Chapter 8

What Is Economics?

In Chapter 3, we began to explain how a system of high-quality schools would emerge if we relied on capitalism rather than the public school monopoly. To carry the analysis further requires a deeper understanding of how capitalism operates, which in turn requires some understanding of economics.

Economics is so frequently misrepresented and misunderstood that it is little wonder many educators oppose its application to their field. This chapter provides the reader with an understanding of the principal tools and concepts of economics, setting the stage for a more complete explanation, in Chapter 9, of the failure of government schools and how a market-based school system would work.

Although the authors have tried to keep this discussion succinct and nontechnical, the subject matter is complicated and sometimes counterintuitive. This chapter is written primarily for liberal critics of market-based school reform who object to applying economic tools to education. Readers who have some training in economics may choose to skip it as unnecessary. Other readers may also wish to go directly to Chapter 9 and return here only if the application of economics to education in the later chapters raises questions not answered there.

ATTACKS ON ECONOMICS

According to Robert Kuttner, an author and columnist for *BusinessWeek,* "much of the economics profession . . . has reverted to a new fundamentalism cherishing the virtues of markets."[1] *Chicago Tribune* columnist Eric Zorn thinks market advocates live in a "world of make-believe."[2]

Harvey Cox, a Harvard divinity professor, claims economics is a theology devoted to worshiping markets, a charge repeated in a recent book by an economist.[3] William Greider claims "Many intelligent people have come to worship these market principles, like a spiritual code that will resolve all the larger questions for us, social and moral and otherwise, so long as no one interferes with its authority."[4]

Educators have been especially critical of economics and markets, perhaps because economists are extremely rare in schools of education. Educators "look at economists as dangerous people who don't know schools," says Martin Carnoy, a Stanford University economist.[5] Education professors Bruce Fuller and Richard Elmore talk disparagingly of the "magic of markets" and describe supporters of school choice as "proponents of idealized markets" who view parents and youths as "blank slates."[6] John Coons, a law professor who favors school choice, nevertheless talks of the application of economics to education as "a parlor

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[1]Robert Kuttner, *Everything for Sale* (Chicago: University of Chicago Press, 1996), 3–4.

[2]Eric Zorn, "School Voucher Fans See Only Rewards—Not the Risks," *Chicago Tribune,* 27 July 1999.

[3]Harvey Cox, "The Market as God," *The Atlantic Monthly* 283, no. 3 (March 1999): 18–23.

Robert H. Nelson, *Economics as Religion: From Samuelson to Chicago and Beyond* (University Park: Pennsylvania State University Press, 2001).

[4]William Greider, *One World, Ready or Not: The Manic Logic of Global Capitalism* (New York: Simon & Schuster, 1997), 473.

[5]Quoted in Bess Keller, "Economic Growth," *Education Week,* 25 October 2000, 44.

[6]Bruce Fuller and Richard F. Elmore, *Who Chooses? Who Loses?* (New York: Teachers College, Columbia University, 1996), 9, 23.

game" by economists blinded by market "idolatry."[7] John Witte, a leading authority on the Milwaukee school-choice program, accuses proponents of market-based reforms of having a "blind faith in competition as the salvation of education in our cities."[8]

Many educators think economics is inseparable from ideology. Paul Hill and Mary Beth Celio, in *Fixing Urban Schools,* say "people who advance extrinsic theories such as contracting and vouchers are typically not educators but political and economic analysts accustomed to thinking about systems of pressures and incentives. These differences are ultimately ideological and cultural."[9]

WHY PEOPLE FEAR ECONOMICS

Many people fear economics because they fear capitalism—a concern we have tried to put to rest—and don't understand what economists do. "It is a fact painful to record," writes George Stigler, "that the level of economic literacy has not risen noticeably in the twentieth century."[10] It does not help that economists often disagree among themselves, a tendency that is much exaggerated, but one that adds to a generally negative stereotype of the professional economist.[11]

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[7]John E. Coons, "Free Market, Fair Market," in *A Choice for Our Children: Curing the Crisis in America's Schools,* ed. Alan Bonsteel and Carlos A. Bonulla (San Francisco: ICS Press, 1997), 178–79.

[8]John F. Witte, *The Market Approach to Education: An Analysis of America's First Voucher Program* (Princeton: Princeton University Press, 2000), 5.

[9]Paul T. Hill and Mary Beth Celio, *Fixing Urban Schools* (Washington, DC: Brookings Institution Press, 1998), 36. Similar opinions appear in Gerald W. Bracey, *The War against America's Public Schools* (Boston: Allyn & Bacon, 2002), and Kenneth J. Saltman, *Collateral Damage: Corporatizing Public Schools—a Threat to Democracy* (Lanham, Md.: Rowman & Littlefield Publishers, Inc., 2000).

[10]George J. Stigler, "The Intellectual and the Market Place," Occasional Paper #1, Institute for Economic Affairs, 1963 (London); address by Stigler to the student body of Carlton College, Northfield, Minn., November 1962, p. 11.

[11]See Richard M. Alston, J. R. Kearl, and Michael B. Vaughn, "Is There Consensus among Economists in the 1990s?" *American Economic Review*, May 1992, 203–9.

Much of the blame rests on how the popular press covers economics. An investigation by the Ford Foundation and the Foundation for American Communications concluded that "informed coverage of economic matters that now dominate civic and political affairs remains measurably and markedly unfilled" by the media.[12] Reasons cited by the study included an uneducated public, poor reporter training, an adversarial relationship between business and the press, and an inherent inaccessibility of economics. Most college economics courses beyond the first year require mastery of calculus, which many students lack.

According to Jim Gray, executive director of the Society of Professional Journalists, "It is my experience that most mainstream reporters have little, if any, basic understanding of economic principles, terms of art or even the fundamental underpinnings that would undoubtedly inject clarity into their reporting."[13] As a result, "an overwhelming number of reporters do not have a clue about the underlying causes of the economic stories they are reporting." Without an understanding of causation, journalists and policymakers resort to anecdotes that seemingly prove convenient myths and faulty conventional wisdom.

Finally, because economists document the true costs and consequences of choices, they most often appear before the public in negative roles, explaining why this program would not work as hoped and that the program would cost more than its benefits. Many idealists inspired by the idea of using government to solve social and economic problems find it irritating, to say the least, to be dogged by economists who seem to "know the price of everything, and the value of nothing."[14] Attempting to remain value-free in a value-laden environment creates its own hazards. "Often, one

[12]Quoted by Ronald A. Wirtz in "Understanding the Cost of Free Lunch," *The Region*, Federal Reserve Bank of Minneapolis, December 2000, 11.

[13]Ibid.

[14]The quotation is Lord Darlington's definition of a cynic from Oscar Wilde's play *Lady Windermere's Fan.* In the play it is followed by Cecil's less-often quoted definition of a sentimentalist, "a man who sees an absurd value in everything, and doesn't know the market price of any single thing."

suspects, it is clarity, rather than economics as such, that anti-economists object to."[15]

WHAT IS ECONOMICS?

Academic economists such as Gary Becker define economics as "the study of the allocation of scarce means to satisfy competing ends."[16] Why those ends are chosen lies outside the domain of economists. As Ludwig von Mises wrote, economics "is the science of the means to be applied for the attainment of ends chosen. Ultimate decisions, the valuation and the choosing of ends, are beyond the scope of any science. Science never tells a man how he should act; it merely shows how a man must act if he wants to attain definite ends."[17]

Generalists and economists addressing untraditional topics define economics more broadly. "The art of economics," wrote Henry Hazlitt, "consists of looking not merely at the immediate but at the longer effects of any act or policy; it consists in tracing the consequences of that policy not merely for one group but for all groups."[18] Mark Skousen, after delivering a harsh criticism

[15]"The Ethics Gap," *The Economist,* 2 December 2000, 78.

[16]Gary Becker, *Economic Theory* (New York: Alfred A. Knopf, Inc., 1971), 1. Similar definitions appear in Milton Friedman, *Price Theory* (1962; reprint, Chicago: Aldine Publishing Company, 1976), 1; Kenneth E. Boulding, *Economics as a Science* (New York: McGraw-Hill, 1970), 17–18; N. Gregory Mankiw, *Principles of Economics* (Fort Worth, Tex.: The Dryden Press), 4.

[17]Ludwig von Mises, *Human Action* (1949; reprint, Chicago: Henry Regnery Company, 1966), 10. James Buchanan, a Nobel Prize–winning economist, suggested viewing the Austrian and neoclassical schools as two parts of a single discipline. The first part, stressed by Austrians, is the logic of choice, which deduces universal laws of human action from the need to produce maximum utility from a given set of inputs. The second part, stressed by neoclassical economists, is the science of behavior, which uses empirical data to test hypotheses about human action. James Buchanan, "Is Economics the Science of Choice?" in his *What Should Economists Do?* (Indianapolis: Liberty Press, 1979), 39–63.

[18]Henry Hazlitt, *Economics in One Lesson,* 3d ed. (1979; reprint, San Francisco: Laissez Faire Books, 1996), 5. See also William D. Grampp, *Pricing the Priceless: Art, Artists, and Economics* (New York: Basic Books, 1989), 3.

of definitions that focus on scarcity rather than the production of goods and services, offers this definition: "Economics is the study of how individuals transform natural resources into final products and services that people can use."[19]

At the center of these definitions is concern with choices being made during the creation of goods and services and a field of inquiry limited to exchanges among individuals or groups of individuals. The values and objectives of the participants are not questioned by the economist. Where goods and services are not scarce, there is no need for efficient allocation and hence no economic problem. Where there exists a single objective, rather than many competing ends, the problem is technological rather than economic.

Gary Becker wrote, "observe how wide the definition is. It includes the choice of a car, a marriage mate, and a religion; the allocation of resources within a family; and political discussions about how much to spend on education or on fighting a Vietnam war. These all use scarce resources to satisfy competing ends."[20]

This definition, Becker admits, may be too broad to describe what most economists do, but it explains why "the economic principles developed for this sector [i.e., the market sector of an industrialized economy] are relevant to all problems of choice." Economics, rooted in the logic of choice, is an appropriate tool wherever choices are made.[21]

INDIVIDUALS VERSUS GROUPS

Economic analysis generally starts with the assumption that individuals, rather than groups, are the basic unit of analysis. According to Peter Abell, "Things happen in the social world

[19]Mark Skousen, *Economics on Trial* (Homewood, Ill.: Business One Irwin, 1991), 18.

[20]Becker, *Economic Theory,* 1.

[21]See Richard D. Fuerle, *The Pure Logic of Choice* (Grand Island, N.Y.: Spooner Press, 1986). See also von Mises, *Human Action,* 3. Some Austrians do, however, object to applying economic tools to action inside a family unit. See Jennifer Roback Morse, *Love and Economics: Why the Laissez-faire Family Doesn't Work* (Dallas: Spence Publishing Co., 2001).

because individuals do and do not do things, and they are the only things that do or do not do things. All statements that attribute 'doing' to other things can, in principle if not in practice, be translated without loss into statements about individuals doing things."[22]

Explaining social phenomena by studying the actions of individuals does not deny the reality that many important decisions are made through collective decision-making institutions such as families and governments; nor does it deny the possibility that what is true for the parts may not be true for the whole, the so-called fallacy of composition. Instead, economists argue that even these situations are best understood (and perhaps become predictable) by understanding the incentives and information available to the individuals involved, rather than speculating about the behavior of abstract collectives such as society or the public. We return later to the matter of how economists approach collective decision making and what they find.

Critics of economics often seem to mistake methodological individualism for ethical individualism (the celebration of individual achievement and fulfillment even at the expense of others). The similarity of the terms may make the mistake easy to commit, but it is wrong nonetheless. Methodological individualism does not place the rights or desires of individuals over the rights or responsibilities assigned to families, churches, or government. Economists can and do study choices and exchanges that advance collective ends, such as philanthropy and religious belief.

Another source of confusion is the mistaken belief that exchanges are often zero-sum transactions, where one person's gain is another's loss. If most transactions operated that way, a methodology focused on the gains and losses of individuals might seem blind or indifferent to social benefits or losses. Business economics focuses on helping businesses create the most value from available inputs and so naturally focuses on material things—the

[22]Peter Abell, "Is Rational Choice Theory a Rational Choice of Theory?" in *Rational Choice Theory: Advocacy and Critique* 7, ed. James S. Coleman and Thomas J. Fararo (Newbury Park, Calif.: Sage Publishing, 1992), 191.

famous bottom line of a balance sheet. To the average person, this conjures up images of Ebenezer Scrooge squeezing every last penny from poor Bob Cratchitt.

Missing from this picture of economics are those branches of economics, such as the economics of law, of public finance, and of health, that help people make better choices when dispensing justice, financing essential public goods and services, and delivering life-saving drugs and hospital care. In fact, voluntary exchanges nearly always create more value than either party brings to the exchange, creating a net increase in value. This is the rule rather than the exception because participation in exchanges is voluntary and other parties compete to exchange on more favorable terms. The pervasive nature of gains from exchange makes economics a potent tool for studying many arenas outside the business world, including families, churches, and governments.

RATIONAL ACTION

A second principle of economics is that the best way to predict the outcome of a transaction is to assume most participants act rationally to attain whatever it is they value.[23] The principle of rational action is a concession to the great complexity of human action. Human action is determined by so many things that a realistic model is impossible in principle; new variables could always be added to the model.[24] Moreover, a set of truly realistic assumptions would compose a photographic reproduction of the transaction. But even such a reproduction would fail to clarify the processes that lay beneath the surface of the transaction.

[23]More precisely, the doctrine of rational action holds that consumers have ordered preferences and choose the combination of goods that is most preferred at any given time. Ordered preferences imply transitivity—if A is preferred to B and B is preferred to C, then A will be preferred to C. They also imply that more is preferred to less. Becker, *Economic Theory,* 26.

[24]Friedrich Hayek, *Individualism and the Economic Order* (Chicago: Henry Regnery Company, 1968).

Economists speak of rational action in two distinct senses. The first and more familiar is as an observation on human nature. This is the sense Aristotle had in mind when he called man the rational animal. It remains at the basis of our concepts of law (the reasonable-person test) and even religion: "Man is rational and therefore like God; he is created with free will and is master over his acts."[25]

Rational action in economics also refers to the outcome of free markets. Markets, as explained in Chapter 4, reward rational action by giving greater control over resources to people who act rationally. When studying markets, it is usually safe to assume rational behavior is the rule rather than the exception because business owners and managers who do not act rationally tend to produce products consumers do not want at prices they will not pay. Consequently, irrational action tends to lose customers and investors. The businesses that survive—the ones we observe—are those that are rationally managed. Similarly, most consumer choices we observe are rational actions.

Economics relies on rational action in its second sense, as the expected outcome of free markets. It does not assume all businesspeople or consumers always act rationally. Gary Becker emphasizes and shows mathematically that "the basic demand relations are derived fundamentally from scarcity alone rather than from an assumption that behavior is 'rational'."[26] For a typical good or service, the number of units demanded falls as its price rises, "even when consumers behave irrationally."[27] Even liberal market critic Robert Kuttner concedes this point: "Even if individual preferences were somewhat arbitrary, unstable, and manipulable, entrepreneurs would remain subject to competitive discipline to offer the best product at the most attractive price."[28]

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[25] *Catechism of the Catholic Church* (New Hope, Ky.: Urbi et Orbi Communications, 1994), 430, quoting St. Irenaeus.

[26] Becker, *Economic Theory,* 21–23.

[27] Ibid., 25.

[28] Kuttner, *Everything for Sale,* 42.

By focusing on the rational acts of individuals, economists can solve the problem of complexity by assuming as little as possible about people's motives. This is in stark contrast to sociology and psychology, where conflicting theories lead to little agreement in explaining people's behavior.[29] Rather than claim to know or to judge an individual's values, economists start with a simple model of the acting self and then borrow from psychology "only the barest minimum required for fitting this model to observed social reality."[30]

Sociologists and other social scientists have taken note of this model and put it to productive use.[31] The result is a "sober and materialist frame [that] offers a great improvement on normative social science saturated with reifications about culture and value: all the shrill talk of inviolable ethnic and cultural identities, collective norms so often obtuse to any kind of elementary analysis or breakdown to the individual level."[32]

Observing how people act when confronted with choices leads to the simplest, yet most important of economic insights: *Incentives matter.* People respond in predictable ways to the expected consequences of their actions. If choosing a particular option is likely to produce greater personal benefits than costs, the decision maker is more likely to choose that option. If the costs associated with the option are greater than the benefit, the decision maker is unlikely to choose it. By studying the costs and

[29]An exception is the late James Coleman and his many followers, who explicitly borrowed the rational action model from economists to create a more stable ground for sociology. See James S. Coleman, *Foundations of Social Theory* (Cambridge: The Belknap Press of Harvard University Press, 1990).

[30]Adrian Favell, "Rational Choice as Grand Theory: James Coleman's Normative Contribution to Social Theory," in *James Coleman,* ed. Jon Clark (New York: Falmer Press, 1996), 156. Similarly, psychologist Steven Pinker refers to "hierarchical reductionism," which "consists not of *replacing* one field of knowledge with another but of *connecting* or *unifying* them. The building blocks used by one field are put under a microscope by another." *The Blank Slate: The Modern Denial of Human Nature* (New York: Viking, 2002), 70.

[31]Ibid.; Coleman, *Foundations of Social Theory.*

[32]Favell, "Rational Choice as Grand Theory," 294.

benefits of choices, economists can predict behavior in some situations as well as the results of changes to institutions that affect costs and benefits.[33]

These insights may seem commonplace today, yet they were hardly accepted wisdom when Adam Smith first created modern economics (or political economy, as it was called at the time) in 1776. Individuals' motivations were much debated, and individual action was often considered far less important than natural forces, political decrees, and the like. More important, the insights of modern economics were, and still are, often set aside by political philosophers seeking to design Utopia and ignored or denigrated by psychologists and sociologists aiming to create a more realistic theory of society by making more assumptions about human motivations.

THE SUBJECTIVITY OF VALUES

Chapter 4 explained how prices enable markets to solve the problem of coordinating the plans of countless individual buyers and sellers who are separated by great distances in time and space. Prices send signals to entrepreneurs, investors, producers, and consumers, ensuring that resources flow to their highest uses and consumers get goods and services at the lowest possible prices.

Prices also provide uniquely reliable information about people's true wants and preferences. Prices can be used to test hypotheses about the effects of private and public action by allowing researchers to view the before-and-after effects of private and

[33]For a general defense of prediction in economics, see Edward P. Lazear, "Economic Imperialism," *Quarterly Journal of Economics* 115, no. 1 (February 2000): 99–146. Economists of the Austrian school sometimes say the inherent subjectivity of values makes prediction impossible, but as James Buchanan explains, "there is nothing in the value dimension itself that logically prohibits the derivation of a fully operational science. Whether or not such analysis is possible depends not on dimensionality but instead on the possible uniformity of valuations over persons." James Buchanan, "The Domain of Subjective Economics," in *What Should Economists Do?* (Indianapolis: Liberty Press, 1979), 13.

public action. Few other social sciences have anything comparable to price information with which to test their theories and predictions.

Thomas Malthus, Karl Marx, and even Adam Smith thought the amount of labor required to create a commodity ultimately determined its objective value or price. Other economists identified land and utility. We now know they were all wrong. Prices in a capitalist system are determined by the interaction of supply and demand. They are the dollar amount at which the cost of production (including profits) and the value to the buyer are equal.

While prices are objective, the value of all commodities is subjective, determined by each person's (the subject's) perceptions of the commodity's expected utility. "What one person disdains or values lightly is appreciated by another, and what one person abandons is often picked up by another."[34] Because we only know what these valuations are by the choices a person makes, this principle is sometimes called the principle of revealed preferences.

The inherent subjectivity of values makes it impossible for people outside a transaction to judge whether the participants made right or wrong decisions. Those involved in economic transactions make decisions based on their "knowledge of the particular circumstances of time and place."[35] Because the totality of this widely dispersed knowledge is not available to any one person, we cannot assert that someone outside the market can know or predict true prices or what choices are best.

Prices are important because subjective values are accurately transformed into objective information (prices) only when producers and consumers are able to make free and uncoerced choices. We have no other reliable way to deduce or infer what people's preferences are. However, prices are only historical data about what choices *were* made, for reasons that may be difficult to discern and are likely to change or to have already changed by

[34]Carl Menger, *Principles of Economics* (1871; reprint, New York: New York University Press, 1981), 146.

[35]Hayek, *Individualism,* 80.

the time the economist interprets them. Opportunity costs cannot simply be measured as foregone revenues (for producers) or foregone purchases (for buyers) but "are ultimately foregone *expected utility*. . . . Because cost was foregone and never actually experienced, it could never be objectively known. Even the chooser does not know what she forgoes precisely because she forgoes it."[36]

The subjectivity of values has important implications for the practice of economics. It means markets can be understood as harmonizing the interests of people with different expectations, knowledge, and values, particularly ones about which they disagree. It means prices and profits, valuable though they are, do not convey all the information economists or planners need to know to be able to decide whether markets are efficient or to design government programs that presumably would work better. Finally, it reveals that markets not only allocate scarce resources among competing purposes but also enable their participants to discover and create values, a process integral to other freedoms to act, form judgments, make choices, and think.[37]

ECONOMICS AND ETHICS

This brief discussion of the methodology of economics enables us to put to rest three common misunderstandings about the relationship between economics and ethics. The first is that economics is limited to addressing only selfish or utility-maximizing choices; the second is that economists defend markets even when their outcomes are unfair, immoral, and wasteful; and the third is that economics implies or assumes a utilitarian code of ethics, or

[36]Steven Horwitz, "Subjectivism," in *The Elgar Companion to Austrian Economics,* ed. Peter J. Boettke (Cheltenham, UK: 1994), 18.

[37]This is a theme of Friedrich Hayek's work. See Friedrich Hayek, *New Studies in Philosophy, Politics, Economics and the History of Ideas* (Chicago: University of Chicago Press, 1973); John Gray, *Hayek on Liberty* (New York: Basil Blackwell, Inc., 1984).

what John Stuart Mill called "the greatest good for the greatest number."[38]

Economics and Selfish Behavior

If the subject of economics is self-interested or selfish behavior, do economists neglect altruistic or charitable behavior? Do they give short shrift to values that are held collectively or express a social consensus? And if rational action is the economist's default assumption, then must all action based on emotion fall outside the economist's purview?

The answer to all three questions is no. The rational-action principle assumes only that our actions are consistent with the goals we set for ourselves. The model is silent on what those goals should be.[39] The conduct in question may be motivated by love as easily as by selfishness. Action may be taken in pursuit of justice or social equality, or it may be based on religious belief or less noble convictions, such as fear and greed.[40] Adam Smith suggested in *The Wealth of Nations,* for example, that the conduct of clergy and church members could be understood as rational action.[41] When confronted by competition, churches behave much like firms: They work harder to keep their members. They also grow complacent when granted a monopoly or subsidy or when they are over-regulated.

Recent research has confirmed Smith's insight. Countries with state-sanctioned or -favored churches report lower levels of reli-

[38]J. S. Mill, in Samuel Gorovitz, ed., *Utilitarianism with Critical Essays* (Indianapolis: The Bobbs-Merrill Company, Inc., 1971), 8, 21ff.

[39]See Anthony de Jasay, *Social Contract, Free Ride: A Study of the Public Goods Problem* (1989; reprint, Oxford: Oxford University Press, 1990), chap. 8.

[40]See Gary S. Becker, *The Economic Approach to Human Behavior* (Chicago: University of Chicago Press, 1976); Richard Posner, *The Economics of Justice* (Cambridge: Harvard University Press, 1981), and *The Problematics of Moral and Legal Theory* (Cambridge: Harvard University Press, 1999); Morse, *Love and Economics.* (In note 22 above.)

[41]Adam Smith, *The Wealth of Nations* (1776; reprint, Chicago: University of Chicago Press, 1976), 309–13.

gious commitment—as measured by church membership, attendance, and revenues—than those that allow churches to openly compete for members.[42] As Laurence Iannoccone explains, "Consumers *choose* what religion (if any) they will accept and how extensively they will participate in it. Nor are these choices immutable—people can and often do change religions or levels of participation over time. As with any other commodity, the consumer's freedom to choose constrains the producers of religion. A particular religious firm can flourish only if it provides a commodity that is at least as attractive as its competitors'. Hence, to the extent that the religious market is perfectly competitive, the cost of providing an attractive commodity drives religious firms toward efficient production and zero (excess) profits."[43]

Economics and Utilitarianism

Does economic inquiry imply or endorse a utilitarian theory of ethics? The question resists a simple answer because capitalism itself, as we discussed in Chapter 6, relies on and encourages certain values.

That a Buddhist has different values and goals than a Protestant does not alter the fundamental logic of choice each faces when making a decision. Members of both faiths seek to maximize whatever outcomes they aim for. But religious beliefs and values do affect market behavior. Some religions, for example, may place more emphasis on getting and spending rather than contemplation.[44] Because trust can make it easier to negotiate and enforce agreements, societies where trust is common experience greater efficiency in production and exchange.[45]

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[42]Laurence R. Iannoccone, "The Consequences of Religious Market Structure," *Rationality and Society* 3, no. 2 (April 1991).

[43]Ibid., 158.

[44]Max Weber, *The Protestant Ethic and the Spirit of Capitalism* (1904–1905; reprint, New York: Charles Scribner's Sons, 1958).

[45]Frances Fukuyama, *Trust: The Social Virtues and the Creation of Prosperity* (New York: The Free Press, 1995).

Economic tools such as the laws of supply (that more will be supplied at a higher price) and demand (that more will be demanded at a lower price) are valid regardless of the values of the people involved, but their use to make accurate predictions depends on the economist's ability to understand what people value.[46] The cattle wandering the streets of a busy city in Hindu India, even as people starve to death in the deepest material poverty, does not pose an explanatory problem for the economist who knows in advance that Hindus consider cows to be sacred and consequently place a very high value on allowing them to live.

Much of the disagreement over applying economics to social concerns, then, has little to do with the tools of economics and much to do with the values parties bring to the research. All sciences grapple with the often unacknowledged role values play in the development of hypotheses and selection of topics to study, the choice of data to analyze and methods to apply, and the interpretation of results. Economics, partly because of its high profile in politics and partly because of the challenge posed by socialists in the late nineteenth and twentieth centuries, faced this difficulty more directly than did other social sciences.[47]

Economics and Economic History

Economists are not required by their training to defend markets in every case. Many of the best-known economists were, or are, harsh critics of the real-world performance of markets, and they have supported expanding government and increasing regulations

[46]This seems to be Frank Knight's position. See Frank H. Knight, *The Ethics of Competition and Other Essays* (1835; reprint, New York: Augustus M. Kelley, Inc., 1951), 135ff. See also Don Lavoie and Emily Chamlee-Wright, *Culture and Enterprise: The Development, Representation, and Morality of Business* (Washington, DC: Cato Institute, 2000).

[47]Ludwig von Mises, in particular, was driven by concern that socialist utopians were waging a "revolt against reason" directed "not . . . at the natural sciences, but at economics. The attack against the natural sciences was only the logically necessary outcome of the attack against economics." Von Mises, *Human Action,* 73.

on individuals and corporations.[48] Even today, economics instruction at prestigious institutions, such as Harvard University, is oriented toward how to regulate, rather than explain, capitalist economies.[49]

Criticizing how markets have worked in the past is not the same as saying markets do not or cannot work now or in the future. For one thing, the stories from economic history, even when correctly reported, often reflect the results of government interference and not the unfettered operation of markets. As Tibor Machan reminds us, "Contrary to popular generalizations, there has never been an era of pure laissez-faire capitalism, even in the history of the United States."[50] Moreover, institutions change, and objectives that could not be obtained privately through voluntary means in the past may now, or at some other time, be reachable under a different set of conditions.[51]

Economists have been rigorous in pointing out instances where the failure to correctly define or enforce property rights can

[48]Richard Ely, the founder and first president of the American Economic Association, believed the "doctrine of laissez faire is unsafe in politics and unsound in morals" and had this language placed in the organization's original platform. Richard T. Ely, "Report of the Organization of the American Economic Association," 1886. For a fascinating and accessible discussion of the views of Joan Robinson, Gunnar Myrdal, J. M. Keynes, and other prominent liberal economists, see G. L. S. Shackle, *The Years of High Theory: Invention and Tradition in Economic Thought 1926–1939* (1967; reprint, London: Cambridge University Press, 1983). James M. Buchanan, a Nobel laureate economist we cite often, made a strong case for income redistribution in "Pareto Optimality, External Costs, and Income Redistribution," chap. 13 in *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (Ann Arbor: University of Michigan Press, 1962).

[49]James M. Buchanan, "Origins, Experiences, and Ideas: A Retrospective Assessment," in James M. Buchanan and Richard Musgrave, *Public Finance and Public Choice: Two Contrasting Visions of the State* (Cambridge: MIT Press, 1999), 17.

[50]Tibor Machan, *Private Rights and Public Illusions* (New Brunswick N.J.: Transaction Publishers, 1995), 106.

[51]Karl Pribram, *A History of Economic Reasoning* (Baltimore: The Johns Hopkins University Press, 1983), 298ff.

result in market failure, and they use that understanding to propose solutions.[52] What is clear from this literature is not that economists think that markets always work but that there are nearly always solutions to economic and even social problems—solutions that frequently do not require government to step beyond its role as enforcer of contracts and the law.

THE ROLE OF ASSUMPTIONS

Our discussion of the methodology of economics lays to rest the objection that economics depends on unrealistic assumptions about human nature. Clearly, economists do not assume people act as perfectly rational profit maximizers in every aspect of their lives.

But other assumptions, such as perfect competition and perfect information, are also widely attributed to economists. It was this caricature of economics that Bruce Fuller and Richard Elmore evidently had in mind when they wrote, "choice schemes assume that the family is highly rational, acts from clear preferences, and is able to effectively demand action from local schools and teachers."[53] Paul Hill, Lawrence Pierce, and James Guthrie fall into a similar trap when they say the voucher proposal "assumes there will be an adequate supply of public and private schools willing to compete for students and their vouchers."[54]

Perfect competition, perfect information, and similar expressions have been common in economic writing since the publication of Alfred Marshall's *Principles of Economics* in 1891. They are commonly used in the work of Marshall's intellectual descendants, the so-called neoclassical school of economics, although not that of economists of the Austrian school.

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[52]The modern literature on the subject is generally dated to H. Scott Gordon, "The Economic Theory of Common-Property Research: The Fishery," *Journal of Political Economy* 62 (1954): 124–42. A major contribution was that of Ronald Coase, "The Problem of Social Cost," *Journal of Law and Economics* 3 (October 1960): 1–44.

[53]Fuller and Elmore, *Who Chooses?* 3.

[54]Hill and Celio, *Fixing Urban Schools,* 83–84.

What are commonly called assumptions in economics are, properly speaking, parameters set forth when modeling the economic phenomenon being studied. They are chosen to simplify the task of studying a particular exchange or institution. If used improperly, they can lead to inaccurate conclusions. When chosen and used correctly, however, they require us to assume less, not more, than if we opened the model to consider every fact or theory that might play a role in a given economic transaction.

Milton Friedman, in his *Essays in Positive Economics,* pointed out that the validity of a hypothesis is not proven by how completely its assumptions reflect reality. Indeed, he pointed out, just the opposite is more often the case:

> Truly important and significant hypotheses will be found to have "assumptions" that are wildly inaccurate descriptive representations of reality, and, in general, the more significant the theory, the more unrealistic the assumptions (in this sense). The reason is simple. A hypothesis is important if it "explains" much by little, that is, if it abstracts the common and crucial elements from the mass of complex and detailed circumstances surrounding the phenomena to be explained and permits valid predictions on the basis of them alone. To be important, therefore, a hypothesis must be descriptively false in its assumptions; it takes account of, and accounts for, none of the many other attendant circumstances, since its very success shows them to be irrelevant for the phenomena to be explained.[55]

Some of the confusion over the role of assumptions in economics arises from the fact that economists use different types of models in the course of their work.[56] The simplest models, called static-equilibrium models, leave out the elements of time and uncertainty and aim to create snapshots of exchanges removed from the processes in which they are embedded. Few economists would try to derive full explanations of an economic phenomenon on the basis of such models. Indeed, many economists question the role of

[55]Milton Friedman, *Essays in Positive Economics* (Chicago: University of Chicago Press, 1953), 14–15.

[56]See G. L. S. Shackle, *Economics for Pleasure* (Oxford: Cambridge University Press, 1962), for an excellent overview of this subject.

static-equilibrium models even as teaching aides.[57] As Ludwig von Mises—a great critic of abstract models in economics—wrote, "Economics deals with the real actions of real men. Its theorems refer neither to ideal nor to perfect men, neither to the phantom of a fabulous economic man (homo oeconomicus) nor to the statistical notion of an average man (homme moyen). Man with all his weaknesses and limitations, every man as he lives and acts, is the subject matter of catallactics."[58]

More sophisticated economic models bring into play time, uncertainty, and expectations. They can take the form of complicated mathematical models using calculus to measure marginal rates of change and regression analysis to control for many variables. At some point, the sheer number of variables at play makes prediction impossible, and deduction from original principles can provide greater explanatory, if not predictive, power.[59]

The claim that economists assume perfect competition figures prominently in the rhetoric of antimarket commentators. Although we addressed it once before (in the discussion of monopoly in Chapter 5) it merits a more complete discussion here. Product differentiation by producers and imperfect information by consumers means there is rarely perfect competition among producers of identical products, just as there is rarely perfect monopoly. Indeed, if perfect competition occurs, profits equal zero and there is no surplus left over to fund investment in new products and manufacturing techniques. Because innovation drives economic growth, imperfect competition must be superior

[57]The criticism is common in works from the Austrian school. See Mark Skousen, *Economics on Trial: Lies, Myths, and Realities* (Homewood, Ill.: Business One Irwin, 1991), 20–27; Mario J. Rizzo, "Praxeology and Econometrics: A Critique of Positivist Economics," in *New Directions in Austrian Economics,* ed. Louis M. Spadaro (Kansas City, Kans.: Sheed Andrews and McMeel, Inc., 1978), 40–56.

[58]Von Mises, *Human Action,* 651. *Catallactics* refers to economic problems embedded in von Mises's general theory of human action, which he calls praxeology.

[59]Mario J. Rizzo, ed., *Time, Uncertainty, and Disequilibrium* (Lexington, Mass.: Lexington Books, 1979).

to perfect competition. "Perfect competition," wrote Joseph Schumpeter, "is not only impossible but inferior."[60]

Why, if it is impossible, do economists assume perfect competition? In fact, they do not. According to Schumpeter, even Alfred Marshall acknowledged the unrealistic nature of perfect competition and "emphasized economic freedom rather than competition and refrained from defining the latter rigorously."[61] What economists mean when talking about competitive businesses, wrote Schumpeter, "is the scheme of motives, decisions, and actions imposed upon a business firm by the necessity of doing things better or at any rate more successfully than the fellow next door; that it is this situation to which we trace the technological and commercial efficiency of 'competitive' business; and that this pattern of behavior would be entirely absent both in the cases of pure monopoly and pure competition. . . ."[62]

Imperfect competition presents a challenge to the neoclassical static-equilibrium models, but such models are primarily teaching devices and not used to make predictions. Austrian economists never had a problem with imperfect competition because the elements of time and entrepreneurship, often missing from equilibrium models, are parts of their theory of market processes.

IDEOLOGY AND ECONOMICS

The label *capitalism* implies an ideology, or system of theories and doctrines, rather than a set of institutions devoted to allocating scarce means to satisfy competing ends. If capitalism were in fact an ideology, it might be legitimate to accuse economists of being simply "providers of a rational and moral justification for capitalist exploitation."[63]

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[60]Joseph Schumpeter, *Capitalism, Socialism, and Democracy* (1943; reprint, London: George Allen & Unwin, 1961), 106.

[61]Joseph Schumpeter, *History of Economic Analysis* (New York: Oxford University Press, 1954), 974–75.

[62]Ibid.

[63]Von Mises, *Human Action,* 78, summarizing Karl Marx's view of economists.

But capitalism is not an ideology, and economists are in fact scientists. Capitalist institutions create prices, which economists use as the basic data for much of their analysis. Prices enable economists to propose refutable hypotheses and subject them to tests using sophisticated statistical techniques. Focusing on individuals rather than groups and rational rather than irrational or random action severely restricts what assumptions can be made and properly directs our attention to the incentives faced by real-world decision makers. This objective analysis is a tool for discovering the most efficient means of attaining the ends of all decision makers, not only or especially those held by economists.

Economics, like most and perhaps all sciences, operates through the discovery, defense, and introduction of new paradigms, or systems of propositions currently accepted by professional practitioners and the procedures by which they may be altered.[64] Because free will makes human action less predictable than the processes studied by the natural sciences, economists place greater reliance on consistency with their accepted paradigm and less on controlled experiments. The dominant paradigm in economics that we have described here, and what Melvin Reder calls the Resource Allocation Paradigm (RAP), is not the same as the ideology of laissez-faire. As Reder explains, "Generically, a paradigm is a research tool. Its acceptance does not entail embracement of any particular ideology, and many RAP adherents are free, or nearly so, of ideological commitments. To adhere to an ideology is to accept certain value judgments as to the desirability of a particular set of social/political/economic arrangements and a commitment to promote their realization. Manifestly, such adherence can neither entail nor be entailed by acceptance of a research paradigm."[65]

[64]Thomas S. Kuhn, *The Structure of Scientific Revolutions* (1962; reprint, Chicago: University of Chicago Press, 1970).

[65]Melvin W. Reder, *Economics: The Culture of a Controversial Science* (Chicago: University of Chicago Press, 1999), 236.

"The best [economists]," wrote Harvard economist Caroline Hoxby, "are not very interested in ideology. They are not that easy to predict. Their interest is in understanding what's going on."[66] Economics may appear to be ideological because, as Reder says, "the two sets of beliefs are—up to a point—symbiotic."[67] It may also be due to the increasing respectability of free-market ideas within the economics profession—a development tracked by Nobel Prize awards to leading advocates of limited government.[68]

Little-appreciated and much-maligned at the time, free-market scholars in the 1930s and 1940s began the task of restating the case for capitalism in contemporary language and in light of contemporary social science and experiences. The harvest came in the 1960s, when such books as *The Constitution of Liberty* (1960) by Friedrich Hayek and *Capitalism and Freedom* (1962) by Milton Friedman attracted the attention of a new generation's best and brightest thinkers. Soon Michael Novak, George Gilder, Robert Nozick, Richard Epstein, Thomas Sowell, and Charles Murray were producing seminal books and essays that have profoundly changed the intellectual climate in the United States.

Writing for the *New Yorker* in 2000, John Cassidy reported that Friedrich Hayek "was vindicated to such an extent that it is hardly an exaggeration to refer to the twentieth century as the Hayek century."[69] Lester Thurow, a noted liberal, has acknowledged free-market ideas are triumphant: "For much of the nineteenth and all of the twentieth centuries, capitalism faced off against socialism on the inside and communism on the outside.

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[66]Quoted in Keller, *Economic Growth,* 44.

[67]Reder, *Economics,* 257.

[68]Friedrich Hayek in 1974, Milton Friedman in 1976, George Stigler in 1982, James Buchanan in 1986, Gary S. Becker in 1992, Robert Fogel in 1993, Robert Lucas Jr. in 1995. See John Cassidy, "The Price Prophet," *New Yorker,* 7 February 2000; Caniel Yergin and Joseph Stanislaw, *The Commanding Heights* (New York: Simon & Schuster, 1998).

[69]John Cassidy, "The Price Prophet," 45.

But those ideologies now have no future except in the history books. Capitalism alone stands."[70]

PUBLIC-CHOICE THEORY

Economics evolved to explain private choices where voluntary exchange, rather than authority, is the rule. But the principles and tools of economics can be applied to all institutions that attempt to allocate scarce resources, allowing economists to compare the performances of the public and private sectors. The extension of economics to the study of the public sector is called public-choice theory.

Modern public-choice theory dates back to 1928, when mathematician John Von Neuman and economist Oskar Morgenstern applied the mathematical theory of games of strategy to the problem of human action in the context of social rules.[71] Starting with simple two-person games, Von Neuman and Morgenstern showed how the economic model of rational action and methodological individualism could be used to predict the conduct of people facing a wide variety of incentives, rules of conduct, and other considerations. The result was a rich vein of research into the behavior of voters, members of interest groups, bureaucrats, elected officials, and other actors not previously thought to be the subjects of economics.[72]

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[70]Lester C. Thurow, *The Future of Capitalism: How Today's Economic Forces Shape Tomorrow's World* (New York: William Morrow and Company, Inc., 1996), 64. For accounts of other prominent leftish intellectuals making similar concessions see Paul Hollander, "Which God Has Failed?" *The New Criterion,* February 2002; George Jochnowitz, "Marx, Money, and Mysticism after Mao," *Partisan Review* 69, no. 1 (2002); Michael Walzer, "Can There Be a Decent Left?" *Dissent,* spring 2002.

[71]John Von Neumann and Oskar Morgenstern, *Theory of Games and Economic Behavior* (Princeton: Princeton University Press, 1944), 43.

[72]Dennis C. Mueller, *Public Choice* (1979; reprint, New York: Cambridge University Press, 1987); Murray N. Ross, "Public Choice: The New Political Economy," *The AEI Economist,* June 1987, 1–8; James M. Buchanan and Gordon Tullock, *The Calculus of Consent* (1965; reprint, Ann Arbor: University of Michigan Press, 1974); James D. Gwartney and Richard E. Wagner, eds., *Public Choice and Constitutional Economics* (Greenwich, Conn.: JAI Press, Inc., 1998).

Game theory helped economists better understand situations involving negative externalities (where activities impose costs, such as pollution, on third parties) and positive externalities (where the activities, such as supporting a school, create benefits for third parties). Buyers and sellers may not always take into account the effects their decisions have on others, resulting in over- or under-investment in the activity.

Game theory shows market failure can occur when one person's consumption does not diminish the ability of others also to consume the product, a condition called nonrivalrous consumption or jointness of consumption. Market failure can also occur when free riders—people who have not paid—cannot be prevented from consuming a good, a condition called nonexcludability. Public goods, a neighbor's beautiful landscaping, for example, by definition exhibit both jointness of consumption and nonexcludability.[73]

While game theory helped economists understand how markets could fail, it also revealed ways to solve problems involving externalities and public goods. When a game is played many times, conventions and expectations develop that increase each actor's confidence that others will act reliably. In the real world, property rights, contracts, and tort law make these conventions well known and enforceable. For example, common law prohibited many kinds of pollution long before state and federal regulators appeared on the scene, and deeds to real estate often contain restrictive covenants obligating owners to refrain from some activities or to pay assessments levied by an owners' association.[74]

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[73]The other three possible combinations are private goods (rival and excludable), common resources (rival but not excludable), and natural monopoly (not rival but excludable). See Mankiw, *Principles of Economics,* chap. 11, "Public Goods and Common Resources."

[74]Jo-Christy Brown and Roger E. Meiners, "Common Law Approaches to Pollution and Toxic Tort Litigation," in *Cutting Green Tape: Toxic Pollutants, Environmental Regulation and the Law* (Oakland, Calif.: Independent Institute, 2000), 99–128.

David T. Beito, "Voluntary Association and the Life of the City," *Humane Studies Review* 6, no. 1 (fall 1988): 19.

Researchers have found that the vast majority of exchanges produce positive or negative externalities, meaning the presence of externalities is insufficient grounds for government intervention.[75] Most externalities are too small to rise to the attention of policymakers or are solved by voluntary contracting among the affected parties.[76] Seemingly indivisible goods can be broken up and sold (or resold) with value-added features to discourage free riding.[77]

Finally, game theory also helps economists understand the behavior of government. The founders of public-choice theory posited that the behavior of elected bodies and bureaucracies could be more accurately predicted by assuming their members tend to act out of concern for their self-interest—for example, higher salaries and more prestige and power—than by assuming they act only to achieve the high-minded social goals recorded in legislation or proclamations.[78] This brought to political science some of the rigor and precision that economics brought to the study of buying and selling commodities.

To the economist, government differs from the private sector only in the rules and institutions that prevail and not because people in the two sectors differ from one another in any fundamental way.[79] The behavior of voters, too, can be modeled: "Since there is no evidence that entrance into a voting booth or participation in the political process causes a personality transformation, there is

[75]Alfred Kahn, *The Economics of Regulation: Principles and Institutions,* vol. 1 (1970; reprint, Cambridge: The MIT Press, 1988), 193–95.

[76]Ronald Coase, "The Problem of Social Cost," *Journal of Law and Economics* 2 (October 1960): 1–44.

[77]Robert W. Poole Jr., *Unnatural Monopolies: The Case for Deregulating Public Utilities* (Lexington, Mass.: Lexington Books, 1985); edited by the same author, *Instead of Regulation: Alternatives to Federal Regulatory Agencies* (Lexington, Mass.: Lexington Books, 1982); and also by Poole, *Cutting Back City Hall* (New York: Universe Books, 1980).

[78]Buchanan and Tullock, *Calculus of Consent.* (In note 74 above.)

[79]R. A. Musgrave, *The Theory of Public Finance* (New York: McGraw-Hill, 1959).

sound reason to believe that the motivation of participants in the market and political processes is similar."[80]

Here the contributions of Mancur Olson, the economist discussed in Chapters 4 and 7, are once again pertinent. Once the life, liberty, and property of citizens is protected by the state, they do not necessarily stop asking the state to intervene on their behalf. The state is called on by well-organized interest groups to protect their members from changes in technology, competition, consumer demands, liability, poor investments, even bad weather and a long list of other possible threats to their well-being.

For reasons Olson explained nearly four decades ago, it is easier for small groups to organize than large ones. Small groups expect to reap most or all of the benefits of special legislation while paying only a tiny fraction of its costs, so they lobby for such legislation even when the cost to society is many times greater than the benefits. This is a win-lose situation: The small interest group's gain comes at everyone else's expense.[81]

Over time, as the demands of small, effectively organized interest groups grow, the state must either raise taxes or interfere with the rules of the game to a degree sufficient to make the system redistribute wealth away from those who produce it to those who do not. Both actions by government discourage production and reward energy spent trying to redistribute, rather than create, wealth.[82]

Public-choice theory has major implications for the study of school reform because many important decisions in the current system take place in the political arena rather than in competitive markets. In Chapter 9, this economic theory is used to explain how markets could address the eight root causes of government school failure that were described in Chapter 2.

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[80]Gwartney and Wagner, eds., *Public Choice,* 3.

[81]See Mancur Olson, *The Logic of Collective Action* (Cambridge: Harvard University Press, 1971); James M. Buchanan, *Public Finance in Democratic Process* (1967; reprint, Chapel Hill: The University of North Carolina Press, 1987).

[82]Jonathan Rauch, *Demosclerosis* (New York: Random House, 1994).

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