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NEO-CLASSICAL ECONOMICS AS 18th CENTURY THEORY OF MAN

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1. *The Real Claim of the Chicago School*

If anything dramatic has happened in economic theory over the last one hundred years – namely, since the advent of marginalism – then, everyone agrees, it was not the rise of the Chicago neo-classical school which, after all, only synthesized the various versions of marginalism, but the Keynesian Revolution. Assessments of this revolution were repeatedly invited, particularly by opponent, chiefly from Chicago. F. A. von Hayek has explicitly and bitterly blames Keynes for all our economic troubles; Harry Johnson has repeatedly declared the most revolutionary work of Keynes, his *General Theory* of 1936, so poor that but for its author's name on its title page it would have totally flopped. Can such a flop cause so much damage? Are these two assessments – of Hayek and of Johnson – in conflict or not? Don Patinkin has raised a different question: how different is Keynes from his Chicago opponents, say, Milton Friedman? How many heads need roll, to use his metaphor, before a revolution may be declared? Patinkin sees Keynes as slightly deviant but still a member of the mainstream – the mainstream of the mainstream being Friedman and his Chicago followers, of course. Now, can a minor deviant be a flop? Can minor deviations from the true blue doctrine be to blame for all of our economic woes? I do not know.

Joan Robinson sees in Keynes a minor deviation from classical theory because he said once his correction of classical theory is implemented, that theory takes over once again. Moreover, Samuelson and Friedman have endorsed a (poor) version of Keynes' theory of short-term relative price and ignored his general theory of price and money, thus compromising the two into a new orthodoxy, hardly different from the old.

Not finding myself qualified to judge details of this discussion, I confess I do not see that Keynes has effected much of a revolution. Yet, he undeniably did make a stir. And he made his stir by a sarcastic assertion. He said this. Nobody believes the classical theory, except naive Lionel Robbins, yet they are all eager to apply it nonetheless. This was a snide remark, and it must have cut deep. It was never tackled head-on, yet it was answered, it seems to me, by Milton Friedman Himself, and in an essay which is generally regarded in the profession as both most significant and most influential – because, let me surmise, it effectively neutralized the bite of Keynes's sarcastic assertion while laying down the rules of the game, rules that have made the victory of the Chicago school a virtual certainty. Without direct reference to Keynes Friedman manages to respond to his attack and even to turn the table on him. The exercise is breath-taking in its sheer elegance. For, Friedman essay begins with a deep bow to Keynes's father – to John Neville Keynes, with a quote from his work and a high praise. Only after the essay is concluded, in a personal after-thought, is John Meynard Keynes himself mentioned, in a composite praise for the Cambridge school as far as the static theory of relative prices goes; as far as the dynamic theory, Friedman adjudicates there, things are not so good. He thus dismissed Keynes's theory by implication. This, nevertheless, is over all hardly different from the assessment of Joan Robinson, who is one of the Cambridge economists whom Friedman seems to have killed with the faint praise that comes as an afterthought.

We can all do a service to learning and scholarship, scientific, historical and any other, by laughing out-of-court such elegant dancing about a point. We can and should demand of authors responding to attacks to say that they are responding, and to what attack, or, otherwise, what other items occasion their critical surveys or essays. Too much of scholarship is pointless dancing around, so the forest is lost very easily by the too many trees that are carefully put for critical examination but carefully located in the hope to conceal the forest. We should better not lose sight of the forest, of the general outlook behind the economic theory of the Chicago school, particularly Friedman. To return to Friedman's response to Keynes, then. Nobody believes the neo-classical theory, said Keynes sarcastically, yet they all wish to apply it. The response is simple: scientific theory in general is not an object of belief but an instrument to apply – if and when it is usefully applicable. Hence Keynes' attack is no attack at all, but an observation of the facts. And it is the facts that make neo-classical economic theory praiseworthy.

Friedman declared the axioms of economic theory as not subject to commitment or faith of any sorts. He found a most unprofitable venture any attempt to decide empirically whether entrepreneurs aim at maximum profit. He acknowledged that a major axiom of economic theory, the claim that there is a free entry to the market, does not hold – at least it does not hold for the manufacture of cigarettes in the United States. Yet he claimed that this is no bother at all. He compared this falsehood to the falsehood of Galileo's theory of gravity, which, it is well known, includes the false assumption that falling bodies are not effected by atmospheric friction. And, as is likewise well known, feathers and parachutes do not fall in the same speed as other bodies, whereas Galileo's chief claim was that gravity is the same for all bodies – light and heavy alike. According to the Aristotelian theory of gravity that was extant in Galileo's times, a two-unit-weight body falls twice as fast as a one-unit-weight body. Galileo denied that, even though a feather falls much slower than a cannon ball.

So much for Friedman's taking the sting out of Keynes's sarcastic assertion. It is not whether one believes a theory but whether its practical predictions come true, or sufficiently near the truth to be useful. It leaves quite beside the point the question, what does Friedman believe? And it raises the point of the technique of applying economic theory to practical affairs and checking it for predictive success. Now, very clearly, apply Galileo's theory of gravity to parachutes will yield false results, yet we approve of his theory and use it, since it yields excellent results for cannon balls and other objects. Hence, says Friedman, our task in economics is, likewise, to find where economic theory fails to apply and where it applies well enough, and then approve of it for its successful applications. Thus, we see clearly, the rules of the game as laid down by Friedman lead inexorably to the conclusion that economic theory is as praiseworthy as is Galileo's theory of gravity.

This is amazing. Praise and blame are not to the point. It is true that Galileo's theory is still used in cases in which predictions based on it are good enough for practical purposes. For predictions about parachutes, and for predictions about the conduct of cannon balls with a high accuracy – so that air friction has to be considered too – not Galileo's theory but a theory of gravitation under friction is applied, whether Newton's or Stokes' or any other. Where is the economic theory which improves upon classical marginalism the way Newton or Stokes improves upon Galileo? What theory is applied these days to the aspects of the market not covered by marginalist equilibrium theory? Moreover, the domain in which Galileo's theory applies fairly successfully is fairly well distinguished, and so it is possible to take it as the standard and then try to find a broader theory which includes it, namely, a theory of gravity under friction, which includes Galileo's theory as a special case (the special case being friction reasonably near zero). Where is the economic equivalent? To talk mathematically, when acceleration is much stronger than friction, Galileo's theory gives better results than when it is not. When friction is almost as strong as acceleration, as is the case of the feather or the parachute, we better not use predictions based not on Galileo's theory bit on other theories. Is there a case like that in economics? Shall we say, the less friction and the stronger the market forces (i. e., supply and demand), the better are the results of the application of neo-classical theory, the more friction the less? We will then have to ask, what is friction and what are the market forces, and how do we compare these sets of forces? Moreover, in Galileo's theory we have only one force, the force of gravity, and one impediment, friction. We may be tempted, then, to compare gravity to market forces (i. e., supply and demand) and friction to all impediments to them, such as no free flow of information, no free entry, competition not being perfect, and so on. Though I have not seen anyone declare this proposal, I have seen many economic texts written more-or-less in accord with it. Except that in economics we have in the market forces other than those of supply-and demand, such as government incentives, the supply of money and more; and we can scarcely compare the lack of information to protective tariffs.

In other word, once we take general equilibrium theory – any general equilibrium theory – as our starting point, then we have already greatly prejudiced issues. We thereby agree to the following assertion, Though some markets are far from equilibrium and the theory applies to them very poorly, and though strictly speaking no market is ever in equilibrium, nevertheless, sufficiently many sufficiently significant markets are so near equilibrium that predictions about them based on general equilibrium theory will be sufficiently accurate to be sufficiently useful. This assertion is simply untrue. Chicago-style economists – almost all economists, really – are fully cognizant of this fact. One can blame different people for this, the unions, the government and the legislature, and even John Maynard Keynes (as did Hayek, we remember). But blaming anyone for this is admitting that this is indeed, the case. If all markets are so far from equilibrium as to make neo-classical predictions about their conduct useless, why start there?

Answer: because this is the most rational place to start with. This answer is the target of my present critical comments. Let me take a practical case, and Friedman's treatment of it in the popular press – in his *Newsweek* weekly column. It concerned the fact that the American export to Japan greatly fell behind the Japanese export to the United States: the forces of the market decreed that the volume of goods that the Americans bought from Japan exceeded that which they could sell to the Japanese. The Japanese side of the picture, incidentally, was less prescribed by forces of the market (i. e., by supply and demand), and the U. S. administration did and still does want more Japanese to buy more American goods. They say that the Japanese market must be more open to market forces and the Japanese consumer must be allowed to develop tastes for luxury items and so on and so forth. The long and the short of it was that many Americans, spokesmen for the general public, journalists and media presenters and legislators and administrators, many of them expressed concern at the fact that imports of Japanese goods greatly exceeded exports to Japan.

Friedman has offered a different view. He opposed any intervention in the market, administrative or legislative, and he therefore tried to show that the fear is exaggerated. The fear, that is, of evil consequences of the trade imbalance. He went so far as to assert that the fear is utterly baseless. What happens, he said, is that the Japanese exchange cars and electronic goods for green dollars. And if the Japanese love green dollars so much that they are willing to depart from their cars and transistors in exchange for them, then why should Americans care? They should rather print more green dollars and exchange them with any Japanese goods on the market which they covet.

Needless to say, the nation refused to follow Friedman's advice, even some of the most Chicago inclined administrators drew the line here. They frankly feared Japanese take-over of American industries. Not Friedman. In the opinion that he expounds Japanese citizens bringing in a lot of green dollars in order to become heads of Texan production companies simply help green dollars circulate; as they come to the United States bringing with them a lot of cargo, they help the economy. The fact that they are not American nationals does not signify in Friedman's book, since, clearly, they have to behave as any law abiding citizen even though they come from Japan.

That economics is strongly linked to politics is no news: political and economic decisions have strong impact on economics and on politics respectively, so that a view on what is desirable economically constrains the choice of views on what is desired politically and *vice versa*. Yet this does not decide matters of priorities: should we have guns instead of butter? And here comes classical liberal philosophy and offers the same guideline both as economic wisdom and as political wisdom: *Laissez faire*! And the Chicago school takes this as its motto.

The weight of this motto is illustrated more in the political and philosophical writings of the adherents of the Chicago school than in their economic writings. An example of a constraint on *Laissez faire* is compulsory education. Though Friedman himself does not oppose it, he at least wishes to liberalize it by leaving as much choice between schools as the market would allow. His writings on this matter are very famous. Most of them are political rather than economic. A more forceful example of a constraint on *Laissez faire* is the current debate among some philosophical adherents to this school is the question of principle: can one eliminate the state's role of policing altogether? Is it possible, in principle, to replace the police force with private police?

The original liberal view was that government should only guarantee liberties by responding to crime; to this the imposition of fulfillment of contracts was added. Why? Why can we say that an inefficient entrepreneur will be ejected from the market but not that a dishonest one will be similarly ejected? One may say, it is impractical to assume this, since by the time information about an entrepreneur's dishonesty is broadcast, too much damage is done. This is an argument from friction. But then friction permits the inefficient to stay too – at least for a second or third chance! Indeed, the inefficient usually blames ill luck, not inefficiency, for their failures, and we are never sure on such matters in the first and second instance, unless they comprise very unusual cases. One may claim that the level of friction is different in different cases; one will then have to measure levels of friction, or at least to be able to. This is not the case.

If we assume that governments can significantly diminish dishonesty, then government can, by the same token, significantly diminish dishonesty in the description of goods on sale. It can, for example, demand the legislation of the laws of truth in advertising. The Chicago economists are almost all against this law. This is the thin edge of the wedge of government control to replace the market mechanism, they aver. But is it not possible that government here, too, acts as a reducer of friction? Will the Chicago school allow government intervention in all cases of friction, since friction is what the classical model does not apply to? No, and because this will stifle the market, whereas the market mechanism is know to work as a mechanism which may very well reduce friction. This is why information markets boom.

The idea can be generalized. On the one hand we have the liberal system applicable to free agents, on the other government-controlled system applicable to the less-than-free. Citizens are, of course, neither utterly free nor utterly controlled. Yet, conditions differ greatly between systems with and without free markets: free markets cause things to improve and government control causes them to deteriorate. This is the true philosophy of the Chicago school. What are its roots? It is true?

2. *The Lack of Empirical Basis for Neo-Classical Economics*

Before discussing the philosophical roots of the neo-classical political-economic theory, let me show that the question is not idle. For, if it has philosophical foundations not shared by all, then those who hold competing philosophies will refuse Friedman's suggestion to take as the primary or default model perfect competition with dynamic equilibrium and then try to branch out. They may want to choose an alternative primary or default model. Indeed, non-Marxist socialists who opt for state planning, and anti-socialist planners, the Stalinists and the other totalitarians who naturally opt for state planning and control, they do take the perfect five-year plan as the primary or default model and the very limited market as a slight modification of it. Moreover, they say, all markets are limited, so that allowing markets in backward countries like Russia or Zimbabwe as much freedom as in the West will only invite either anarchy or neo-colonialism. This point is well taken by the Chicago school adherents, who love to polarize matters and present the choice between liberal advanced post-industrial fairly-free-market economies and dictatorial backward planned economy. Though the Soviet economy was not exactly as backward as that of Zimbabwe, the Chicago school is confident that the free competitive system is better than the planned one. If they discuss progress in Soviet Russia, they find the cause for it in the Soviet endorsement of some capitalist economic ideas. And, in particular, they stress the *a priori* obvious idea that tight planning leads to tighter planning whereas free competition leads to greater freedom.

Here a finicky critic might object: early in the industrial revolution, entry to the market was fairly free, which is both a freedom which we may wish to value as such and a freedom which secures competition and so serves the consumer. Not so today, where entry is limited to huge capital investors and is increasingly limited by gigantic take-over bids which threaten to establish oligopoly which is finance monopoly. (Marxists critics of current economic theory insist on the distinction between early and late capitalist systems, so-called, and on Marx's praise for the early stage of the system, when it brought so much economic progress, and his blame for its late stage, which brought about so much needless pain.) But the critic of this sort is usually dismissed as naive: money still goes to where returns are greatest, and the smallest investor if free to buy shares. The market in share works even on the biggest corporations, says Friedman, forcing them to invest where returns are highest. (At times he declares the fluctuations in the share market significant as the expressions of benign market forces and at times he views them as statistically insignificant expressions of unfortunate friction. But we should ignore minor inconsistencies as the result of mere friction in communication.)

Friedman defends the market against the complaint about the lack of free entry required by the *Laissez faire* slogan just by this observation. The entry to the stock market is much less limited than the entry to the market in goods and services. Yet the question is, is entry to the stock market sufficiently free an entry to the production system to impose maximal efficiency on it? The stock market, after all, is also controlled by big money to this or to that extent, and unavoidably so. For the small investor it is not a market mechanism but a roulette and a rip-off, a place where small funds are voluntarily given away and to big corporations, with the guidance of hunches offered by ignorant stockbrokers. No one denies, at least, that this was so worldwide until recently, and has only ceased to be so in some countries where only recently relatively tight government controls were instituted on stock exchanges (especially checks on inside trading, that are extremely hard to exercise efficiently without limiting freedom seriously). Yet Chicago economists insist on the value of the stock market as promoter competition.

This should illustrate a different point. Critics of the Chicago position as outlined here do voice objections. These objections are usually examined. They are usually shot down, of course. Otherwise they may lead to some modification or another of the Chicago position. What is missing in all this is something different, a different fundamental position different from the neo-classical market mechanism theory and different from the state planning no-market theory. It should be such that it will be possible to develop it, and its development should be open to criticism and possible modifications. Is there such a possibility? If we could state the neo-classical philosophy and then have a better substitute, then perhaps we will be able to rid ourselves once and for the tyranny of Friedman's rules of the game and then we will have a fair competition between neo-classical economics and some other viable substitute to it. The substitute does already exist. Its very existence shows that no empirical facts suggest that the neo-classical theory has to be preferred. The basic philosophical idea of classical economics, as well as of neo-classical one, is that of the consumer's sovereignty or, when more politically considered, the autonomy of the individual citizen.

The neo-classical theory is incomparably more elaborated and sophisticated as compared to the ideas of the early originators of classical economics, David Hume, Adam Smith, and even David Ricardo. Yet this is no real advantage. As Jerome Rothenberg has claimed in his essay on conscious sovereignty in the 1968 *International Encyclopedia of the Social Sciences*, the old theory is so much tampered with and modified, that it has lost all of its character. The starting point of the classical theory of the consumer these days is presented as the idea of consumers' preference arranged in indifference curves and cut-off by budget lines. This theory is cumbersome, incorrect, and irrelevant. It is cumbersome as it permits consumers to change their real preferences more rapidly than the speed with which supply can adjust to demand by the use of the market mechanism. It is false because the budget line is not given, since consumers can purchase liquid money or refrain from so doing. Keynes utilized this idea, we remember, when he made the practical proposals that made his economic theory so very significant in practical political terms. And, finally, consumers' preferences are irrelevant to economic theory since the market treats consumption as aggregates, and, indeed, the way consumption aggregates is what differentiates mass markets from other markets on one side and the cottage industry and the specialty markets on the other.

Why then not drop the theory of consumers' preferences altogether and go straight to the market mechanism, supply-and-demand, relative prices, elasticity, and all that? Because the same way we thus eliminate the consumer we may also have to eliminate the entrepreneur, especially when the entrepreneur is but a share holder and few share holders have a say in the conduct of large corporations. The conduct of a multi-national multi-product corporation bears no resemblance to the conduct of small entrepreneurs, decisions like the one to open a shop on main street or a small workshop in which to train a few local youngsters to produce or repair a small implement. The differences are manifest even if hard to articulate, and it is particularly hard to say what difference is crucial. There is a simple way these days to distinguish between the small and the big: in the small-scale case the entrepreneur is more stable than the enterprise, in the large-scale it is the other way around. Thus, as we follow the careers of small-scale entrepreneurs as they move, say, from a hot-dog stand to a restaurant or a shop, we scarcely view the hot-dog stand as a fixture with changing owners. This we do with big corporations which retain their identities day in day out with no notice at all of their shares changing hands to some extent everyday the stock exchange is active and which may survive a take-over as well. Indeed, we may remember, the free entry into the market is largely through the purchase of shares, and Friedman suggest that this will do for the free entry that the *Laissez faire* theory requires. And perhaps shareholders maximize profits. But not firms, not multi-national corporations. They, William Baumol observes, expand rather than maximize profits.

All this is no recent discovery and no secret. Edward S. Mason mentions this and more in his essay on the corporation in the already mentioned *International Encyclopedia of the Social Sciences,* where he cites A. A. Berle and G. C. Means work of 1932, *The Modern Corporation and Private Property*: capital and capitalism still exist, and so does private property, but not capitalists – i. e., not entrepreneurs. He also narrates and explains the growth of both corporations and legislation regulating them – as well as the story interaction of these two processes, with no reference to classical economic theory. He adds (p. 400), as an after-thought, a simple, obviously true observation: Economic analysis has tended to neglect questions of the internal organization of corporations and to assume that entrepreneurial conduct is unaffectedly the obsolete size of the firm. It hardly needs adding that this assumption is apologetic and false; even economic analysts have attempted to study the optimal size of the firm – optimal profitwise, that is. This is why Baumol's claim that firms tend to expand conflicts with the claim that they tend to maximize profits: size and profit do not grow together (the one is not a monotone function of the other). Of course, one can claim that long-term considerations favor expansion even for the purpose of profit making. Perhaps; who knows.

The same holds for many fields which belong to economics, which were neglected, and concerning which some theories evolve which are veiled excuses for the neglect. One example should suffice here. Economists neglected economic growth. Robert Solow's theory that growth is the outcome of technological progress is the excuse: technological progress is relegated to production functions which are supposedly the concern of engineers, not of economists. The only connection, again, between technological progress and economic growth, has to be *via* the stock exchange which, we are told, forces industry to modernize. That Detroit refused to modernize for so long concerns no economist in particular.

No one denies some causal connection between consumers' preferences and stock-exchange activity. Somehow, the feel that when a commodity is no longer in demand – say because it is replaced by a more modern, cheaper and better substitute, or when it proves poisonous, or when public taste for it practically disappears as fashions move on – then, intuitively, the stock of the company selling it may lose its value. In fact this is not so. Companies do not specialize that much; they invest in research; they move to new products when the first hint appears of the fall in demand for the old. Moreover, if a company does this not so well and is thus on the verge of bankruptcy, then it is often purchased by its luckier or smarter competitors. Thus, the identity of firms is maintained. By whom? Why? It is good for the economy? Neo-classical theory is at a loss to study such phenomena. In a desperate last-ditch move, its advocates repeat old excuses and declare such questions to pertain not to the economy but to production characteristics such as economies of scale and availability of distribution channels and so on. We come back, thus, to the idea that the production functions should enable us to learn about market behavior – when we are better off with more firms, when with less, and how we do what is best so as to avoid dropping out of the market.

This is clearly conjectural and question-begging. Also it is only a part of an answer. For, the firm is maintained by management, and the economic interests of management differ both from those of consumers and from those of shareholders / owners. In post-industrial society, where the economy is run to a large extent by powerful corporation-managements, who are known to be very acutely aware of their personal interests and class interests, in a society in which fields of study such as management, social stratification, the sociology of work, and political sociology, also some political science proper, study to the conduct and impact of high and middle management, neo-classical, Keynesian and even neo-Ricardian economics (to the extent that there is any neo-Ricardian economics), all ignore management and its economic role the moment they move from empirical observation to theorizing. This is truly amazing.

The historical roots of all this are clear. The eighteenth century thinkers of the Enlightenment movement tried to erect a truly scientific theory of human affairs. They therefore wished their theories to rest on observations. And they considered observable only individuals and their actions. They hoped that social theory based on facts will also rest on individual conduct and so, first and foremost, on the concern for individual basic needs. Their theory of consumers' behavior rests on the axiom that we all have more-or-less the same needs, and that once these needs are taken care of, curiosity will be the most forceful and most worthwhile and most unlimited need – and they assumed that these needs will be taken care of fairly soon. This axiom remained with all heirs of the Enlightenment movement, including Karl Marx. As Robert C. Tucker has argued, Marx endorsed Hegel's pessimistic views of human irrationality, but limited them to the past and stuck to the Enlightenment movement’s aspirations for an enlightened future. And, clearly, here the concession made by Marx to the Romantics is not very great since Hume, Smith, Bentham, and Ricardo, they all agreed that economic theory is more future-oriented then than past-oriented. There is sufficient indication that they all considered the chief difference between past and future in that in future – in the very near future – the basic needs of individuals – for food and shelter – will be fully met, so that attention would then be given to truly challenging tasks such as the battle against disease, the reduction of the work-day, and so forth. Today this theory is popular – outside economics – to the extend that it is at all popular, in the garb of the psychological theory of Abraham Maslow. It is no accident that some of his followers who work on the improvement of the quality of working life pay more attention to the day-to-day work of middle management – in their effort to bring workers and management to cooperate for the common good. Members of the Chicago school does not oppose, of course, any management-worker cooperation: they prefer this to the adversary relations between worker representatives and management. But they have no attitude on the matter, since management-workers relations are not regulated by the market mechanism – at least not in the first instance. True, firms which manage to improve the quality of their workers' working life may benefit financially through increased productivity, the reduction of absenteeism and turnover. And so they may have an edge over their competition in the open market. But the very undesirability of absenteeism and turn over is the undesirability of a firm going into the open labor market every day: only in factories with work of extremely low quality, with training being a matter of a few minutes on the job, only they will not mind what is the level of absenteeism and turnover. Hence, the demand for the labor market being regulated by the market mechanism is often the demand for Taylorism and thus for very poor quality of working life. The alternative option is when all workers are so very highly trained in all the diverse professions in their workplace, that their adaptability is high enough to enable them to contain the damage due to absenteeism and turn over. But this is quite utopian. Only Prudhon and Marx envisaged workers able to switch jobs within the same workday.

Classically-minded social philosophers might object. They will, no doubt, notice that the classical theory of rational conduct is very broad and covers all the cases here deemed exceptions. The classical theory ascribes to the individual aims and circumstances and recommends that individual action be viewed as optimal under the circumstances. This is known as the rationality principle. And it looks obvious that it applies to the cases discussed by Maslow and his disciples as much as to the individual consumers and entrepreneurs. That this principle is the heart of neo-classical economic theory is the thesis of Samuelson's celebrated *Foundations* where he presents the whole system as a mathematical apparatus plus a few axioms about the market, such as free entry, the axiom of optimization: consumers optimize their choices and producers maximize their income. Samuelson's book is erroneous on almost all counts. Yet he does show the rationality of individuals to be the heart of the neo-classical theory. This is exactly its basic error: their version of the rationality principle is too narrow.

Within the discussion of rational action, what is the goal of the action is less problematic than the other assumptions involved. Especially in economics, specific goals are entirely eliminated and replaced by general abstract goals: maximizing profit, maximizing utility, achieving the most desirable economic state-of-affairs under given economic and material constraints. Even the economic constraints are generalized – the budget line. What, then, makes the difference? Where does society come in? The answer to this is that society never comes in, nor is it supposed to. Other individual come in, individual consumers and producers, chiefly, perhaps also legislators who impose taxes and tariffs. Many constraints on economics are from national politics, yet economists ignore the non-economic factors of national politics.

There are two ways of ignoring facts. One is to have theories indifferent to them. For example, all management-labor negotiations are totally ignored by neo-classical economics. Now in some respect management-labor relations characterize national systems, as even the most cursory and vulgar contrast between Japan and other industrialized countries illustrates. The Chicago economists are not interested in this. It is irrelevant to their ideas; it leaves them unchanged. A worse way of ignoring national politics is not seeing the contradiction between theory and observation. When politicians do mention theory and fact in one breath they may become ridiculously inconsistent. Senator Everet Dirkson, the senior member of the United States Senate said in the Senate in 1963, of course I am all for free trade, but I will not have the United States the be dump heap of the world's scrap iron. This is plainly inconsistent: if you are all for free trade and the steel industry prefers to purchase scrap iron to raw steel then you must accept this. Dirkson thought this cannot be: the result will be that mines will have to be shut down and the government will have enormous expenses in the wake of this, whereas if there will be a high tariff on scrap iron imports, these will virtually vanish and all the government will end up is a possible small profit from these tariffs.

One need not be a neo-classical economist to say, evidently there is advantage to the purchase of cheap scrap iron, yet just because the scrap iron is imported the local product is preferred. This is at least as bad as government propaganda for the purchase of any expensive product in preference to its better and/or cheaper imported substitute. It is worse, because taxes are imposed and propaganda is not. The power of classical economic theory is in its assertion that international trade is good because it is beneficial to both trading sides. The proof of this is utterly obvious: both sides do so voluntarily, so that they expect to be better off as a result. This is the proof of Adam Smith. Why then do people object? Because of external effects. External effects to a transaction are the effects it has on a third party. Every transaction has external effects. Some benefit all or almost all, and so we simply overlook them. Some are harmful. What is the neo-classical theory of external effects? It is, explicitly or implicitly, that of Adam Smith: if everyone takes care of one's own self, sooner or later thing will straighten out. This optimism is gone, and the neo-classical economic theory is defeated on the general point: its optimism has no place in the contemporary scene.

3. *Rationality, Classical and Modern*

Smith's starting point is the refutation of the theory that profit is robbery. The idea that one side in any transaction gains because the other loses has a great intuitive force and was the center of economic debate from antiquity, through the Middle Ages, to the debate between physiocrats and mercantilists. And mercantilists were offering some general explanation justifying the profits of trade. Smith said, it two sides freely trade, they both expect to be better off as a result. Otherwise it is no free trade. Where does the extra value come from, then? It comes from increased productivity due to specialization, and specialization imposes exchange, exchange creates money, and so it goes.

The liberal anti-paternalist attitude of Smith is expressed in his starting with the single rational individual who interacts rationally with another. The market does not exist here, nor any other social institution – only individuals, their aims, and their knowledge of their circumstances. The theory was always narrower than its application, since into the circumstances we can always add social institutions – like government economic activities. Is that kosher? Pro-tem; if the institution is a shorthand for aggregates to be eliminated later on, then it is permissible. This answer was given by John Stuart Mill and by Max Weber. Perhaps also by F. A. von Hayek, grand-old-man of the Chicago school, as well as by Keynes, the leader of its loyal opposition. It is known as psychologism, psychologistic reductionism, psychologistic individualism, reductionist individualism, methodological individualism, or even simply as individualism.

The fault of reductionism is that it is halfway. Reductionists like to start with individuals and their actions unconstrained by institutions, and they introduce institutions only under pressure. This prevents most of the neo-classical economists from coming around to the study of corporations whose economic significance is enormous and growing. Reductionism is a logical conjecture: all institutional analysis is deducible from some individual analysis. Yet today’s best logic is still quite insufficient for such an exercise. Institutions have what logicians call opaque reference: we do not know who belongs to the aggregate which allegedly comprises a given institution, and modern logic at its best still cannot handle referential opacity. Many logicians are trying to construct such a logic, and it even has a name: intensional logic. Yet to the extent that even partial proposals in that direction have been made, they have not received the consensus which is hoped for.

And so, the modern, much more powerful substitute for the classical rationality principle is the much more realistic institutional analysis or situational logic. The situational logic of share holders many resemble their rationality more than that of management; yet the situational logic of management is in many cases fairly simple and hypotheses about it are much more easily testable than the standard material taught in introductory economic courses. And the picture of the economy as a whole, created by the situational logic of some simple id eal types la Weber and of individuals in key political positions, is much livelier and nearer to reality – and quite recognizably so. This proposal goes well with some parts of the Weblen, American institutionalist school of economics, but that school was rather a disappointment than the success if could easily be. But this is another story.