Journal of Private Enterprise, Special Issue, Volume XXII, Number 2, Spring 2007

Liberty vs. Power in Economic Policy in the 20th and 21st Centuries

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Every semester students from throughout the world are introduced to the teachings of economics and political economy. What are the first things students learn as they enter the world of the economic way of thinking? Obviously the answer to that question varies from instructor to instructor (Heyne, Boettke, and Prychitko). Some will emphasize behavioral assumptions and the logic of choice, others will emphasize institutional structure and economic performance as captured in notions of efficiency; some will emphasize the harmony of interests that are reconciled through the market system, while others will highlight the conflict of interests that result from market imperfections. The intellectual battle lines in public policy between liberty and power are often drawn based on these points of emphasis in economic teaching.

I believe that in studying the development of the history of ideas in political economy it is useful to distinguish between the mainline of argument, and the mainstream in the currently fashionable practice of the science. The mainline of argument emphasizes the core propositions that have been argued throughout the history of the discipline. Mainstream, on the other hand, defines whatever is currently fashionable within the discipline. Economics is whatever current economists do. To be a mainstream economist does not necessarily mean that one is comfortable with the mainline of argument from Adam Smith onward. The mainline of argument stresses the harmony of interests that emerges through the competitive market process. David Hume and Adam Smith emphasized this reconciliation power of the market economy in the 18th century, J. B. Say and Frederic Bastiat did so in the 19th century, and F. A. Hayek and James Buchanan represent perhaps the most articulate defenders of spontaneous order in the 20th century. But throughout the history of political economy there were always individuals who sought to juxtapose their own position with this harmony of interest doctrine: from those who argued against free trade such as Friedrich List to those who emphasized the possibility of a general glut in economic activities such as Thomas Malthus; from those who emphasized class conflict such as Karl Marx to those who emphasized the instability of financial markets such as John Maynard Keynes. Modern mainstream economists such as Joseph Stiglitz, who emphasize the imperfections in market structure and imperfect information, are more in line with List, Malthus, Marx and Keynes than they are with Hume, Smith, Say, Bastiat, Hayek and Buchanan.

The contemporary discipline of economics has often lost sight of the core propositions that emerge in the mainline of political economy. My contention is that economics as a discipline should be defined by the propositions it advances about the real world, and not the form in which economic statements are presented. Mathematical models and techniques of statistical significance are useful tools in examining certain economic propositions, but we must never forget that it is the propositions that must be assessed rather than the formal tools utilized in examining them. The crisis in modern economics is that theorists as divergent on substance as Stiglitz and Robert Lucas are accounted as mainstream, while figures such as Hayek and Buchanan are often described as non-mainstream. But one would be hard pressed to deny mainline status to Hayek and Buchanan, and would be hard pressed to force fit Stiglitz or Jeffrey Sachs or Paul Krugman into the mainline of argument in political economy from Hume and Smith to Hayek and Buchanan. Lord Acton perhaps stated the position best when he wrote: "But it is not the popular movement, but the traveling of the minds of men who sit in the seat of Adam Smith that is really serious and worthy of all attention."

So let's go back to our erstwhile principles of economics students being exposed to the economic way of thinking for the first time. They learn about incentives and choice on the margin, the productive gains from the division of labor, and the mutually beneficial aspect of trade. Even those teachers who want to emphasize the currently fashionable critique of the mainline must first teach students the mainline claim about how competing interests are reconciled through the market system to produce social cooperation and harmony, if only to criticize it.

I've stressed this distinction between mainline and mainstream because my contention is that the intellectual oscillations around the mainline proposition concerning the harmony of interest define the policy ethos of any historical era. The choice is between liberty and power. For much of the 20th century mainstream opinion in economics and political economy deviated considerably from the mainline of political economy. The consequences of this deviation were not trivial. Grand social experiments, with government power substituting for the voluntary choices of individuals with the market process, were undertaken through the world. The most extreme versions led to totalitarianism and economic depravation; the tamer version led to economic stagnation and the "nanny state". Since the 19th century, the intellectual moments when the mainline and the mainstream were aligned have been fleeting.

In my narrative of modern political economy I argue that the 20th and 21st century has seen three critical historical moments when the oscillation around the mainline was particularly volatile. The first was the End of *Laissez Faire* that described the intellectual discourse between 1900 and 1930. The second was the End of Socialism that defined the period of 1980-1995, when the mainline seemed to push back against the mainstream. The third is the Rise of Leviathan that has emerged since September 11, 2001. To make sense of these historical moments I rely on three propositions. The first proposition is that political and economic ideas can and do have consequences in the world of public policy. In short, we must pay attention to ideas if we want to make sense of the policy choices that are ultimately made. Interest group machinations are always present but they take place within a climate of public opinion that is shaped by ideas. The second proposition is that there must be an alignment of ideas and circumstances for rapid change based on ideas to be manifested in public policy. And the third proposition is that whenever ideas that argue that liberty must give way to power in human affairs become dominant, the consequences are dire to the social progress of humanity. Reliance on power makes us worse off, not better off. And this last proposition brings us back to the core teachings of political economy from Adam Smith to F. A. Hayek. Material progress, social cooperation, and harmony results not from judicious government planning but through the free choices of individuals within a system of private property, freedom of contract and consent.

The Presumption Toward Liberty and Against Power

Among the first lessons one learns in economics is the positive sum nature of voluntary exchange. Both parties expect to benefit from exchange, otherwise they would not have engaged in the act of exchange. The essence of wealth creation in a market economy is to be found in the act of mutually beneficial exchange. Of course, errors can be made in making the decision to trade, but not ex ante. Regret is an ex post phenomena. Moreover, because economic decision makers must bear the costs of their decision, they have a strong incentive to be alert to those opportunities in their interest to be alert to. Individuals may err, but they will learn of those errors quickly in their exchange behavior and adjust to avoid economic losses in the future.

That individuals should be regarded as the best judge of their situation has been a building block in economics since the writings of Adam Smith. In *The Wealth of Nations* Adam Smith argued that a virtuous circle led to greater prosperity. The source of economic growth and development was the gains from specialization and trade realized through the greater division of labor and the expansion of the market. The division of labor was indeed limited by the extent of the market. But as the market expands, the division of labor is refined even further and the gains from specialization increase productivity even more. There are, in other words, increasing returns to the expansion of the market arena. This Smithian virtuous circle counteracts any tendency toward being caught in the Malthusian trap of subsistence levels of production and represents instead the progressive march of modernity.

In the lectures and notebooks used in writing his great treatise, Smith summarized his position in the following manner: "Little else is requisite to carry a state to the highest degree of opulence from the lowest form of barbarism, but peace, easy taxes and a reasonable administration of justice: all the rest being brought about by the natural course of things" (1976, xl). Smith goes further and argues, "All governments which thwart this natural course, which force things into another channel or which endeavor to arrest the progress of society at a particular point, are unnatural, and to support themselves are obliged to be oppressive and tyrannical" (Smith). Evidence from the history of economic development supports Smith—both in terms of the path to successful development and the consequences of steering off that path. But one must unpack the basic institutional infrastructure that serves as the background to Smith's policy prescription. Smith's system of natural liberty, or Hume's system of property, contract and consent, consists of a network of complementary institutions that all serve to minimize the threat of predation from both public and private actors.

Once stated in this manner the "paradox of government" becomes apparent. Government is called upon to ward off the threat of private predation, but in so empowering government the problem of public predation is created. As James Madison put it:

> "If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a

> government which is to be administered by men over men, the great difficulty lies in this: You must first enable the government to control the governed; and in the next place, oblige it to control itself" (1788, 164).

Neither appeals to the wisdom of nobility, nor romantic dreams of the perfectibility of mankind address this paradox. Instead, institutional arrangements must be forged that will check ambition against ambition to ward off predation by private and public actors.

The system that Smith and Hume built to understand the political economy of growth and development did not rely on behavioral assumptions to generate the conclusions concerning the beneficial consequences of the "invisible hand." Self-interest is postulated as a universal aspect of man's nature, but the pursuit of self-interest is not the causal factor relied upon to explain how beneficial social order can emerge. In Smith's comparative political economy the self-interest of businessmen (reflected in their special interest pleading), the self-interest of the clergy and academics (reflected in the laziness demonstrated when in protected positions), and the self-interest of politicians (reflected in their arrogance and grabs for power) are all contrasted with situations where the self-interest of buyers and sellers in a system of property, contract and consent produce a social order that is both unintended and desirable. To put it another way, both the 'invisible hand' and the 'tragedy of the commons' explanations of social phenomena utilize the self-interested motivational assumptions, but the driving force in the analysis is the institutional context not the behavioral assumptions.

The intellectual project of Hume and Smith was to discover through analytical inquiry and historical investigation the institutional environment that could produce peace and prosperity despite the foibles of man. F. A. Hayek summed up the Smith project as follows:

> [T]he main point about which there can be little doubt is that Smith's chief concern was not so much with what man might occasionally achieve when he was at his best but that he should have as little opportunity as possible to do harm when he was at his worst. It would scarcely be too much to claim that the main merit of the individualism which he and his contemporaries advocated is that it is a system under which bad men can do least harm. It is a social system which does not depend for its functioning on our finding good men for running it, or on all men becoming better than they now are, but which makes use of men in all their given variety and complexity, sometimes good and sometimes bad, sometimes intelligent and more often stupid. ... The chief concern of the great individualist writers was indeed to find a set of institutions by which man could be induced, by his own choice and from the motives which determined his ordinary conduct, to contribute as much as possible to the need of all others; and their discovery was that the system of private property did provide such inducements to a much greater extent than had yet been understood (1948, 11-13).

In the reading that Hayek provides, the classical political economy of Smith was grounded in comparative institutional analysis. The subject matter of economics in this conception of the discipline is exchange and the institutions within which exchange takes place. Human beings are in possession of two competing natural proclivities—to rape, pillage and plunder on the one hand, and to truck, barter and exchange on the other. Which proclivity is stimulated and encouraged is a function of the institutional context within which man finds himself interacting with others. Institutions are defined as the 'rules of the game' that are in operation and their enforcement in any given specific historical situation.

The presumption toward liberty that existed in classical political economy was predicated on two subsidiary arguments. First, that individuals, not government officials, are the best judge of their situation and thus should be free to choose. Second, that the specific institutional context that is consistent with the freedom of the individual will steer individuals in the direction of truck, barter and exchange rather than the violent path of rape, pillage and plunder. The social order will not be predatory, but cooperative.

On the issue of who is in the best position to pass judgment on economic decisions, Smith stated clearly that:

> "The statesmen, who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would no-where be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it" (1776, BK IV, 478).

The teachings of political economy, Smith argued, were disregarded by an alliance of the sophistry of the businessman engaged in special interest pleading, and power wielding preferences of politicians. In short, the disregard for the first argument led directly to the second argument concerning government arrogance and power.

The great French political economist Frederic Bastiat chose satire to expose the sophistry of special interest protection by government when he penned his petition of the candlestick makers for protection against the unfair competition from the sun. (1845) Bastiat's countryman, J. B. Say, didn't choose ridicule but instead soberly discussed the problem of political power and economic efficiency that results from government sanctioned monopolies in his Treatise in Political Economy. (1821, 146-147) As Say put it: "The public interest is their plea, but self interest is evidently their object." (Smith, 161) The system of government privileges that sought to control trade was "pregnant with injustice" (164) and created serious mischief throughout the economy, according to Say.

John Stuart Mill perhaps wrote some of the most elegant passages on the presumption for voluntarism. He argued in his Principles of Political Economy (1848, 881-883) that the first principle of social order is the protection of persons and property. Without this protection, the social order breaks down into uncertainty and violence. Mill was quick to point out that government was not the only source of this protection, though a government that habitually violated these protections would destroy society. The prosperity experienced by the free cities of Italy, Flanders, and the Hanseatic League in an age of "lawlessness" demonstrates that a certain level of insecurity can be managed through means of self-protection.

> Insecurity paralyzes only when it is such in nature and in degree that no energy of which mankind in general are capable affords any tolerable means of self-protection. And this is a main reason why oppression by the government, whose power is generally irresistible by any efforts that can be made by individuals, has so much more baneful an effect on the springs of national prosperity, than almost any degree of lawlessness and turbulence under free institutions. Nations have acquired some wealth, and made some progress in improvement in states of social union so imperfect as to border on anarchy: but no countries in which the people were exposed without limit to arbitrary exactions from the officers of government ever yet continued to have industry and wealth. A few generations of such a government never fail to extinguish both. Some of the fairest, and once the most prosperous, regions of the earth have, under the Romans and afterwards under the Turkish dominion, been reduced to a desert, solely by that cause (1848, 882-83).

As a general rule, a progressive social order is built upon a foundation of individual liberty and the system of property, contract and consent. Even though John Stuart Mill would eventually make the case for an expanded role for government interference, he argued that "Whatever theory we adopt respecting the foundation of the social union, and under whatever political institutions we live, there is a circle around every human being which no government, be it that of one, of a few, or of the many, ought to be permitted to overstep" (1848, 943). Violating this principle ran the risk of the loss of human freedom and dignity. As such, Mill argued that "the onus of making out a case always lies on the defenders of legal prohibitions" (Smith). Mill even argued more forcefully when he stated later in this chapter that "*Laissez-faire,* in short, should be the general practice: every departure from it, unless required for some great good, is a certain evil" (Smith, 950).

The German sociologists and economic historian Max Weber made similar arguments to explain why capitalism had developed in the West but not in China. In his General Economic History (1927) Weber enumerated the defining characteristics of modern capitalism. Though there is no doubt that the value system in a society was a significant contributing factor, it was not just the existence of, or lack of, the Protestant Work Ethic that provided the explanation as to why there was no capitalism in China according to Weber as so many have concluded. Weber, instead, put great emphasis on the arbitrariness in the law and in the tax system that was practiced in China and which was inconsistent with the development of a modern economy.

Modern capitalism was instead characterized by rational accounting, freedom of the market, modern scientific technology, rule of law, free labor, a rationalization of the conduct of life consistent with market activity, and the commercialization of economic life. These factors all worked to provide a rational ethic for enterprise, and a political and legal environment that was predictable and guaranteed market participants a semi-autonomous area in society. In short, the basic lesson was once again that whenever peace, easy taxes and a reasonable administration of justice prevail, economic development follows in the natural course of things, and efforts by governments to thwart the natural development lead instead toward poverty and tyranny.

When one reads these different arguments from a Scotsman, two Frenchmen, a Brit, and finally a German, the consensus on the fundamental question of the causes of the wealth and poverty of nations is striking. But this consensus proved to be extremely fragile. Classical political economy proved to be quite vulnerable to critiques that focused on (a) instability, (b) monopoly, and (c) inequality. Karl Marx was the most thorough critic along these lines, but several others contributed along the way by pecking holes in the classical system of political economy. The presumption was being reversed.

Obviously, as with all living bodies of thought, there were weak spots in the classical presentation of *laissez faire*, but eventually these would be addressed to a considerable extent by the neoclassical theory of value and price (Boettke, 2006).[1] For example, the neoclassical theory of factor pricing challenged theories of exploitation. But as Hayek has pointed out, by the time those theoretical revisions were made the public mind had already been swayed to the other side.

> It takes a long time to rebuild the structure of a science if one starts by revising the fundamental concepts. And the modern revision of theoretical economics has occupied sufficient time to allow what was at first the heretical view of a number of radical economists—who had to fight what was then the conservatism of the practical men who were still under the

[1]The tension evident in the classical liberal position between the presumption toward voluntarism, but the claimed necessity for government coercion to provide the framework within which voluntary action can be relied upon to produce social order will not be discussed here, but is addressed in my paper, Anarchism as a Progressive Research Program in Political Economy."

> influence of economic liberalism—to pervade the thought of the public and to establish itself as the dominating doctrine, not only among advanced social reformers, but even among the most conservative businessmen. The public mind in all leading countries of the world is now completely under the domination of the views which spring from the revolt against the classical economics of seventy years ago (1931, 24).

After examining their refinements to the core of economic theory, the early neoclassical economists increasingly came to the consensus that classical economists had arrived at essentially the correct conclusions with cruder instruments. Despite this fact, the classical presumption toward freedom of choice gave way to a popular demand for government action, and concern with the abuse of political power was dismissed as the groundless fear of a pre-democratic era. Theory and experience sided with the general thrust of the classical political economists, but the public mind and the political elite resisted that conclusion and were instead under the sway of interventionism guided by democratic consensus.[2] By the first decades of the 20th century the classical presumption against interventionism was reversed, and now those who argued for *laissez faire* were on the defensive.

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[2]Ludwig von Mises (1949, 692) points out that once the state was attributed both benevolence and omniscience, "Then one could not help concluding that the infallible state was in a position to succeed in the conduct of production activities better than erring individuals. It would avoid all those errors that often frustrate the actions of entrepreneurs and capitalists. There would no longer be malinvestment or squandering of scarce factors of production; wealth would multiply. The 'anarchy' of production appears wasteful when contrasted with the planning of the omniscient state. The socialist mode of production then appears to be the only reasonable system, and the market economy seems the incarnation of unreason."

The End of *Laissez Faire*

In the US in 1900 the government expenditures at the local, state and federal level added up to only 6% of GDP, but by 1944 that figure was 48%. The policy changes of the Progressive Era that were initiated to address the supposed problems of private market monopoly, worker exploitation and consumer ignorance were pushing against an 'open door'. The economists' presumption was gone as a constraint, and the intellectuals, politicians, and special interests were able to form a coalition that would not be denied. As government grew with WWI and in response to the Great Depression and then WWII, the problems of instability and injustice were said to be finally addressed by democratic governments in the West. The intellectual consensus was that capitalism was plagued by microeconomic inefficiencies in the form of monopoly and external effects in production and exchange as well as macroeconomic instability that manifested itself in the form of business cycles and unemployment. *Laissez faire* as a policy rule was unable to meet the challenge of the modern age. Instead government was called upon to serve as a corrective to the social ills through microeconomic regulation and macroeconomic fine-tuning and economic management. The discipline of economics was transformed to provide these policy tools of economic planning and social control, and various policy institutions were established with the purpose of carrying out the mission of economic policy so defined. As a consequence government grew in both scope and scale.[3]

The main generation of economists and public policy intellectuals of the 20th century came of political consciousness during

[3]The best work on the growth of government in the U.S. during the 20th century is Robert Higgs's *Crisis and Leviathan* (1987). Also see his most recent work *Depression, War and the Cold War* (2006) for an examination of the critical decades dealing with the Great Depression and WWII.

the Great Depression, finished their graduate education either during or after WWII, rose to professional prominence in the 1950s and 1960s and became elder statesmen of the profession in the 1970s and 1980s. This was a generation who had lost faith in unbridled capitalism, believed deeply in the ability of democratic governments to address the social ills of poverty, racism, sexism and other forms of social injustice, and took great pride in the new science of economics they had helped create which could serve as a tool for social control to meet those challenges. This was a generation who defeated Hitler in their youth, and put a man on the moon by middle age. Only the most cynical and superstitious of that generation, it was believed, could doubt the progressive thrust of the new science of economics and democratically elected government, and instead demand a return to the older teachings of classical political economy that emphasized the institution of private property and freedom of contact, and constitutional constraints on the power of government.

By 1950 economic thought and policy was dominated by Keynesian demand management on the macroeconomic side, and market failure theory on the microeconomics side. During the period of 1946-1980, the intellectual consensus was collectivist, but the policy practice was lagging behind. Government spending as a percentage of GDP in the US expanded quickly as action chased after thought – while government spending declined immediately after WWII to 17% of GDP by 1948 it climbed to 32% by 1975. There was no serious intellectual resistance, save Milton Friedman, to the growth of government. Ideas and interests aligned to transform Western societies and also to build a policy consensus in the West's efforts abroad to address underdevelopment that was decidedly anti-market.[4] The voices of economists born in the 19th century, such as Mises and Hayek, that were raised to caution this trend were dismissed. But a growing counter-revolution that emphasized the institutional infrastructure and economic processes started to emerge within the profession to challenge the Keynesian and market failure hegemony.

The property rights economics of Armen Alchian, Ronald Coase and Harold Demsetz; the public choice economics of James Buchanan and Gordon Tullock; the new learning in industrial organization associated with George Stigler and Yale Brozen; the theory of the entrepreneurial market process associated with Israel Kirzner; the new economic history associated with Douglass North; and the monetarist critique of Keynesianism associated with Milton Friedman all emerged in the 1960s as a formidable opponent to the policy consensus from 1950-1970. By the mid-1970s the presumption in thought had swung back decidedly in the direction of classical liberal political economy.

The reason for the counter-revolution was not exclusively intellectual. The fact that the Keynesian system was flawed due to its lack of a choice theoretic foundation was only part of the problem with the policy consensus. The real problem is that empirically the policy recipe did not deliver either in the US or the UK. These economies stagnated and they did so while also experiencing inflation. Unions were

[4]Consider the dismissive intellectual treatment that the work of P. T. Bauer on the economics of underdeveloped and the failture of foreign aid received in the 1960s and 1970s. A conference honoring P. T. Bauer was held at Princeton University in May 2004 and during the question and answer period, Amartya Sen was asked what is the biggest difference in development economics from 1964 to 2004 and his answer was that in 1964 everyone viewed the market system as a zero sum game and thus politics had to provide the answer, while in 2004 it is the other way around.

granted too much legal power and thus ossified labor markets, regulations and taxes strangled businesses and stifled innovation, permanent deficits, and the distortions caused by inflation could all be accounted as a consequence of Lord Keynes. Even the Scandinavian welfare states had to confront the reality of fiscal imbalance, bloated bureaucracies and the inverted pyramid as more and more citizens were public employees or on public support rather than in the private sector generating the wealth that in this system was taxed. Absent wealth generation, there just wasn't enough to tax to finance the extensive state that was created. Government could no longer be seen as the corrective, since it was now evident that government was in fact the problem.

Policy would lag behind this intellectual recognition and unlike in the move from *laissez faire* to statism, interest groups and politicians would block moves for policy to catch up to the new thinking. If the period between 1945 and 1975 was one of "galloping socialism" in western democracies such as the US and UK as big government was called upon to serve as a corrective to economic ills (justified by market failure theory and Keynesianism), the period between 1975 and 2005 was one of "creeping liberalism" in the western democracies as the justification for the pervious policies were soundly defeated on the intellectual level, but the actual behavior of government in terms of spending, taxation, and regulation changed at a slower rate than should have followed from the intellectual victory.

Milton Friedman has argued that we have seen a victory in the realm of ideas, but a failure of implementation.[5] In the move from rhetoric to thought, and from thought to action, the classical liberal movement has been tripped up at the second stage. The stumbling blocks have mainly been a consequence of forces of inertia—the political resistance to change. Friedman explained this tyranny of the

[5]Friedman being interviewed on *The Charlie Rose Show*, PBS (December 26. 2005).

status quo as the alignment of intellectuals, interest groups and politicians, an 'iron triangle' who benefited from the existing array of policies and would block any proposed change. Still it is important to recognize that a counter-revolution in economic thought had been successful and that the Keynesian and market failure dominance was defeated to a considerable extent by 1980 and thereafter.[6]

The End of Socialism

The collapse of socialism in the late 1980s represented what many thought would be a final blow against government planning and interventionism. The resurgent classical liberal political economy that represented the counter-revolution was firmly established in the academic world. Its basic rhetorical message was creeping into the intellectual culture and general climate of public opinion: Socialism does not work. However, the general sentiment in the dominant intellectual culture, that humanity failed to live up to the ideals of socialism, got the message completely backwards. Socialism did not fail because humanity could not live up to its lofty ideals, but the other way around; socialism failed to live up to the demands of humanity. To go back to the two natural proclivities mentioned earlier, socialism by suppressing our proclivity to engage in truck, barter and exchange, unleashed our proclivity for rape, pillage and plunder. Instead of an egalitarian paradise, we had a reality of perverse incentives, economic inefficiency, political corruption, and regimes of ruthless brutality.

As socialism collapsed and the transition to capitalism was undertaken, it became evident fairly quickly that this would not be a smooth process. The triple transition of politics, economics and national

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[6]Consider the recognition by the Nobel Prize committee as weak evidence of this shift in thought: Hayek (1974), Friedman (1976), Buchanan (1986), Coase (1991), and North (1993).

psychology was going to be more difficult than the promises of '500 day plans' or 'shock therapy' seemed to offer.

The lesson to be learned from the experience in East and Central Europe and the former Soviet Union is not that 'shock therapy' is wrong. It is that (a) the introduction of market forces are only the first step in the process of transition, (b) that implementation via half-measures more often than not will result in unintended and undesirable consequences that will undermine the long-term legitimacy of the policy change, and (c) that economic reforms do not exist within a vacuum but instead take place within a context of political/legal systems and social/cultural belief systems.[7] But the lesson that most policy observers come to is different. Instead, the difficulties of the transition were attributed to the so-called callousness of 'neo-liberalism'. We are told Monetarism failed in Russia, when in fact we saw wild inflation in the 1990s as the Russian central bank printed rubles with reckless abandon. The result was that while in 1992 a ruble exchanged for a dollar at roughly 180r to $1, in 1995 a ruble exchanged for over 5000r to $1. Monetarism, if it means anything, should mean something about price level stability and the monetary rule. Obviously Russia did not follow monetarism. Privatization also gets criticized, as does trade liberalization.

By the late 1990s, intellectual and policy patience with *laissez faire* had worn off. Instead, questions such as 'who lost Russia?' or 'what to do about African underdevelopment and the AIDS epidemic?' or 'how is globalization adversely impacting the lives of the least advantaged members of underdeveloped countries?' moved to the center stage in

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[7] It is not my purpose here to detail the politics and economics of socialist transformation, but I have presented my position elsewhere (see Boettke, *Why Perestroika Failed* [1993] and *Calculation and Coordination* [2002). For a quick summary of the basics of what we have learned from our experience with economics in transition see Boettke,(2004).

intellectual and policy discussions. We knew from economics and political economy that foreign aid was not particularly effective at addressing the systemic problems in underdeveloped countries, but the intellectual culture refused to follow the implication that it was trade and not aid that would lift the economic conditions (Easterly, 2000, 2006).

Similarly, we learned from economics that trade harmonizes conflicting interests through market reconciliation over the terms of exchange, but our intellectual culture instead emphasized the clash of civilizations and the disillusion with globalization. Most of these critiques come from sources unenlightened by the economic way of thinking, but not always as some of the more vociferous criticisms and calls for government solutions come from the likes of Joseph Stiglitz, Jeffrey Sachs, and Paul Krugman.

Stiglitz (2003) basically argues that globalization has gone astray mainly because the world's governments have not listened to him. Sachs (2005) argues that Africa is trapped in a geographic situation that it cannot lift itself out of; it requires saviors, and he has volunteered. Krugman (2004) has decided that since he is so very smart, it is perfectly reasonable to use the op-ed page of the "New York Times" to discredit himself and his profession by becoming a political hack instead of practicing the sober analysis of the dismal science. In all three cases, we have economists who wish to return to the days of the Keynesian consensus when economists were in control of the instruments of social control and economic management (Krugman, 2000). The lessons of the counter-revolution are alien to them, and as with Keynes before them they ushered in a shift in the presumption in economic affairs.

The current presumption is that liberty must cede space to government power to do those things which liberty alone cannot accomplish. Fearfulness of the arrogance of power, on the one hand, and bureaucratic ineptitude on the other, are disregarded. Instead, the mistaken belief is that if the right people are in power, and listen to the right ideas, then government can be the most significant source of positive change in the world, and that economists can provide the vital information required for efficient and just social control.[8] We can eliminate underdevelopment and poverty within a generation and establish an era of global justice, but only if we act in concert with one another and utilize the great power evident in good government.

The Rise of Leviathan

On the morning of September 11 2001, the emerging intellectual consensus that challenged *laissez faire* at the end of the 20th century was cemented into the cultural and policy zeitgeist of our times. Socialism may have failed. Interventionism may have proved unstable and fiscally unsound. But the belief was that the market had indeed met its match in the difficult transitions of the 2nd world, and the lingering underdevelopment in the 3rd world. Moreover, none of the thriving 1st world countries followed strict *laissez faire* despite the instability and fiscal imbalance that interventionism wrought. Instead, the philosophy of 'best practice' seemed to suggest that some form of mixed economy, which encourages technological innovation and wealth creation and yet redistributes income to care for the least advantaged, was the system to be emulated. The secret of success was not to be found in the power of the market, but in 'good governance.'

After the terrorist attacks on U.S. soil, the argument about markets versus government seemed to be completely off the mark. Certainly *laissez faire* could not provide an answer to questions of national security against the terrorists' attacks. Liberty had to cede space to government power not only to realize global social justice, but also to provide security and safety at home.

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[8] For a critique of this idea of economists as saviors see Boettke and Coyne (2006a).

Benjamin Franklin once wisely remarked that a people who would be willing to give up their liberty in the name of security deserve neither. Franklin understood something that our contemporary policy culture fails to appreciate—namely, that the sicknesses in government can generate a sickness in the people. The human character can atrophy under government domination, and a culture of dependency replaces a culture of self-reliance and initiative. Classical thinkers from Montesquieu to Tocqueville understood this point about human faculties, as did Hume, Smith, Hayek, and Buchanan (see Buchanan, 2005).

Despite these warnings from our forbearers, big government has returned in the name of providing security to protect our way of life—which was presumably grounded in individual liberty. Total government spending as a percentage of GDP was 32% in 1976 and it is at 31% in 2005. The counter-revolution in economic thought has not produced the same change in actual government behavior that was evident in the wake of the Keynesian and market failure revolutions in thought. Whereas those earlier shifts in ideas, pushed against an 'open door' of government's natural proclivity to spend and cater to special interest groups, the counter-revolution of privatization, deregulation, fiscal restraint, monetary responsibility and free trade pushes against a 'closed door'.

To put it another way, the expansion of government promises direct benefits to well-organized and well-informed interest groups with costs being spread to the unorganized and ill-informed mass of voters. However, when that process is reversed we confront a situation where we are attempting to concentrate costs on the organized and well-informed (who will lose their special privileges) and disperse the benefits on the unorganized and ill-informed who will experience these benefits. As a result, while the Keynesian and market failure revolutions produced "galloping socialism" in the US, the counter-revolution in political economy has produced only a "creeping liberalism."

We were poised for more change in the direction of liberty and against power, but the disillusionment with market reforms in the former Soviet Bloc and in Latin America (in particular Argentina) and then the terrorist threat effectively eliminated the momentum for real substantive changes.[9] Ironically, the intellectual battle was so decisively won by the counter-revolution that the champions of big government often use the language of the market and voluntarism to defend the expansion of powers by the state.

Those in power see the great creative responsiveness of the voluntary non-profit sector in responding to those in need, and so they establish government programs to support the voluntary sector (and in the process co-opt the voluntary sector into the coercive sector of the state). Those in power see the great innovativeness of the entrepreneurial market economy, and so they establish government programs to encourage entrepreneurship and seek to orchestrate clusters of scientists, businessmen, and intellectuals in would-be economic growth areas (and in the process undermining the natural development of mutually reinforcing bonds of inquiry, innovation and profit-seeking). We have President Bush preaching fiscal conservatism, while increasing spending more than any other president, including Lyndon Johnson during his "Great Society" programs.[10]

Consider the spending of the Department of Homeland Security alone – in fiscal year 2001 it was a little over $10 billion but in fiscal year 2005 that figure was over $25 billion. Also consider the organizational logic of that department. Faced with a crisis, the government vertically

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[9] See the critiques of the "Washington Consensus" that emerged in the late 1990s and early 2000s. Stiglitz (2003) is the most recognized critique, but also see Amsden, Kochanowicz and Taylor (1995).

[10] The annualized real growth in discretionary spending by Bush is 8% and Johnson is 4.6%.

integrated and established a hierarchical bureaucracy. The US centralized to fight an enemy which is decidedly decentralized. A bureaucratic behemoth was created to defeat a nimble entrepreneurial enemy. If the lessons of the mainline of argument in political economy had been learned, then perhaps we would think about this differently.[11]

The push toward centralization and the expansion of powers was set in motion well before the domestic crisis that hit the Gulf Coast in August/September 2005. Katrina was in many ways a first test case of the ability of this new bureaucracy to respond quickly and effectively to a crisis that threatened domestic tranquility and it failed miserably. Government ineptitude and callousness stood out in stark contrast to the individual initiative and heroic compassion of the voluntary sector first-responders. If the heroes of 9/11 were the New York City firemen that risked their lives to save others, the heroes of Katrina were the Church leaders and others in the voluntary sector who worked around the government system to get into the impacted areas to get people out before the storm, and to recover and rescue individuals who were stranded after the storm. And in the rebuilding effort after the storm, we can see the power of individual initiative in the voluntary sector as neighborhoods, commerce, and lives are rebounding, and the ineptitude of government that slows the recovery with unnecessary regulations and

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[11] Obviously there are many issues associated with the post-9/11 world we live in. On why the war on terror is not being carried out in an effective manner from an economic point of view see Boettke and Coyne, "Liberalism in a Post-9/11 World" (2006b). Coyne's book, *After War: The Political Economy of Exporting Democracy* (2007), is the most comprehensive examination of the difficulties associated with constructivist attempts to impose sustainable democracies and market economies in these war-torn regions.

restrictions and often devolves into opportunities for corruption.[12]

If Katrina is any sort of "test" of the system in a post-9/11 world, then we should be concerned that the increased centralization of the response to crisis fails to address the basic economic problems of incentives and information. The "mainstream" response from mechanism design theory, which says that duplication and delays in response to crisis can be avoided through centralization, has confused the issue. The "mainline" wisdom about who is in the best situation to judge the use of local knowledge and the arrogance and abuse of power problem associated with state centralization is directly on point (Sobel and Leeson, 2006).[13] Indeed, how can anyone schooled in the teachings of political economy from Smith to Hayek expect a behemoth bureaucracy, competing with a nimble entrepreneurial enemy, to secure domestic safety and leave room for the freedom that we are supposedly fighting for?

A century after we started our narrative we are back to the critical question of whether *laissez faire* or government control should be

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[12]See the recent working papers released by the Mercatus Center at George Mason University by Emily Chamlee-Wright (2006) and Peter Leeson and Russell Sobel (2006).

[13]An interesting story from WWII by George Stigler when he worked at the Office of Price Administration is right on this point. Stigler was amazed at how unprepared and ridiculous the procedures for military procurement were. He was later asked by Tjalling Koopmans whether it was true or not that he (Stigler) had advocated the use of the price system to evacuate Manhattan in the case of a bombing. Stigler responded that he did not make the proposal, and that in the case of a bombing of Manhattan, he expected any system of evacuation to be confused and inefficient. But then he added, "If the bombings became repetitive, however, I thought the price system could handle the problem well. ... I believe now even more than I did then in the market system's flexibility, adaptability, and resourcefulness in finding new ways to make money" (Stigler, 1988, 61).

the basis for the political economy of the future. The argument and evidence weight on the side of *laissez faire*. Moral intuitions about zero sum nature of exchange and the lust for power by those in politics cuts against the teachings of political economy. Ludwig von Mises perhaps summed up the state of intellectual affairs best when he wrote:

> The issue has been obfuscated by the endeavors of governments and powerful pressure groups to disparage economics and to defame the economists. Despots and democratic majorities are drunk with power. They must reluctantly admit that they are subject to the laws of nature. But they reject the very notion of economic law. Are they not the supreme legislators? Don't they have the power to crush every opponent? No war lord is prone to acknowledge any limits other than those imposed on him by a superior armed force. Servile scribblers are always ready to foster such complacency by expounding the appropriate doctrines. ... In fact, economic history is a long record of government policies that failed because they designed with a bold disregard for the laws of economics.
>
> It is impossible to understand the history of economic thought if one does not pay attention to the fact that economics as such is a challenge to the conceit of those in power. An economist can never be a favorite of autocrats and demagogues. With them he is always the mischief-maker, and the more they are inwardly convinced that his objections are well-founded, the more they hate him (1949, 66-67).

The intellectual battleground that Mises so clearly envisioned is the very battleground we must be ready to engage today. We are at a critical juncture in the history of political economy and public policy. If, as in the past, the dominant historical interpretation comes to be that power is the only appropriate response to crisis, then the gains that classical liberal political economy earned (however fleeting) with the defeat of Keynes and the collapse of socialism will be lost on the new generation. Just as the interventionist interpretation of the Progressive Era, the Great Depression, and New Deal were countered with impeccable historical scholarship informed by the teachings of the mainline of political economy a whole new set of arguments must be countered.. The idea that market reforms in East and Central Europe have failed, the idea that big government initiatives to generate development in the underdeveloped world, and the idea that big government must protect us from foreign invasion in our homeland must be countered with careful reasoning and close attention to the historical facts.

The greatest accomplishment of the discipline of political economy demonstrating how peaceful social cooperation can emerge through voluntary choices and mutually beneficial exchange. Conflicting interests are reconciled in the market and social harmony is produced—as stated in the classical tradition the Jew, the Gentile and the Muslim may be at war with one another but can find peace through their transactions in the market. It is a great intellectual shame that "mainstream" economics has often lost the ability to understand the civilizing function of trade and commerce.

Conclusion

The role of the economist in a free society is that of a teacher, scholar and critic, but never that of a social engineer and planner. The political economists in the tradition of the mainline reject the role of expert for state directed economic planning. But if government is seen as a corrective to social ills, someone must be there to supply the arguments and tools to aid the government in this task. Economists, as they have come to be defined in the mainstream of economics throughout much of the 20th and into the 21st century, are precisely those who pretend to be able to provide the arguments and tools for government policy to fine tune, manage or plan the economy.

I have argued that the distinction between mainline and mainstream helps us understand the critical points in policy history and the role that economic ideas played in them. These historical turning points turned on who won the debate over the relative merits of liberty versus power. Unfortunately, in the historical sample we considered the policy world turned in favor of power over liberty with the consequence of economic depravation and political tyranny in the worst cases, and economic stagnation and the nanny state in the best cases.

The unfortunate consequences of ceding liberty to power should give us pause. The intellectual argument for liberty has only had fleeting success in the 20th century, but hope remains for the 21st century. My sincere hope is that groups like the Association for Private Enterprise will serve as a catalyst for a new generation of political economists who want to walk in the mainline path of Adam Smith, Frederic Bastiat, and F. A. Hayek.

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