In Defence of the Profession*

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There is much to be criticized with economics. Economists should focus more closely on political issues and stop beating their students to death with mathematics, for instance. But I do not wish to go into this any further here. I will rather address critics of the profession among the general public, for many of their views are based on misunderstandings and ignorance.

1. The Invisible Hand

Much criticism has been heaped on the theory of the "invisible hand", put forth by British economist Adam Smith (1776) and proven by the Nobel prize-winning work of Kenneth Arrow and Gérard Debreu (1954) on general equilibrium. According to this theory, the market equilibrium is efficient if perfect competition prevails and there are well-defined property rights.

That sounds like economists are naïve believers in the wisdom of markets. Far from it, in fact: mainstream economics does not assume that the ideal conditions under which the invisible hand performs are always given. On the contrary, economists tend to use these conditions as a benchmark for analysing market failures. Like sniffer dogs, economists search the economy for market failures and ponder how these failures can be corrected through intelligent state intervention. A major shortcoming of their critics is that they tend to overlook this fact.

Of course, in this case the rule applies that anyone who calls for state intervention must be able to provide evidence of the market failure that he wishes to correct. The motto "As much market as possible and only as little state as necessary" describes the basic approach.

In this respect, economists are like doctors, who also have to know what a healthy body looks like before they can diagnose illnesses and prescribe a therapy. A good doctor does not intervene arbitrarily in the body's processes, but only in cases where there is objective proof of a disease in the sense of a deviation from the norm, and where an effective treatment can be prescribed.

2. Ecology versus Economics

A particularly striking example of market failure can be found in the environmental sector. Markets are generally efficient if the revenues generated by companies correctly reflect all the advantages, while the costs reflect all disadvantages affecting third parties. In this case, maximising profit leads to maximising social welfare. If part of the negative side-effects of production are environmental damages for which companies do not have to pay anything, incentives are distorted and companies become rank polluters; they may turn a profit, but function inefficiently in economic terms. Charging fines for environmental damages or issuing bans are ways of addressing this matter.

The focus of economic theory on the environment predated by a large margin the foundation of green parties. Ever since the work of Arthur Cecil Pigou (1920), economic theory has seen the environment as one of its most important fields of application. Economics is not only about money; it is equally about how economic interaction and decision-making processes can take place in the absence of pecuniary elements. Claims of a contradiction between ecology and economics in the public debate make economists' hair stand on end. How can anyone misunderstand economics so fundamentally!

3. Keynesianism versus Neoclassicism

Among the possible defects that economists diagnose is the Keynesian disease. As the British economist John Maynard Keynes described it, if demand is too weak, it can – since wages and prices are rigid in the short term – lead to a sharp drop in employment. The Keynesian disease can be cured with the help of public, debt-financed economic stimulus packages. This is like giving a heart disease patient nitro-glycerine capsules to keep the heart going.

Contrary to what many people believe, there is no fundamental bias against Keynes and his medicine in mainstream economics today – but such medicine cannot be seen as a universal remedy. Many of the ailments that may afflict an economy are of a longer-term, structural nature and call for other types of treatment. Neoclassical theory provides a comprehensive framework for analysing ailments like, for example, the structural problems currently affecting the countries of southern Europe. Trying to resolve such problems using Keynesian remedies is as wrong as trying to cure a broken leg with heart disease medication.

A nitro-glycerine capsule is only needed when there is the risk of circulatory collapse, as in 2008 when the economy slumped without warning. But the long-term use of such medication can be fatal.

4. Competition

Competition is one of the basic conditions that must be fulfilled for the invisible hand to work, since monopolies and oligopolies exploit consumers and restrict production. However, only competition between providers of similar services is good. Competition between providers that offer complementary services is harmful, and can be even worse than a monopoly. This is illustrated by competition between unions that represent the same profession within a company. Such unions damage not only the company and its customers, but also its employees, as they saw off the branch they are sitting on. That is why train drivers and pilots, for example, should be forced into monopoly unions that represent all of the other employees of their respective companies.

Systems competition between states is usually not efficient either, because the market failures that initially give rise to public sector intervention tend to recur as well at the level of competition between states (selection principle). Examples of this include the competition between welfare states to deter economic migrants, the race to the bottom in tax competition, and the regulatory competition in the banking and insurance sectors.

There are ideologists on both the right and the left. Beware of those who sing the praises of competition always and everywhere.

5. Neoliberalism

Left-wingers use the expression neoliberalism as a term of invective. They assume that neoliberalism is the doctrine of deregulating the economy, of pure laissez-faire. That is simply not true. Although the Anglo-Saxon press labelled the "Chicago boys" who went to Chile under Pinochet to reform the economy as neoliberalists, the European expression neoliberalism has a very different meaning. It was coined by Alexander Rüstow who, at the annual meeting of the Verein für Socialpolitik (Association of German Economists) in 1932, proclaimed the end of old liberalism and called for a new liberalism with a strong state that lays down a solid legal framework for firms to operate in.

The term neoliberalism achieved international currency at a conference held in Paris in 1938 in which Rüstow participated. The term has the same meaning as what Walter Eucken later called ordoliberalism. The misinterpretation of the term neoliberalism by the media was also recently criticised by Germany's Federal President Joachim Gauck.

6. Homo economicus

Homo oeconomicus, the rationally acting egoist often postulated by economists in their analysis, has recently attracted criticism because he all too often does not represent the real behaviour of individuals. Experiments show that the predictive value of this artificial construct is limited.

However, *homo oeconomicus* is not meant to be used for forecasting, but to make it easier to separate failures in markets from failures in minds. Economists seek to detect collective irrationality, and that is easiest to achieve in economic models if one assumes that each individual acts rationally. This "methodological individualism" ensures that measures taken by politics are never due to the fallibility of individuals and their irrationality, but always, and solely, to failures in the rules of the game under which individuals act. It prevents us from sliding into dictatorial paternalism.

The analytical value of *homo oeconomicus* is illustrated particularly clearly by gambling on the part of banks that work with too little equity and grant risky loans. The profits they turn are privatized, but if they incur any losses that exceed their equity they simply declare bankruptcy and dump the remaining losses on their creditors, or even better: they let themselves be bailed out by the taxpayer.

This asymmetry turns banking into a casino. The banks choose particularly risky investment projects, which may be profitable in business terms but are economically damaging. The problem is not caused by human irrationality, but, on the contrary, arises when bankers act particularly rationally. It is for this very reason that economists do not advise politicians to preach common sense or ethics to bankers, but urge them to do their business with higher equity-asset ratios.

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