Introduction

The last hundred years have seen dramatic experiments in economic policy: the adoption of central banking in the United States and elsewhere; command economies during the First World War; communist central planning in the Soviet Union, Eastern Europe, and China; fascism in Mussolini's Italy; National Socialism in Hitler's Germany; the New Deal in Roosevelt's United States; the Bretton Woods international monetary system and the adoption of Keynesian macroeconomic policies after the Second World War; major nationalizations in postwar Great Britain; the reemergence of free-market principles in postwar Germany; Soviet-style Five-Year Plans in India; the final abandonment of gold in favor of a system of fluctuating exchange rates among unanchored government fiat monies; regulation and deregulation and reregulation around the globe; the collapse and repudiation of communism in Russia and Eastern Europe; market-led growth policies in the East Asian "tigers" and then in China and India; "neoliberal" policies promoting the globalization of economic activities. In recent years an unhappy sequence – a worldwide housing credit bubble, followed by the collapse of mammoth financial institutions, followed by expensive government bailouts and takeovers, followed by record-breaking budget deficits and fiscal crises – has returned the issues of monetary policy, regulation, nationalization, and fiscal policy to the front of the economic policy stage across the developed world.

Behind these movements and countermovements in economic policy lies an ongoing and often dramatic clash of economic ideas. The chapters that follow trace the connections running from historical events to debates among economists, and from economic ideas to major economic policy experiments. They will dig selectively into the history of economic doctrines – back to Adam Smith when necessary – to understand how the ideas originated and developed over time to take the forms that they did.

Economists are notorious for the frequency of their policy disagreements. "If all the economists were laid end to end, they still would not reach a conclusion," goes one version of a witticism sometimes attributed (without evidence) to George Bernard Shaw. Because this book focuses on disagreements, a disclaimer is in order. The immediately policy-relevant parts of economic thought are not the whole of economic thought, and the other parts involve somewhat less disputation and more collaboration. Because the noneconomist hears much less about economists' policy-detached work, which focuses mainly on technical issues in dissecting and understanding observed economic phenomena, it is easy to form the false impression that disagreements over policy occupy more of the typical professional economist's efforts than they do. The economist George Stigler once rightly noted:

> The proposition that the economist is not addicted to taking frequent and disputatious policy positions will appear incredible to most noneconomists, and implausible to many economists. The reason, I believe, for this opinion is that in talking to a noneconomist, there is hardly anything in economics except policy for the economist to talk about. The layman would find [the economist's technical work] … quite incomprehensible. The typical article in a professional journal is unrelated to public policy – and often apparently unrelated to this world.[1]

In this book the focus is on economic theory and empirical work that *are* related to public policy, though much of the literature was written for other economists rather than for the layman. The chapters look into the substance and impact of the disputed positions. How have economists thought – and argued – about the great economic policy issues? How have they sometimes influenced policy and institutional design?

Given the book's focus on the policy-relevant parts of economics, it is natural to proceed policy issue by policy issue, framing each issue with an important historical debate or policy experiment. This approach contrasts with encyclopedic histories of economic thought that proceed thinker by thinker in chronological order, beginning with the ancients or the Scholastics or the mercantilists. Within each chapter, when necessary to explain how economists came to think as they did about the issue at hand, there will be flashbacks to the theoretical developments and debates of previous centuries. If a defense of this nonlinear approach is needed, one has been offered by the filmmaker Quentin Tarantino, who told a British interviewer: "When

[1] George Stigler, "The Economist as Preacher," in Kurt R. Leube and Thomas Gale Moore, eds., *The Essence of Stigler* (Stanford, CA: Hoover Institution Press, 1986), p. 305.

I made *Reservoir Dogs* and *Pulp Fiction* nonlinear, I was not just doing it to show what a clever boy I was. Those stories were better served dramatically to be done the way I did them."[2] Sometimes the most vivid way to tell the story of an intellectual debate similarly involves flashbacks. Thus the reader should not think of the chapters that follow as chronologically scrambled or filled with detours. Think of them as *Tarantinoesque* – only with more polite language and slightly less bloodshed.

AN OVERVIEW OF THE COMING CHAPTERS

The episodes and debates examined here were chosen for their historical importance and for the light they shed on how the rival positions have evolved that are held in today's major disagreements over economic policy. Policy-relevant theorizing rarely arises in a self-contained ivory tower, or purely in response to other theories. Economists read the newspapers. Theory develops to grapple with the issues and events of the day. This is why the chapters use the history of the last one hundred years to frame the economic policy debates.

Chapter 1 sets the stage, describing economic thought on the verge of the First World War. It introduces two figures who will reappear throughout the book, the English economist John Maynard Keynes and the Austrian economist Friedrich A. Hayek. Each subsequent chapter begins with a major economic problem that triggered or revived debate among economists, or a policy experiment to which economists contributed. Chapter 2 examines the issue of central economic planning versus the market price system, starkly posed by the Bolshevik Revolution of 1917 and developed in the crucial "socialist calculation debate." Chapter 3 examines pre-Keynesian business cycle theory, in particular the theory developed by Hayek and other Austrian economists, in light of the boom of the Roaring Twenties that ended in the crash of 1929. The New Deal policy experiment of the early 1930s followed in the United States, and Chapter 4 traces its origins to the institutionalist school of economics, especially as represented by the economist Rexford G. Tugwell. The Great Depression dragged on. Chapter 5 relates how Keynes's 1936 book *The General Theory of Employment, Interest, and Money* fomented a revolution in economic thinking about the causes of ups and downs in the economy as a whole.

[2] Quentin Tarantino, "Interview with Quentin Tarantino," *Guardian*, 5 January 1998,http://film.guardian.co.uk/Guardian_NFT/interview/0,,78433,00.html.

Chapter 6 focuses on a very different book, Hayek's *Road to Serfdom* of 1944, which grew out of his concern about the dangers of continuing the central planning policies pursued during the Second World War. In the immediate postwar period, very different economic policy paths were taken by different nations. Chapter 7 chronicles the nationalizations undertaken by the Labour Party in Great Britain and traces those policies to the socialist ideas that the Fabian Society had tirelessly developed and advocated in the previous six decades. Chapter 8 tells the story of a society with a strongly contrasting policy outlook, the Mont Pelerin Society, which Hayek founded after the war to rally the intellectual opponents of socialism. Chapters 9 and 10 offer case studies of two countries that headed in very different directions and had very different results over the next thirty years. With important input from some Mont Pelerin Society economists, Germany moved in a market-friendly direction and prospered. With important input from Fabian thinkers, India adopted nationalization and quasi-Soviet Five-Year Plans and did not prosper.

The next two chapters examine postwar developments in monetary regimes and policies. Chapter 11 tells the story of the 1944 Bretton Woods conference, how and why Keynes and other economists there hashed out an international monetary system that reduced the role of gold and allowed greater scope for discretionary national monetary policies. The Bretton Woods system collapsed in 1971, for reasons that economists have debated. Its collapse coincided with the onset of a period of high inflation that, Chapter 12 recounts, served as the seedbed for the revival and development of "monetarist" ideas by Milton Friedman and others, who challenged the dominance of Keynesian thinking. Chapter 13 notes the growth of government in the postwar era and contrasts two leading economic theories that see the growth of government through very different lenses: the optimistic-about-government theory of public goods and the cynical-about-government theory of public choice. The growth of international trade in the postwar era frames Chapter 14's discussion of the long-running debate between free traders and protectionists. Chapter 15 examines the clash between Keynesian and "new classical" economists over the benefits and costs of government budget deficits and debt. The debate over deficits and debt has naturally reemerged with the sovereign debt crises of Greece and Ireland in 2010, followed by Portugal in 2011 with Italy and Spain in the wings, and the growing indebtedness of other national governments including those of the United States and the United Kingdom.

DO ECONOMIC IDEAS HAVE CONSEQUENCES?

Does the clash of ideas among economists really matter for practical policy making? Do economic ideas have consequences? Economists have clashed over that issue, too. Both Keynes and Hayek thought that the impact of economic ideas on public policy was profound. In his essay "The Intellectuals and Socialism" Hayek wrote:

> [T]he views of the intellectuals influence the politics of tomorrow.... What to the contemporary observer appears as the battle of conflicting interests has indeed often been decided long before in a clash of ideas confined to narrow circles.[3]

Keynes declared, in a passage from his 1936 book *The General Theory of Employment, Interest and Money* that academic economists love to quote (for obvious reasons):

> The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back.[4]

Other economists have disputed the hypothesis advanced by Hayek and Keynes. The great Italian economist Vilfredo Pareto offered a diametrically opposed view in his book *The Mind and Society* (1935). In Pareto's view, the politically dominant interests in a society, calculating what best serves their well-being given the sociopolitical environment, determine both the economic policies that its government chooses and the economic theories that its mainstream academicians adopt. Academic theories are mere window dressing with no impact on the policies chosen.

Pareto summarized his view using the example of international trade policy. When the state of elite opinion, "a psychic state that is in great part the product of individual interests, economic, political, and social, and of the circumstances under which people live," turns toward protectionism, Pareto argued, a country's trade policy will eventually change toward protectionism. At the same time, "modifications in [trade theory] will be

[3] F. A. Hayek, "The Intellectuals and Socialism," in *Studies in Philosophy, Politics and Economics* (New York: Simon & Schuster, 1969), p. 179. Hence this book's title.

[4] John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (London: Macmillan, 1936), p. 383.

observable and new theories favorable to protection will come into vogue." Thus a "superficial observer may think that [trade policy] has changed because [trade theory] has changed," when actually both have changed with interests and circumstances. That theorists influence policy makers is an illusion: "Theoretical discussions … are not, therefore, very serviceable directly for modifying" policy.[5]

The University of Chicago economist George Stigler took a similarly cynical view. In his well-known essay "The Economist as Preacher" he urged his fellow economists to give up the fond hope that by preaching the merits of economic efficiency to policy makers they could convince them to mend their inefficient ways. In Stigler's view "the assumption that public policy has often been inefficient because it was based on mistaken views has little to commend it," because it cannot explain why policies like tariffs persist for decades despite knowledge of their effects. Instead the economist should assume that politicians are pursuing their own goals, distinct from overall prosperity, and that tariffs represent "purposeful action" that achieves the politician's goals with "tolerable efficiency." Namely, "Tariffs were redistributing income to groups with substantial political power, not simply expressing the deficient public understanding" of the argument that free trade promotes overall prosperity.[6] That Stigler bothered to preach this message to his fellow economists, who by the same logic must be considered self-interested pursuers of their own goals when they persist in their preaching ways, is something of a paradox.

In response to Keynes's previously quoted statement about the influence of the "academic scribbler," a follower of Pareto commented:

> [T]he politician has a vast choice as to the scribbling, since there is almost no hypothesis that has not been expounded at some time by a so-called economist. Hence, it remains true that the politician, not the writer, is the active factor which determines the trend.[7]

Some cases discussed in the chapters that follow seem to fit Pareto's view, especially cases in which the theoretical rationale for a policy was provided after the fact. Politicians embraced "Keynesian" deficit spending to combat the Great Depression well before interpretations of Keynes's *General Theory* became available to motivate such policies. (Similar ideas had long been

[5] Vilfredo Pareto, *The Mind and Society*, vol. 1, ed. Arthur Livingston, trans. Andrew Bongiorno and Arthur Livingston (New York: Harcourt Brace, 1935), p. 168.
[6] George Stigler, *Essence of Stigler*, pp. 308–9.
[7] Otto von Mering, "Some Problems of Methodology in Economic Thought," *American Economic Review* 34 (March 1944, Part I), p. 97.

available, but few respected economists had endorsed them.) Other important cases fit better the view of Keynes and Hayek that academic ideas have had important policy consequences, such as the repeal of the British Corn Law tariff in 1846 (discussed in Chapter 14) and the formulation of the first New Deal programs of 1933 (Chapter 4).[8]

THE STRUCTURE OF INTELLECTUAL PRODUCTION

Commercial forests produce trees, which go to sawmills to be turned into lumber, which factories then embody in furniture for ultimate consumers. Hayek's and Keynes's remarks suggest a similar structure to intellectual production. High-level economic researchers produce abstract ideas, which applied economic researchers turn into less abstract policy ideas, which journalists and intellectuals then embody in mass-market books, op-ed pieces, and radio and television commentary for the consumption of policy makers and the public. James M. Buchanan and Richard E. Wagner have described the spread of Keynesian economics in just this way: "The American acceptance of Keynesian ideas proceeded step by step from the Harvard economists, to economists in general, to the journalists, and, finally, to the politicians in power."[9]

At the earliest stage of intellectual production, academic economists seeking to advance their understanding of the world develop ideas that (they hope) will be found useful and novel by other researchers. They distribute their findings through articles in scholarly journals and monographs from university presses. Examples of such economics-for-other-economists discussed in later chapters include Keynes's *The General Theory of Employment, Interest, and Money*, Hayek's *The Pure Theory of Capital*, and Milton Friedman's *A Theory of the Consumption Function*. At the next stage, in applied research, academic and think-tank economists seek to develop the ideas further, particularly by confronting them with historical and statistical evidence, in ways that (they hope) will be useful and interesting to journalists and economics instructors. They publish books for intelligent laymen, textbooks, and reports. Examples include Keynes's *Essays in Persuasion*, Hayek's *The Road to Serfdom*, and Friedman's *Capitalism and Freedom*.

8 For a critical take on intellectuals and the impact of their ideas see Thomas Sowell, *Intellectuals and Society* (New York: Basic Books, 2010).

9 James M. Buchanan and Richard E. Wagner, *Democracy in Deficit* (San Diego: Academic Press, 1977), p. 6. The most important economist to apply and popularize Keynesian ideas at Harvard during the postwar period was Alvin Hansen, as discussed in Chapter 15.

At the third stage (the divisions here are of course somewhat arbitrary), journalists and sometimes economists themselves sort through and repackage applied research to provide ideas to policy makers and the general public. They lecture to college students, publish newspaper and magazine columns, write blogs, and appear on TV and radio talk shows. The Nobel laureate economists Friedman and Paul Samuelson wrote regular columns for *Newsweek* magazine. Thomas Sowell, a former student of Friedman, writes a widely syndicated column. Paul Krugman, a former student of Samuelson, writes a column and a blog for the *New York Times*. (Of course, neither Sowell nor Krugman confines the topics of his columns to economics.) The economist John Kenneth Galbraith wrote best-selling books and hosted a PBS series, *The Age of Uncertainty*. Friedman responded with his own PBS series, *Free to Choose*.

At the end-user stage of the production and distribution of economic policy ideas comes real-world political application. If we arrange the stages from top to bottom, with ideas moving downward from the theoretical heights (think "ivory tower"), politics becomes the lowest stage, which some may think appropriate. The real point of picturing intellectual activity this way, though, is to give greater concreteness to the view that to understand economic policy change one needs to understand the preceding developments in economic ideas from pure theory on down.

GOVERNMENTS VERSUS MARKETS

Economic policy ideas clash when their advocates have different views about the role government should play in the economy. As the narrator of the 2002 PBS documentary series *The Commanding Heights* intoned (in his authoritative narrator's voice), the twentieth century witnessed

> a century-long battle as to which would control the commanding heights of the world's economies – governments or markets; the story of intellectual combat over which economic system would truly benefit mankind.... [10]

Here the "commanding heights" of an economy – a phrase due to the Russian revolutionary Vladimir Lenin – basically means the institutions that steer the economy by deciding where investment funds go. Government control over the commanding heights is seen in state direction of the major banks and industries (formal state ownership is not necessary if state

[10] *The Commanding Heights Episode One: The Battle of Ideas*, video transcript, http://www.pbs.org/wgbh/commandingheights/shared/minitext/tr_show01.html.

regulation is pervasive enough), dominance of the bond market by government issues, a limited or nonexistent stock exchange for shares in privately owned firms, and possibly a central economic planning board.

Are competitive markets, guided by impersonal forces of profit and loss, better than government command-and-control for directing investment toward the greatest prosperity? The key insight of economics as a discipline – its greatest contribution to understanding the social world and to avoiding harmful policies – is that, under the right conditions, an economic order arises without central design that effectively serves the ends of its participants. In Adam Smith's analysis and famous phrase, investors are "led by an invisible hand" that aligns their private pursuit of profits with (what is no part of their intention) the greatest contribution to the economy's overall prosperity. Chapter 8 directly examines this Smithian idea in detail, while Chapter 13 considers modern challenges to it. But debates over the relative reliability of markets and governments for steering the economy recur in every chapter of the book.

It should be noted that when economists speak of "which economic system would truly benefit mankind," their emphasis is normally on satisfying human preferences as they currently exist, not on morally reforming mankind. In this way they can focus on the cause-and-effect or if-then questions that their economic training equips them to address, and finesse questions of moral philosophy. An economist who says, "If the government imposes and enforces an excise tax on whiskey, then it will reduce the volume of whiskey sold," is advancing a value-neutral or positive proposition. It is as true for the listener who favors allowing whiskey buyers and sellers to satisfy their preferences as it is for the listener who wants to reduce whiskey sales through tax policy when moral reformation proves ineffective.

The ideal of value-freedom (sometimes known by the German term *wertfreiheit*) has a great deal to recommend it in pure economic research. Policy advice, by contrast, can hardly avoid embodying value-laden or normative propositions. A policy commentator whose advice rests on the proposition that "the government *should not* interfere with the satisfaction of consumer preferences as they currently exist" or "a higher average real income in society is better than a lower one" is mixing in a normative proposition – whether controversial or not – that lies outside positive economics. Economists have often left the normative propositions underlying their policy advice implicit. The critic of a policy prescription may reject either the normative presuppositions or the positive analysis that goes into it (or both). For the sake of clarity it is helpful to identify which it is.

Greater preference-satisfaction is reflected in the aspects of life that people care about. For most people these aspects can be judged by measurable indicators like better nutrition, longer life expectancy, more leisure, greater material comfort, a wider variety of enjoyments, and cultural and environmental amenities. Taking *prosperity* as a blanket term for the abundance of means by which individuals can satisfy their preferences, and assuming that most people are concerned to have greater prosperity rather than less, the key question for an economic analysis that speaks to the concerns of most people is, Which economic system – government or market control of the commanding heights – delivers more prosperity? The answer to this question depends on the underlying analytical questions: How and why does each system perform the way it does? Economists who favor free markets with minimal government interference tend to frame the choice as an up-or-down vote on government control. Economists who favor a larger role for government tend to frame the question as one of finding the best mix (or balance) of market and government control.

SOCIALISM VERSUS CAPITALISM

A system of government control over the commanding heights of the economy, over the financial system and major industries, is more simply called *socialism*. There are at least as many different types of socialism, however, as there are different techniques of government control over the commanding heights. The alternative of leaving finance and production in private hands subject to the guidance of free market forces – competition, profit and loss, supply and demand, the price system – is more simply called *capitalism*. This term is equally fraught with complications. "*Free-market* capitalism" or simply "a free economy" is a clearer way to designate the antithesis of socialism, because phrases like "crony capitalism" and "state capitalism" are often used to refer to an industrial economy molded by government direction rather than guided by free market forces.

Jeffrey Sachs, a Columbia University economist well known for his efforts to persuade the governments of rich nations to give more aid to the governments of poor nations, has summarized the outcome of the twentieth-century battles over economic policy as follows:

> Part of what happened is a capitalist revolution at the end of the 20th century. The market economy, the capitalist system, became the only model for the vast majority of the world.[11]

[11] Ibid.