

Are We Misled by Economists?

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In a recent article (*Herald*, 26 October), economics teacher Peter Lyons ran a valiant attack against ‘neoclassical economics’. He described this as an unrealistic ideology, which has dominated New Zealand’s political life. He is right on the first point and wrong on the second.

I agree with his criticism of the assumptions that underpin ‘neoclassical economics’. In an address to a joint meeting of *New Zealand Association of Economists* and the *Law and Economics Association of New Zealand* last June, I made some of the same points – and much more – to the visible discomfiture of some university lecturers in the audience. Their feelings may soon be reinforced when the New Zealand Business Roundtable publishes my address.

It is indeed unrealistic to assume that consumers are all-knowing. We are often ignorant and discover only with hindsight that we should have made different choices. It is also unrealistic to assume that there is ‘perfect’ competition and that people are ‘perfectly mobile in space’. Nor is it acceptable to assume that we do not incur costs when we coordinate what we produce and consume. In a modern economy, coordination costs come close to half of all costs of producing and distributing the national product.

But who outside those breathing the rarified air of academic enclaves pay attention to such models? University departments of business, law and engineering, for example, have long dropped such textbook economics from their syllabuses – and with good reason because these models have no role for entrepreneurs, the legal profession or technical innovators. More importantly, such abstract theorising has long been almost irrelevant to economic policy. When Peter Lyons writes that neoclassical

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economics has shaped actual reforms in New Zealand and elsewhere, he is plain wrong. The successful reforms in Thatcher's Britain, Reagan's America, the Hawke-to-Howard era in Australia, and the Douglas and Richardson reforms in New Zealand were inspired by Austrian economics, institutional-evolutionary economics and public choice theory. These conceptions offer much more realistic visions of economic life. They are not based on blind trust in 'market forces', but induce us to mistrust the visible hand even more. This brand of economics now also inspires the rise of Eastern Europe, East Asia and other formerly poor countries.

The basic message from this more realistic worldview has been that economic welfare – as well as social peace and equity – are best promoted if the millions of producers and consumers are left to search and use the knowledge that they believe is best for them. Knowledge is, after all, humankind's ultimate resource. It is dispersed throughout the community and is best tapped when people compete. In our imperfect world of ignorance and transaction costs, government regulations only distort those complex, daily discovery processes. This is why living standards have risen wherever greater economic freedom has prevailed. More importantly still, untrammelled markets have given the enterprising and the young more confidence and hope. Where the clumsy, visible hand of government re-regulates and redistributes income, people feel insecure and despondent. This is arguably one of the consequences of the Clark-Cullen era of re-regulation and the present timid approach to setting New Zealanders economically free.

Peter Lyons asserts that a 'well-funded public sector' is needed to guarantee greater equality of incomes and wealth. Actually, the empirical facts contradict this belief. Where governments do not intervene to play favorites for this industry or that interest group and where people with diverse capabilities and assets are free to search for market opportunities, we observe greater equality, less envy and less political discontent.

This insight will, however, only become accepted if the wider public realises that self-seeking, opportunistic people, like all of us, do not suddenly become white knights in shining armour if elected to political office or appointed to the public service. To the contrary. They then enjoy coercive powers and are not disciplined by having to compete with others. They work in offices remote from the real world and

typically lack the means to find the knowledge necessary to produce welfare-enhancing solutions. And they lack the motive to take risks without which practical improvements are often not attainable.

The economics profession could greatly contribute to the long-term prosperity of New Zealanders if it began to teach students about the merits of genuine competition, about the role of secure property rights, the rule of law and modest, but reliable government. Such a constructive approach is now increasingly taken by teachers in many countries with which New Zealanders have to compete. If a critic such as Peter Lyons could move from mere criticism to inculcating the evolutionary-institutional way of thinking about economic life, he would do infinitely more good than by flogging the long-dead horse of 'neoclassical economics'.

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