When Jesse retired, I had the privilege of succeeding him as the teacher of that course.

### **E. On History of Economic Thought and the value of skeptical reflection ...**

At the opening class of my history of economic thought course for the economics Ph.D. students, I explain to them that my goal is to introduce them to some alternative perspectives on the subject of economics. I tell them that I want to offer them these alternative perspectives as tools for skepticism about what they are learning in their other economics courses.

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<sup>26</sup> For example, Mr. Volcker’s engineered recession of the early 1980s is not such a case.

<sup>27</sup> As one who studies Smith, did I feel this foreboding? I at least recognized that there was something rotten in the state of Denmark. See my blog entry of Jan. 22, 2008, “Reflections on the Current Economic Conditions” at <http://supa.syr.edu/blog/econ/?m=200801>

I then go on ... You are learning economics at a specific point in time. You are learning the economics of “now”. The field has not always been as it is and, if the past is any indication of the future, it will not always be as it is. The history we are about to study is the economic thought of the past, but this past is more than prologue.

The subjects that we struggle to understand today ... human behavior, the dynamics of interpersonal behavior, the origin and impact of institutions as they relate to this interpersonal dynamic ... how humans in an interdependent world make their way as they seek to “better their condition” (*WN*, 341) through their day to day activities in “ordinary business of life” (Marshall, 1) ... these subjects have been the focus of, to name a few of our great predecessors: Adam Smith, David Ricardo, John Stuart Mill, Alfred Marshall, John Maynard Keynes, Milton Friedman.

These subjects have not changed because the basic subject-matter has not changed. Adam Smith lived from 1723 to 1790. He died just over 200 years ago. 200 years is a micro-moment relative to the course of human evolution. We are the same in our nature as we were 200 years ago.

Certainly our technical context is worlds apart. Thanks to human imagination, invention has changed our context dramatically ... but imagination itself is timeless. That imagination which brought us to the technological wonders of the 21<sup>st</sup> century is the same imagination that was central to Smith’s analysis of humans and humankind. It is the same today as it was then, and so too the entire nature of human nature. We are as we were 200 years ago and will be 200 years hence ... made of the same “coarse clay” as Smith described us to be in 1759. We are the same and so too our subject-matter is the same.

But, I’m often asked by my Ph.D. students: Don’t we know more because we have built on the understandings of our predecessors? And, isn’t our analysis much better because it is much more sophisticated?

I respond to the first of these points as follows: The assertion that “we know more because we have built on the understandings of our predecessors” is an empirically testable hypothesis.

We can examine the history of economic thought with a comparative eye on the present, constantly asking ourselves: Have we separated the wheat from the chaff and moved beyond the understandings of the past, or have there been gains and losses in the discourse as it has evolved?

We could assume that we know more and ignore the past, but why be so arrogant when the past is available for exploration. If we find nothing new, we can at least examine how analytical progress proceeded. This alone would be worth the price of admission, for understanding the dynamic



of analytical progress might help us to accelerate it. But, I note, there is always the possibility that there are lost insights to be found in the past.

Good scientists are skeptical; they want to challenge their own ideas. The venue for such challenges, the marketplace of ideas, is greatly diminished if that marketplace is limited to the participants of the “now” discourse. That limitation privileges the “now” norms: We’ve all learned from the same texts and we all read the same journals ... all of which are written based on the norms of “now”. Certainly there are debates about issues in the “now” model, but there is little in the way of fundamental challenges to the premises, the norms, of the extant system of thought.<sup>28</sup>

The articles accepted this year in the leading journals, those “hits” most likely to advance or secure one’s academic standing and position, privilege the “now” assumptions ... for example *homo economicus*. Where will the challenges to such assumptions come from? Think “Adam Smith” ...

Good science requires thoughtful skepticism. One ready source of divergent thinking that can nurture such skepticism is the work of our predecessors who studied and wrote about the same subject-matter. When, in 1936, Keynes wrote that the “now” economic thinking of his day needed to escape from “habitual modes of thought and expression”, he believed that the problem of his 1936 “now” discourse derived from a lack of “generality of premises” (Keynes, 1964, xiii). Keynes had seen this show before.

In his “Essay” on Malthus, Keynes quotes an exchange of letters between Ricardo and Malthus. In one quotation we hear Malthus criticizing Ricardo’s premises as follows: “A writer may, to be sure, make any hypothesis he pleases; but if he supposes what is not at all true practically, he precludes himself from drawing any practical inferences from his hypothesis.” (Keynes, 1956, 33) As Keynes sees it, through Malthus’ eyes, Ricardo’s assumptions abstract from the complexity of the real world ... and yet Ricardo prevailed.<sup>29</sup> Keynes continues: “One cannot rise from a perusal of this correspondence without a feeling that the almost total obliteration of Malthus’s line of approach and the complete domination of Ricardo’s for a period of a hundred years has been a disaster to the progress of

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<sup>28</sup> In the minutes of the November 21, 1890 meeting at which the British Economic Association and its journal, the *Economic Journal*, were established, Leonard Courtney is cited as asserting that the editors of this new journal must “exercise a wholesome influence” if the journal is to be credible. “There were some things which must be taken to be finally fixed ... a mathematical journal would [for example] exclude contributions which affected to square the circle.” But, the minutes continue, the words “exercise a wholesome influence” “were not quite consistent with the catholicity which Professor Marshall had rightly demanded.” Marshall was wary of a privileged orthodoxy ... of endogenous “now” thinking. (Edgeworth, 9-10)

<sup>29</sup> “From the time of Say and Ricardo the classical economists have taught that supply creates its own demand. ... The doctrine is never stated to-day in this crude form. Nevertheless it still underlies the whole classical theory, which would collapse without it.” (Keynes, 1964, 18, 19)

economics.” (Keynes, 1956, 33) Keynes looks to the past, to Malthus, for divergent thinking and to see his way into the future.

We should invite those from the past to join the discourse by exposing graduate students to this rich source of divergent perspectives ... of constructive skepticism. We should invite such challenges from our predecessors, not neglect them based on the assumption that we know all they did about these human issues and more. If Shakespeare still speaks to us about our humanity and the human condition, it is because our nature and our condition are the same as when he explored those subjects in his plays and poems over 400 years ago. So too, Adam Smith can still speak to us about our humanity and the human condition, because our nature and our condition are the same as when he explored these subjects in his works over 200 years ago.

As for the second question my Ph.D. students ask: Isn't our analysis better because it is more sophisticated? I point out that growing technical complexity is often treated as a proxy for increased sophistication. Part of our sense of methodological advance derives from the mathematization of the field. In the “best” journals the discourse looks like physics, complex equations laid out with crisp precision.<sup>30</sup> Math is the medium of the economics conversation ... it is the language of “now”. If you don't speak the language, you're not going to be a part of the conversation.

Precision is good. But is that language up to the fullness of subject? Is math sufficient to capture all that we wish to understand and represent about the human condition and the human prospect? The strength of math is its rigor. Does it have any drawbacks?<sup>31</sup>

Every language, by its nature, casts light and shadows on the subject to which it is applied. Is math a perfect language for all expression? Clearly not. If it was we would have long since started to

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<sup>30</sup> It should be no surprise that Grove and Wu find that one of the two most significant predictors of incoming economics Ph.D. student's “completion and research productivity 17 years later” is the incoming student's Quantitative GRE score. (Grove and Wu, 511) See also (Dutkowsky, et. al.)

<sup>31</sup> Joseph Schumpeter asserts in his *History of Economic Analysis* (1954) that, in contrast to the “history of Systems of Political Economy or ... [the] history of Economic Thought” (Schumpeter, 38), we can say with confidence that the history of economic analysis is a story of progress because our analytical “box of tools” (Schumpeter, 41) is better than that which was used in the past. He writes that our “new apparatus [primarily mathematical modeling] poses and solves problems for which the older authors could hardly have found answers” (Schumpeter, 39).

Maurice Dobb writes in response:

A mathematical ‘model’ can be (and should be, inter alia) examined in its purely formal aspect, as a consistent structure. At the same time, qua economic theory, its very structure is relevant to the statement it is making about reality ... In choosing one structure in preference to another, the model-builder is not only providing a scaffolding or framework within which human thought can operate, but is laying emphasis upon certain factors and relationships and excluding others or casting them into the shadows; and in doing so he can be judged to be ... illuminating some corners or facets of reality, or certain situations that recur, at the same time as he is obscuring, or totally concealing others (Dobb, 7).

translate Shakespeare into its mathematical equivalent, eliminating all those superfluous flourishes as “full of sound and fury, Signifying nothing” (Shakespeare, *Macbeth*, 2005, 156).

Adam Smith does not use math. Does that mean that his analysis of the human condition and the human prospect is less insightful, less valuable, less sophisticated? There’s a simple way to find out: Read him.

At this point one of my Ph.D. students would invariably ask, having just arrived from econometrics: But clearly our method is better when it comes to empirical testing of the models ... right? We use incredibly sophisticated techniques, huge data sets, and high powered computers to determine from the numeric data whether the evidence supports or rejects a hypothesis. This is obviously “better” ... Right?

Is it? Is the analysis of numeric data sufficient to capture and represent the “invisible chains” (Smith, 1980, 45), the invisible connecting principles, that underlie the visible human actions and human interactions that we seek to understand?<sup>32</sup> Certainly the modern empirical methods have borne much fruit, but are they sufficiently fruitful to understand the complexities of humankind in a historical, multicultural, multi-institutional world? Maybe. But why assume it’s so. Why not compare the fruitfulness of our modern methods to the empirical methods used by our predecessors. Why assume computers can capture all complexities of the human condition more richly than the observant human mind.

Adam Smith did not have access to econometric techniques or a computer. Would he have abandoned his own method if he had? Would he have rejected the modern tools if they had been available? Or, would he have found usefulness in both? If we examine Smith’s empirical method we might find it has strengths that complement the modern methods. His database was rich, woven narrative history. His method was to cull from the narratives of history, from stories of contemporaneous societies (nascent anthropology), from participant observation (nascent sociology), the invisible connecting principles that guide human action and humankind’s evolution. His method was very persuasive in his day. Shall we assume that his approach is antiquated, lacking sophistication, and

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<sup>32</sup> “Philosophy, by representing the invisible chains which bind together all these disjointed objects, endeavours to introduce order into this chaos of jarring and discordant appearances, to allay the tumult of the imagination, and to restore it, when it surveys the great revolutions of the universe, to that tone of tranquility and composure, which is both most agreeable in itself, and most suitable to its nature. Philosophy, therefore, may be regarded as one of those arts which addresses themselves to the imagination....” (Smith, 1980, 45-6)

thus ignore it? Why not examine how he made his case.<sup>33</sup> We might learn something that improves our own work. At worst we can establish that our modern methods are at least as comprehensive and are more powerful, not by assumption, but by comparison.

If modern economic theory has one potential weakness that an exploration of the past can easily address, that is the character of the assumptions upon which it is constructed. In my introductory textbook as I develop the role of assumptions in model building, having explained the distinction between strong and weak assumptions and the process of relaxing assumptions, I note that in an odd twist of language it is true that models are only as strong as their assumptions are weak. I constantly remind my students to keep their eye on the assumptions for they set the foundation on which we are building.

Given the assumptions, the construction begins. In the modern discourse the assumptions are indeed “given”, the construction of the superstructure of a model is where the action is. Identifying any weakness in the superstructure is an opportunity for personal distinction, for there is notoriety in such a “victory”. It is this competition for distinction that leads to constant improvement in the superstructure. There is no such a competition regarding the assumptions.

The assumptions on which my Ph.D. students build as they reconstruct the superstructure of modern economic theory in order to master its intricacies are not examined or challenged at all. They reflect the shared belief system, a shared norm, the “natural order” thinking of the “now”: Humans maximize utility ... assume *homo economicus* ... now on to model building.

Keynes writes in his “Preface” to the *General Theory*:

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<sup>33</sup> The historical analysis presented in Book III of the *WN* is the fulcrum of Smith’s argument in the *WN*: “*WN* Books I and II lay out the general principles of natural progress. *WN* Book III presents a narrative history of the particular unnatural process that led to progress in Europe.

“All narrative history is particular. Every story is unique, driven by the peculiarities of chance, circumstance, and intended and unintended consequences of individuals’ choices at the time and place covered by the narrative. Smith’s purpose in moving from theoretical to narrative history is to demonstrate that his general principles regarding the natural progress of opulence are applicable to particular cases, even those that seem on the face of it to be entirely inconsistent with those principles, if one adapts those general principles to the particular conditions prevailing in that time and place.

“In *WN* Book III, Smith traces the evolution of laws and institutions in feudal Europe that led to unnatural progress. In this story, distorting laws and institutions caused the towns to progress before the country, but those laws and institutions ultimately evolved such that the country followed the towns in making progress. This progress is an inversion of the natural course but it is progress, and the principles that give rise to this progress are those general principles that always lie behind progress in Smith’s moral philosophy: Laws and institutions maturing to bring justice, independence, and security. Smith’s goal in *WN* Book III is to persuade his reader of the power of the analysis he has developed in *WN* Books I and II” (Evensky, 2005, 168)

[I]f orthodox economics is at fault, the error is to be found not in the superstructure, which has been erected with great care for logical consistency, but in the lack of clearness and of generality of the premisses. (Keynes, 1964, v)

Whether or not one agrees with the argument Keynes makes in his *General Theory*, isn't he right to suggest that we should examine our assumptions? Keynes learned the importance of doing so from Malthus. Keynes appreciated that there are lessons to be learned from the past.

I've gone on and on about my opening conversation with my Ph.D. students in the History of Economic Thought course ... but, fact is, I don't get to teach that History of Thought course anymore. ... I don't get to encourage skepticism in those who seek to be economists. ... I don't get to tell them about a time when human nature was not defined by *homo economicus* so they can decide for themselves if this is a weak or a strong assumption ...

When I joined the faculty at Syracuse over 25 year ago the History of Economic Thought course was a core requirement of the Ph.D. program, but my Department – as have almost all economics departments in the United States – deemed the opportunity cost of a History of Thought class, that cost being a real, relevant, and up-to-date, “now” economics course like an additional econometrics class, to be too dear a price to pay ... so the History of Economic Thought requirement, and with it the course, died in the spring of 2002.

I don't get to teach History of Economic Thought to Ph.D. students anymore. I think that's a shame ... not just for me, not just for my students, but for the future of the field. Ph.D. students today spend five or so years in courses and dissertation work that reflect the “now” system of thought, followed by six years of publication in pursuit of tenure that is only successful if one participates on the “now” terms. Eleven or so years of systematic “now” thinking in a “Life Among the Econ” (Leijonhufvud) will almost surely socialize one to think of “now” norms of analysis as the natural order of things. How do we escape this “now” normative constraint? How do we empower our students to consider alternative assumptions, assumptions such as: Norms matter.<sup>34</sup>

Keynes' opening words in the “Preface” to his *General Theory* are:

This book is chiefly addressed to my fellow economists. I hope that it will be intelligible to others. But its main purpose is to deal with difficult questions of theory, and only in the

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<sup>34</sup> What an irony that the analytical norm for human nature, *homo economicus*, represents a non-normative being.

second place with the applications of this theory to practice. For if orthodox economics is at fault, the error is to be found not in the superstructure, which has been erected with great care for logical consistency, but in a lack of clearness and of generality in the premisses.  
(Keynes, 1964, v)

It is in this spirit that I write to my fellow economists: Open up a window of constructive skepticism in the minds of your students. Introduce them to ideas of the brilliant predecessors in their field who have struggled with the same questions your students have come to school to explore. Teach them the history of economic thought.

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