Everything You Need to Know About Laissez-Faire Economics

evonomics.com/the-invisible-hand-laissez-faire/

20/03/2015

By David Sloan Wilson and Alan Kirman

I'll bet money that Alan Kirman is the only economist with animated ants running around his email signature. Highly regarded by mainstream economists, he is also a critic of equilibrium theory and proponent of new economic thinking that takes complex systems theory into account. It was my privilege to work with Alan and Germany's Ernst Strungmann Forum to organize a conference titled "Complexity and Evolution: A New Synthesis for Economics" that was held in February 2015 and will result in a volume published by the MIT press in 2016.

After the conference was over, I sought Alan out to help me understand the complex history of laissez faire, the "let it be" philosophy that underlies mainstream economic theory and public policy.

DSW: I'm so happy to talk with you about the concept of laissez faire, all the way back to its origin, which as I understand it is during the Enlightenment. Then we can bring it up to date with some of its formalized versions in economic theory. Tell me what you know about the early history of laissez faire.

AK: I think the basic story that really interests us is that with the Enlightenment and with people like Adam Smith and David Hume, people had this idea that somehow intrinsically people should be left to their own devices and this would lead society to a state that was satisfactory in some sense for everybody, with some limits of course–law and order and so on. That's the idea that is underlying our whole social and philosophical position ever since. Economics is trying to run along side that. Initially the idea was to let everybody do what they want and this would somehow self-organize. But nobody said what the mechanism was that would do the self-organization. John Stewart Mill advanced the same position. He had the idea that people had to be given, as far as their role would permit, the possibility of doing their own thing, and this would be in the interests of everybody. And gradually we came up against this difficulty that we couldn't show economically, in a market for example, how we would ever get to such a position. I think what happened was on the one hand people became obsessed with proving there was some sort of socially satisfactory situation that corresponded to markets in equilibrium, and on the other hand, there was a lot of effort made, right up to the 1950's, to try to show that a market or an economy would converge on that. But we gave up on that in the 70's when there were results that showed that essentially we couldn't prove it. So the theoreticians gave up but the underlying economic content and all of the ideology behind it has just kept going. We are in a strange situation where on the one hand we say we should leave markets to themselves because if they operate correctly and we get to an equilibrium this will be a socially satisfactory state. On the other hand, since we can't show that it gets there, we talk about economies that are in equilibrium but that's a contradiction because the invisible hand suggests that there is a mechanism that gets us there. And that's what we're lacking–a mechanism. Is that clear more or less?

DSW: Yes, but it was very fast! I want to pull us back to the early times and make a couple of observations. First of all, that the first thinking about laissez faire came at a time when government was monarchy and absolutist rule. The whole struggle of the Enlightenment, to have a more egalitarian and inclusive society, was part of this. Am I right about that?

AK: Absolutely right. There was a social and philosophical revolution, precisely because of that. Men were trying to liberate themselves from a very hierarchical and monarchical organization. And economics tried to go along with that. There were good reasons and I think that even now there is no reason to say that there is anything wrong with the liberal position. On the other hand, what we can't show is that there is anything that would enable a liberal approach like that to get things under control. So you're right. It was a reaction to very autocratic systems that led the whole of the laissez faire and liberal position to develop.

DSW: Right. So laissez faire made a lot of sense against the background of monarchy and controlling church and so on. Now I know that Adam Smith invoked the invisible hand metaphor only three times in the entire corpus of his work and it is said that his first book on moral sentiments is much more nuanced than the popular notion of the invisible hand. Could you speak a little more on Adam Smith? On the one hand he's an advocate of laissez faire but on the other hand he is very nuanced in both of his books but especially in his *Theory of Moral Sentiments*. What do you have to say about that?

AK: Right. Adam Smith was fully cognizant of the fact that man is motivated by many things. Nowadays, if you take a very primitive version of the invisible hand, people say something like "greed is good". Somehow, if everyone is greedy and tries to serve their own interest, it will get to a good position socially. Adam Smith didn't have that view at all. He had the view that people have other things in mind. For example he said that one of the strongest motivations men have is to be seen to be a good citizen and therefore would do things that would appear to other people to be good. If you have motivations like that then you can be altruistic and you're not behaving like the strict *Homo economicus*. Adam Smith didn't take the strong position that people left entirely to their own selfish devices will make things OK. He had the view that man is much more complicated and governed by his emotions. He talks a lot about sympathy, which we would now call empathy.

DSW: That's great! Now let's talk about Walras and what his ambitions were to come up with the first mathematical justification for laissez faire, as I understand it.

AK: Actually, Walras himself didn't talk so much about laissez faire. He at that time had a very simple idea, that the amount of goods that people wanted to supply at a given price would be the amount that people would want to buy; i.e, demand at that price, so if those two were equal then that was the equilibrium price. Then he said that if we have many markets, how can we be sure that they will simultaneously be cleared, because after all if you raise the price in one market then that will effect the price in other markets. If you raise the price of bananas then the price of oranges will be effected, and so forth. He said "my problem is to solve the market clearing for all goods", but he was not so interested in the underlying philosophical context. Walras wasn't someone who pushed hard for laissez faire, but he started to build the weapons for trying to understand whether all markets could get into equilibrium. He wasn't so interested, himself, on whether the equilibrium was good for society; in other words, Adam Smith's original position. I would say that Walras was more a person who was worried about the very existence of equilibrium and he tried desperately at various points to show how we might get there. I don't think he was arguing in favor of laissez faire. I wouldn't regard Walras as being strictly in that tradition.

DSW: OK, that's new for me. So what about the rise of so-called neoclassical economics. At what point did it become toward demonstrating what I understand is the first fundamental theorem of economics—laissez faire leads to the common good and that being justified by some mathematical apparatus. Where does that come from, if not from Walras?

AK: We missed a very important step, which is [Vilfredo] Pareto. Pareto was concerned about the idea of the invisible hand himself. He said: "Look, what I want to show you is that the competitive equilibrium is a social optimum. He was the person to define what we now call a Pareto optimum, a situation in which you cannot make one person better off without making somebody else worse off—which is a pretty weak criterion, but still is a criterion for some sort of social efficiency. He was interested in the relationship between the two, so he brought us back on track to what I interpret as the invisible hand. Then, we can make a huge jump it you want to the first theorem of welfare of economics. That, mistakenly, is often referred to as the invisible hand theorem. But it is nothing about the invisible hand. It just says that if you are in a competitive equilibrium, then that will be a Pareto optimum, in the sense that I have just mentioned. You couldn't make someone better off without making someone else worse off. That's all it says. It does not say that if you leave a society alone it will get there, but thousands of people have interpreted it in that way.

DSW: OK. So where do we go from here? Tell me a little about agency theory, which is also something that seems to imply, if I understand it, that the only responsibility of corporations is to maximize their profits. The economy will work well if that's their only obligation.

AK: That's not exactly a sideline but a development where people are worrying about firms in addition to individuals. When you are just dealing with individuals in a simple economy, when they are exchanging goods there is no problem. When you get firms in there you need to ask "What's the objectives of these firms?" The objective, the argument is, is if they maximize profit then they are maximizing their shareholders' benefits and so therefore we get to the idea of increasing the welfare of society as a whole. But there is a huge leap there, because we haven't specified closely in our models who owns these firms and how ownership is transferred between these people. So I think there is a fuzzy area there, which is not completely included in the theory.

DSW: Please give me a thumbnail history of the Mont Pelerin Society and the role it played in advancing economic theory and policy. So this would be Hayek, Friedman and all that.

AK: The great hero of that society was Hayek. He had a different position from Walras & company and he wasn't very consistent in his views. According to Hayek, Walras said that nobody influences prices but take prices as given, and then somebody, not specified, adjusts them until they get to equilibrium. There is some mechanism out there. That was Walras. Hayek said "Not at all!" He said—actually he was a horrid man.

DSW: Wait a minute! Why was he a horrid man? You can't just glide over that!

AK: The reason I say that is—he had very clever ideas—but he was extremely bigoted, he was racist. There is a wonderful interview with him that you can find on You Tube, where he says (imitating Hayek's accent) "I am not a racist! People accuse me of being a racist. Now it's true that some of the Indian students at the London School of Economics behave in a very nasty way, typical of Indian people…" and he carries on like this. So that's one reason he is horrid. A second thing is that if you don't believe he is horrid, David, I will send you his book *The Road to Serfdom*, which said that if there is any planning going on in the economy, it will inevitably lead you to a fascist situation. When he produced that book it had a big success, particularly in the United States, and what is more, he authorized a comic book version of it, which is absolutely dreadful. One Nobel Prize winner, [Ronald] Coase, said "you are carrying on so much against central planning, you forget that a large part of our economy is actually governed by centrally planned institutions, i.e., big firms, and these big firms are doing exactly what you say they can't do. Hayek shrugged that off, but what he did in his book was say that if any planning goes on then eventually you are all going to wind up in a fascist state where you'll be shot if you don't do what you're told to do. At the end of the book there is some poor guy who's being shot because he wants to be a carpenter or a plumber, or something like that. It's terrible! And the irony of the whole situation is that comic book was issued and financed by General Motors, and GM of course is one of those corporations that Hayek didn't see were centrally planned institutions. That's way I say that Hayek was a dreadful person.

Hayek's idea was, there is no way that people could know what was going on and could know what the prices of goods are. Everyone has a little piece of information of their own, and in acting upon it, this news gets out into the market. So, for example I buy something such as a share, and you say "Oh, Kirman bought a share, so something must be going on there, based on information that he had that I didn't have", and so forth. Hayek's idea was that this mechanism—people watching each other and getting information from their acts, would lead you to the equilibrium that would be a socially optimal state. But again, he never specified closely what the mechanism was. He has little examples, such as one about shortage of tin and how people would adjust, but never really specified the mechanism. He believed that people with little information of their own, like ants, would somehow collectively get it right. It was a very different view of the world than Walras.

DSW: So he was a pioneer in two respects. First of all, he grasped the idea of self-organizing and decentralized processes—that the intelligence is in the system, not in any individual, and secondly cultural group selection, that the reason economic systems were like this is because of some past history of better systems replacing worse systems. The wisdom of the system was the product of cultural group selection, as we would put it today, and that we shouldn't question its wisdom by tampering with it. Is that a fair thing to say?

AK: Yes, that's a fair thing to say and I think it is what Hayek believed. He didn't actually show how it would happen but you're absolutely right—I think that's what he believed and he thought tampering with this system would make it less perfect and work less well, so just leave it alone. I don't think he had in mind, strictly speaking, group-level selection, but that's clearly his idea. A system that works well will eventually come to outstrip other systems. That's why he was advising Thatcher. Just trust the markets and let things go. Get rid of the unions, and so forth. So it's clearly he had in mind that interfering with that system would just lead you to a worse social situation. He was much less naïve than Friedman. Friedman has a primitive natural selection argument that if firms aren't doing better than other firms they'll go bust and just die. That's a summary of Friedman's evolutionary argument! But Hayek is much more sophisticated—you're absolutely right.

DSW: I think Hayek was explicit about cultural group selection, and Friedman—I've paid quite a bit of attention to his 1953 article on positive economics, in which he makes a very naïve evolutionary argument. Friedman and Hayek didn't see eye to eye at all, as I understand it. Hayek was actually very concerned that Friedman and other mathematical economists took over the Mont Pelerin Society, if I understand it correctly, but now let's put Friedman on center stage, and also the society as a whole and the creation of all the think tanks, which caused the society to become politically influential.

AK: Yes, I think that it coincided very nicely with conservative ideology and people who had really strongly liberal —not in the Mills sense (you have to make this distinction particularly in the United States where these words have different meanings), but really completely free market leave-everybody-to-their own-thing libertarian point of view. Those people found it a wonderful place to gather and reinforce themselves. And Hayek was a strong member of that. Another was Gary Becker, but I don't know how directly. Becker had the economics of everything —divorce, whatever. You'd have these simple arguments, but not necessarily selection arguments, often some sort of justification in terms of a superior arrangement. The marginal utility of the woman getting divorced just has to equal the marginal utility of not getting divorced and that would be the price of getting divorced, and that sort of stuff. Adam Smith would have rolled over in this grave because he believed emotions played a strong role in all of this and the emotions that you have during divorce don't tie into these strict calculations.

DSW: This is a tailor-made ideology for powerful interests, powerful people and corporations who simply want to have their way. Is that a false statement to make?

AK: No, I think that's absolutely right. They can benefit from using that argument to advance their own ends. As someone once said, if you think of saying to firms, we're going to diminish their taxes, no firm in its right mind would argue with that. Even though they might think deep down that there are other things that could be done for society. There are some things which are part of this philosophy which is perfect for firms and powerful interest groups. You're absolutely right. And so they lobby for this all the time, pushing for these positions that are in fact in their own interest.

DSW: So, at the end of the day, "Greed is Good" sounds so simplistic, but what all of this seems to do is to provide some moral justification for individuals or corporations to pursue their own interests with a clear conscience. It's a moral justification for "Greed is Good", despite all of the complexities and all of the mathematics—that's what it seems to come down to. Am I wrong about that?

AK: I think you're absolutely right. What's interesting is that if you look at various economic situations, like today the first thing that people tell you about the Greeks is that they are horrid ideological people. But the people on the other side have an equally strong ideology, which is being justified by the sort of economic models that we are building. Remember that even though we had this discussion about how this became a real difficulty in theoretical economics, in macroeconomics they simply carried on as if these theoretical difficulties hadn't happened. Macroeconomic models are still all about equilibria, don't worry about how we got them, and their nice efficient properties, and so forth. They are nothing to do with distribution and nothing to do with disequilibrium. Two big strands of thought—Keynes and all the people who work on disequilibrium—they're just out of it. We're still working as if underlying all of this, greed—we don't want to call it greed, but something like greed—is good.

DSW: Could I ask about Ayn Rand and what role she played, if any? On the one hand she was not an economist, she was just a philosopher and novelist. On the other hand, she is right up there in the pantheon of free market deities alone with Smith, Hayek and Friedman. Do you ever think about Ayn Rand. Does any economist think about Ayn Rand?

AK: That's an example of my narrowness that I never read Ayn Rand, I just read about her. I think it would be unfair now to make any comments about that because I'd be as uninformed as some people who talk about Adam Smith. What I should do at some point is read some of her work, because she is constantly being cited on both sides as a dark bad figure or as a heroine in the pantheon as you said, with Hayek and everybody else. I just admit my ignorance and I don't know if Rand had a serious position on her own or whether she is being cited as a more popular and easily accessible figure.

DSW: Fine! I'd like to wrap this up with two questions. This has been a wonderful conversation, by the way. Nowadays, you hear all the time about how neoliberal ideology and thought is invading European countries and is undoing forms of governance that are actually working quite well. I work a lot in Norway and Scandinavia and there you hear all the time that Nordic model works and at the same time it is being corrupted by the neoliberal ideology, which is being spread in some sort of cancerous fashion. Please comment on that—Current neoliberalism. What justifies it? Is it spreading? Is that a good thing or a bad thing? Anything you would like to say on that topic.

AK: I think that one obsession that economists have is with efficiency. We're always, always, worrying about efficiency. People like to say that this is efficient or not efficient. The argument is, we know that if you free up markets you get a more efficient allocation of resources. That obsession with efficiency has led us to say that we must remove some of these restraints and restrictions and this sort of social aid that is built into the Scandinavian model. I think that's without thinking carefully about the consequences. Let me tell you my favorite and probably not very funny story about how economists are obsessed with efficiency. There were three people playing golf; a priest, a psychoanalyst, and an economist. The got very upset because the guy in front was playing extremely slowly and he had a caddy to help him. So these guys get very upset and they start to shout and say "Come on, can we play through please! You can't waste all of our afternoon!" They sent the priest up to find out what was going on and he came back absolutely crestfallen and said "You know why that poor guy is laying so slowly? It's because he's blind. I'm so upset because every Sunday I'm preaching to people to be nice to others." He turns to his psychoanalyst friend and say's "Joe, what do you think?" Joe says "I have these guys on my coach every week. I'm trying to help them live with this problem and here I am screaming at this guy. It's horrible!" Then they turn to the economist and say "Fred, what do you think?" Fred says "I think that this situation is totally inefficient. This guy should play at night!" As you can see, this is a very different attitude to how the world works.

I think what has happened is, because of this mythology about totally free markets being efficient, we push for that all the time and in so doing, we started to do things like—for example, we hear all the time that we have to reform labor markets in Europe. Why do we want to reform them? Because then they'll be more competitive. You can reduce unit labor costs, which usually means reducing wages. But that has all sorts of consequences, which are not perceived. In model that is more complex, that sort of arrangement wouldn't necessarily be one that in your terms would be selected for. When you do that, you make many people temporary workers. You have complete ease in hiring and firing so that people are shifting jobs all the time. When they do that, we know that employers then invest nothing in their human capital. When you have a guy who may disappear tomorrow—and we have a lot of these temporary agencies now in Europe–which send you people when you need them and take away people when you don't. Employers don't spend anything on human capital. We're reducing the overall human capital in society by having an arrangement like that. If you're working for Toyota, Toyota knows pretty much that you'll be working all your lifetime, so they probably invest quite a lot in you. They make you work hard for that, but nevertheless it is a much more stable arrangement. Again, the idea that people who are out of work have chosen to be out of work and by giving them a social cushion you induce them to be out of work—that simply doesn't fit with the facts. I think that all the ramification of these measures—the side effects and external effects—all of that gets left out and we have this very simple framework that says "to be competitive, you just have to free everything up." That's what undermining the European system. European and Scandinavian systems work pretty well. Unemployment is not that high in the Scandinavian system. It may be a little bit less efficient but it may also be a society where people are a little bit more at ease with themselves, than they are in a society where they are constantly worrying about what will happen to them next. The last remark I would make is that to say "you've got to get rid of all those rules and regulations you have"—in general, those rules and regulations are there for a reason. Again, to use an evolutionary argument, they didn't just appear, they got selected for. We put them in place because there was some problem, so just to remove them without thinking about why they are there doesn't make a lot of sense.

DSW: Right, but at the same time, a regulation is a like a mutation: for every one that's beneficial there are a hundred that are deleterious. So…

AK: You are an American, deep at heart! You believe that all these regulations are dreadful. Think of regulations about not allowing people to work too near a chain saw that's going full blast, or not being allowed to work with asbestos and so forth. Those rules, I think, have a reason to be there.

DSW: Well of course, but just to make my position clear, the idea of no regulations is absurd. For a system that is basically well adapted to its environment, then most of its regulations are there for a reason, as you say, but one of the things that everyone needs to know about evolution is that a lot of junk accumulates. There is junk DNA and there is junk regulations. Not every regulation has a purpose just because it's there, and when it comes to adapting to the future, that's a matter of new regulations and picking the right one out of many that are wrong. The question would be, how do you create smart regulations? Knowing that you need regulations, how do you create smart ones? That's our challenge and the challenge of someone who appreciates complexity, as you do. How would you respond to that?

AK: I think you're absolutely right. It's absolutely clear that as these regulations accumulate, they weren't developed in harmony with each other, so you often get even contradictory regulations. Every now and then, simplifying them is hugely beneficial. But that doesn't mean getting rid of regulations in general. It means somehow managing to choose between them, and that's not necessarily a natural process. For example, in France when I arrived here it used to take about a day and a half to make my tax return. Now it takes around about 20 minutes, because some sensible guy realized that you could simplify this whole thing and you could put a lot of stuff already into the form which they have received. They have a lot of information from your employer and so forth. They've simplified it to a point where it takes me about 20 minutes a year to do my tax return. It used to take a huge amount of time.

DSW: Nice!

AK: What's interesting is that you have some intelligent person saying "let's look at this and see if we can't make these rules much simpler, and they did. I have conflicting views, like you. These things are usually there for a reason, so you shouldn't just throw them away, but how do you select between them. I don't think that they necessarily select themselves out.

DSW: I would amend what you said. You said that some intelligent person figured out how to make the tax system work better in France. Probably not just a single intelligent person. Probably it was an intelligent process, which included intelligent people, but I think that gets us back to the idea that we need systemic processes to evaluate and select so that we become adaptable systems. But that will be systemic thing, not a smart individual.

AK: You're absolutely right. I shouldn't have said smart individual because what surely happened was that there was a lot of pressure on the people who handle all of these things, and gradually together they realized that this situation was becoming one where their work was becoming almost impossible to achieve in the time available. So there was some collective pressure that led them to form committees and things that thought about this and got it together. So it was a natural process of a system, but it wasn't the rules themselves that selected themselves out, as it were. It was the collectivity that evolved in that way to make it simpler.

DSW: There's no invisible hand to save the day.

AK: (laughs). Joe Stiglitz used to say that we also need a visible hand. The visible hand is sometimes pretty useful. For example in the financial sector I think you really need a visible hand and not an invisible hand.

DSW. That's great and a perfect way to end. I'm so happy to have had this conversation, Alan, and to be working with you at the conference we just staged and into the future.

AK: A pleasure. Always good to talk with you.

Alan Kirman is professor emeritus of Economics at the University of Aix-Marseille III and at the Ecole des Hautes Etudes en Sciences Sociales and is a member of the Institut Universitaire de France. His Ph.D. is from Princeton and he has been professor of economics at Johns Hopkins University, the Universite Libre de Bruxelles, Warwick University, and the European University Institute in Florence, Italy. He was elected a fellow of the Econometric Society and of the European Economic Association and was awarded the Humboldt Prize in Germany. He is member of the Institute for Advanced Study in Princeton. He has published 150 articles in international scientific journals. He also is the author and editor of twelve books, most recently Complex Economics: Individual and Collective Rationality, which was published by Routledge in July 2010.