**A SHORT HISTORY OF MODERN ECONOMICS**

1. **ECONOMICS**

**Economics** is the social science that analyzes the production, distribution, consumption of goods and services.

The term *economics* comes from the Ancient Greek *oikonomia* ("management of a household, administration").

**Political economy** was the earlier name for the subject, but economists in the latter 19th century suggested 'economics' as a shorter term for 'economic science' that also avoided a narrow *political-interest* connotation and as similar in form to ‘mathematics’, ‘physics’, and so forth.

A focus of the subject is how economic agents behave or interact and how economies work. Consistent with this, a primary textbook distinction is between microeconomics and macroeconomics.

**Microeconomics** examines the behavior of basic elements in the economy, including individual agents (such as households and firms or as buyers and sellers) and markets, and their interactions.

**Macroeconomics** analyzes the entire economy and issues affecting it, including unemployment, inflation, economic growth, and monetary and fiscal policy.

There are a variety of modern definitions of economics. Some of the differences may reflect evolving views of the subject or different views among economists.

The philosopher **Adam Smith** (1776) defined what was then called political economy as "an inquiry into the nature and causes of the wealth of nations".

**Alfred Marshall** provides a still widely-cited definition (1890) that extends analysis beyond wealth and from the societal to the microeconomic level: “Economics is a study of man in the ordinary business of life. It enquires how he gets his income and how he uses it. Thus, it is on the one side, the study of wealth and on the other and more important side, a part of the study of man.”

**Lionel Robbins** (1932) developed implications of what has been termed the most commonly accepted current definition of the subject: “Economics is a science which studies human behavior as a relationship between ends and scarce means which have alternative uses.”

**Microeconomics** is the study of economics analyzing individual players of a market and the structure of such markets. Microeconomics studies how these players interact with each other through individual markets (assuming that there is a scarcity of tradable units and government regulation.

A market might deal with a *product* (such as apples, aluminum and mobile phones), or with *services of a factor of production* (brick laying, book printing, food packaging).

Microeconomic theory considers the aggregates (the sum) of *quantity demanded* by buyers and *quantity supplied* by sellers, studying each possible price per unit (i.e. supply and demand). It studies the complex interaction between market players both through buying and selling.

Theory holds that markets may reach equilibrium between "quantity demanded" and "quantity supplied" (supply and demand) over time.

Microeconomics also examines various market structures:

***Perfect competition*** describes a market structure such that no participants are large enough to have the market power to set the price of a homogeneous product. Another way of putting this is to say a perfectly competitive market exists when every participant is a "price taker", and no participant influences the price of the product it buys or sells.

***Imperfect competition*** refers to market structures where the conditions of perfect competition do not exist. Forms of imperfect competition include: ***monopoly*** (in which there is only one seller of a good), ***duopoly*** (in which there are only two sellers of a good), ***oligopoly*** (in which there are few sellers of a good), ***monopolistic competition*** (in which there are many sellers producing highly differentiated goods), ***monopsony*** (in which there is only one buyer of a good), and ***oligopsony*** (in which there are few buyers of a good).

Unlike perfect competition, imperfect competition invariably means market power is unequally distributed. Firms under imperfect competition have the potential to be "price makers", which means that, by holding a disproportionately high share of market power, they can influence the prices of their products.

**Macroeconomics** examines the economy as a whole to explain broad aggregates and their interactions "top down".

Such aggregates include ***national income and output***, the ***unemployment rate***, and ***price inflation*** and subaggregates like total consumption and investment spending and their components. It also studies effects of ***monetary policy*** and ***fiscal policy.***

Macroeconomic analysis also considers factors affecting the long-term level and growth of national income. Such factors include capital accumulation, technological change and labor force growth.

1. **MERCANTILISM**

Mercantilism is “economic nationalism” for the purpose of building a wealthy and powerful state.

This system dominated Western European economic thought and policies from the mid-sixteenth to the late eighteenth centuries.

The goal of these policies was, supposedly, to **achieve a “favorable” balance of trade that would bring gold and silver into the country and also to maintain domestic employment.**

The most important economic rationale for mercantilism in the sixteenth century was the consolidation of the regional power centers of the feudal era by large, competitive **nation-states.** Other contributing factors were the establishment of colonies outside Europe; the growth of European commerce and industry relative to agriculture; the increase in the volume and breadth of trade; and the increase in the use of **metallic monetary systems**, particularly gold and silver, relative to barter transactions.

During the mercantilist period, each government’s primary economic objective was to command a sufficient quantity of hard currency to support a military that would deter attacks by other countries and aid its own territorial expansion.

Most of the mercantilist policies were the outgrowth of the relationship between the governments of the nation-states and their mercantile classes. In exchange for paying levies and taxes to support the armies of the nation-states, the mercantile classes induced governments to enact **policies that would protect their business interests against foreign competition.**

**Shipping** was particularly important during the mercantile period. With the growth of colonies and the shipment of gold from the New World into Spain and Portugal, control of the oceans was considered vital to national power. Because ships could be used for merchant or military purposes, the governments of the era developed strong merchant marines.

During the mercantilist era it was often suggested, if not actually believed, that the principal benefit of foreign trade was the **importation of gold and silver.**

According to this view the benefits to one nation were matched by costs to the other nations that exported gold and silver, and there were no net gains from trade. For nations almost constantly on the verge of war, draining one another of valuable gold and silver was thought to be almost as desirable as the direct benefits of trade.

Adam Smith refuted the idea that the wealth of a nation is measured by the size of the treasury in his famous treatise ***The Wealth of Nations***, a book considered to be the foundation of modern economic theory.

Smith made a number of important criticisms of mercantilist doctrine. First, he demonstrated that ***free trade benefits both parties.*** Second, he argued that ***specialization*** in production allows for economies of scale, which improves efficiency and growth.

The mercantilist era has passed. Modern economists accept Adam Smith’s insight that free trade leads to international specialization of labor and, usually, to greater economic well-being for all nations. **But some mercantilist policies continue to exist**. Indeed, the surge of protectionist sentiment that began with the oil crisis in the mid-1970s and expanded with the global recession of the early 1980s has led some economists to label the modern pro-export, anti-import attitude **“neomercantilism.”**

Since the GATT went into effect in 1948, eight rounds of multilateral trade negotiations have resulted in a significant liberalization of trade in manufactured goods, the signing of the General Agreement on Trade in Services (GATS) in 1994, and the establishment of the World Trade Organization (WTO) to enforce the agreed-on rules of international trade.

Modern mercantilist practices arise from the same source as the mercantilist policies of the sixteenth through eighteenth centuries. Groups with political power use that power to secure government intervention to protect their interests while claiming to seek benefits for the nation as a whole.

1. **PHYSIOCRACY**

**François Quesnay** was the leading figure of the ***Physiocrats,*** generally considered to be the first school of economic thinking. The name “Physiocrat” derives from the Greek words *phýsis,* meaning “nature,” and *kràtos,* meaning “power.”

The ***Physiocrats*** believed that an economy’s power derived from its agricultural sector. They wanted the government of Louis XV, who ruled France from 1715 to 1774, to deregulate and reduce taxes on French agriculture so that poor France could emulate wealthier Britain, which had a relatively laissez-faire policy. Indeed, it was Quesnay who coined the term “laissez-faire, laissez-passer.”

In his ***Tableau economique,*** he detailed a circular flow diagram of the economy that showed **who produced what** and **who spent what,** in an attempt to understand and explain the causes of growth. ***Tableau*** defined three classes: landowners, farmers, and others—called “sterile” classes—who consumed everything they produced and left no surplus for the next period. Quesnay believed that **only the agricultural sector could produce a surplus that could then be used to produce more the next year**—and therefore help growth. Industry and manufacturing, thought Quesnay, were sterile.

Although Quesnay was wrong about the sterility of the manufacturing sector, he was right in ascribing France’s poverty to Mercantilism. The government had protected French manufacturers from foreign competition, thus raising the cost of machinery for farmers, and had also sold to wealthy citizens the power to tax farmers. These citizens had then used this power to the limit.

**Quesnay** advocated reforming these laws by consolidating and reducing taxes, getting rid of tolls and other regulations that prevented trade within France, and generally freeing the economy from the government’s stifling controls. These reforms were much more sensible than his theorizing about the sterility of industry.

**Turgot** was the French Adam Smith. His ***Reflections on the Production and Distribution of Wealth*** argues against government intervention in the economic sector. Turgot recognized the function of the division of labor, investigated how prices were determined, and analyzed the origins of economic growth. Like Quesnay, Turgot was a leading Physiocrat who attempted to reform the most stifling of his government’s economic policies.

Probably Turgot’s most important contribution to economics was to point out that **capita**l is necessary for economic growth, and that the only way to accumulate capital is for people not to consume all they produce. Most capital, he believed, was accumulated by landowners who saved the surplus product after paying the cost of materials and of labor. Turgot agreed with Quesnay’s notion of the circular flow of savings and investment, where savings in one period become investment in the next.

In *Reflections,* Turgot analyzed the interdependence of different rates of return and interest among different investments, noting that **interest is determined by the supply and demand for capital.** Although the rates of return on each investment may vary, he argued, in a competitive free-market economy with capital mobility, rates of return on all investments will tend toward equality. Turgot distinguished between a commodity’s **market price**—determined by supply and demand—and its **“natural” price,** the price it would tend to if industries were competitive and resources could be reallocated. An increase in demand, for example, could increase a good’s price, but if resources were free to enter that industry, the new supply would bring the price back down to its “natural” level. In this reasoning Turgot anticipated Adam Smith.

Turgot also predated Smith in recognizing the importance of the **division of labor** for an economy’s prosperity, and he was the first economist to recognize the law of diminishing marginal returns in agriculture. Predating the Marginalists by a century, he argued that “each increase [in an input] would be less and less productive.”

1. **ADAM SMITH**

With ***The Wealth of Nations*** Adam Smith installed himself as the leading expositor of modern economic thought.

Today Smith’s reputation rests on his explanation of how rational self-interest in a free-market economy leads to economic well-being. It may surprise those who would discount Smith as an advocate of ruthless individualism that his first major work concentrates on ethics and charity. In ***The Theory of Moral Sentiments***, Smith wrote: “How selfish soever man may be supposed, there are evidently some principles in his nature which interest him in the fortune of others and render their happiness necessary to him though he derives nothing from it except the pleasure of seeing it.”

Smith did not view sympathy and self-interest as antithetical; they were complementary. “Man has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence only,” he explained in *The Wealth of Nations.* Charity, while a virtuous act, cannot alone provide the essentials for living. Self-interest is the mechanism that can remedy this shortcoming. Said Smith: “It is not from the benevolence of the butcher, the brewer, or the baker, that we can expect our dinner, but from their regard to their own interest”.

Someone earning money by his own labor benefits himself. Unknowingly, he also benefits society, because to earn income on his labor in a competitive market, he must produce something others value. In Adam Smith’s lasting imagery, “By directing that industry in such a manner as its produce may be of greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an **invisible hand** to promote an end which was no part of his intention.”

*The Wealth of Nations* sought to reveal the nature and cause of a nation’s prosperity. Smith saw the main cause of prosperity as increasing **division of labor**. Using the famous example of pins, Smith asserted that ten workers could produce 48,000 pins per day if each of eighteen specialized tasks was assigned to particular workers. Average productivity: 4,800 pins per worker per day. But absent the division of labor, a worker would be lucky to produce even one pin per day.

Smith vehemently opposed **Mercantilism** —the practice of artificially maintaining a trade surplus on the erroneous belief that doing so increased wealth. The primary advantage of trade, he argued, was that it opened up new markets for surplus goods and also provided some commodities from abroad at a lower cost than at home. With that, Smith launched a succession of free-trade economists and paved the way for theories of **comparative advantage** a generation later.

Smith’s writings are both an inquiry into the science of economics and a policy guide for realizing the wealth of nations. Smith believed that economic development was best fostered in an environment of free competition that operated in accordance with universal “natural laws.” Because Smith’s was the most systematic and comprehensive study of economics up until that time, his economic thinking became the basis for classical economics. And because more of his ideas have lasted than those of any other economist, some regard Adam Smith as the alpha and the omega of economic science.

1. **KARL MARX**

Karl Marx was capitalism’s most zealous intellectual adversary. His comprehensive writings on the subject laid the foundation for later political leaders, notably V. I. Lenin and Mao Tse-tung, to impose communism on more than twenty countries.

It has become fashionable to think that Karl Marx was not mainly an economist but instead integrated various disciplines—economics, sociology, political science, history, and so on—into his philosophy. But Mark Blaug, a noted historian of economic thought, points out that Marx wrote “no more than a dozen pages on the concept of social class, the theory of the state, and the materialist conception of history” while he wrote “literally 10,000 pages on economics pure and simple.”

According to Marx, **capitalism** contained the seeds of its own destruction. Communism was the inevitable end to the process of evolution begun with feudalism and passing through capitalism and socialism. Marx wrote extensively about the economic causes of this process in Capital. Volume one was published in 1867 and the later two volumes, heavily edited by Engels, were published posthumously in 1885 and 1894.

The labor theory of value, decreasing rates of profit, and increasing concentration of wealth are key components of Marx’s economic thought. His comprehensive treatment of capitalism stands in stark contrast, however, to his treatment of socialism and communism, which he handled only superficially. He declined to speculate on how those two economic systems would operate.

1. **FRIEDRICH LIST AND**

**“THE NATIONAL SYSTEM OF POLITICAL ECONOMY”**

Georg Friedrich List (1789-1846) was a leading 19th century German economist who developed the concept of the “National System” of economics, was considered as the original European Union theorist whose ideas were the basis for the European Economic Community.

His book, The National System of Political Economy (published in 1841 ) is in fact the first, and probably still the most powerful, challenge to Adam Smith, David Ricardo and colleagues who developed the tenets and assumptions of the Free Trade, Laissez-Faire movement, starting in 1776 with Smith's 'The Wealth of Nations'.

List comprehensively compares national systems which promote industrial and agricultural development through tariffs and government support, notably the German and American systems, with the British colonial system of unrestricted Free Trade. It is a powerful indictment of the underlying motives and effects of the colonial system. The book has gone into extreme disfavor and total exclusion from college curriculums as these have gravitated to roles of corporate apologists or to reactions of Marxist and post structural ideology. It cogently presents, however, the argument against the world wide movement to limit economic sovereignty of nation states, and paints a grim picture of the inevitable result of unrestrained Free Markets, notably in the experience of British workers during the Industrial Revolution.

Friedrich List advocates an economic policy of nationalism based on the philosophy of **protectionism.** List argues that protectionism can lead to greater national economic benefit and argues against the system of *laissez-faire* free trade. The book is divided into four parts: The History, The Theory, The Systems, and The Politics, each focusing on a particular aspect of the theory of protectionism. List rails against the "cosmopolitan" theory of free trade economists such as Adam Smith as espoused in his *Wealth of Nations*. In particular, List contrasts the systems of protectionism in America and Germany against the system of free trade advocated by the British. He gives the history of the rise of the Hanseatic League in Germany against the British. He advocates abolishing the tariffs between the individual German states but erecting a tariff wall around the German nation, thus creating a strong federated Germany. List refers to this as the "insular supremacy of the Continental powers". Against Britain, List advocates a protectionist policy for North America as well.

Of particular interest is List's discussion of the difference between agriculture and manufacturing powers. For instance, List contends that an agriculture nation without manufacturing will remain subsidiary to a nation which has manufacturing. Thus, the need for creating a nation which can sustain both manufacturing and agriculture.

Rather than the individualistic standpoint of economists such as Adam Smith, List argues for political economy to be seen from the standpoint of the nation. The book contains many further insights into the value of protectionism as a trade policy to create a strong national economy. In a world being continually driven in the direction of mass globalization and technocracy, this book by List offers an alternative policy to maintain national sovereignty. While the classic works of free trade economics are highly important, especially the ideas of their originator Adam Smith, List offers cogent critique based on his nationalistic point of view.

1. **NEOCLASSICAL ECONOMICS**

By the middle of the nineteenth century, English-speaking economists generally shared a perspective on value theory and distribution theory. The value of a bushel of corn, for example, was thought to depend on the costs involved in producing that bushel. The output or product of an economy was thought to be divided or distributed among the different social groups in accord with the costs borne by those groups in producing the output. This, roughly, was the "Classical Theory" developed by Smith, Ricardo, Malthus, Mill, and Marx.

But there were difficulties in this approach. Chief among them was that prices in the market did not necessarily reflect the "value" so defined, for people were often willing to pay more than an object was "worth." The classical "substance" theories of value, which took value to be a property inherent in an object, gradually gave way to a perspective in which value was associated with the relationship between the object and the person obtaining the object. Several economists in different places at about the same time (the 1870s and 1880s) began to base value on the relationship between costs of production and "subjective elements," later called "supply" and "demand." This came to be known as the Marginal Revolution in economics, and the overarching theory that developed from these ideas came to be called neoclassical economics.

The framework of neoclassical economics is easily summarized. Buyers attempt to maximize their gains from getting goods, and they do this by increasing their purchases of a good until what they gain from an extra unit is just balanced by what they have to give up to obtain it. In this way they maximize "utility"—the satisfaction associated with the consumption of goods and services. Likewise, individuals provide labor to firms that wish to employ them, by balancing the gains from offering the marginal unit of their services (the wage they would receive) with the disutility of labor itself—the loss of leisure. Individuals make choices at the margin. This results in a theory of demand for goods, and supply of productive factors.

Similarly, producers attempt to produce units of a good so that the cost of producing the incremental or marginal unit is just balanced by the revenue it generates. In this way they maximize profits. Firms also hire employees up to the point that the cost of the additional hire is just balanced by the value of output that the additional employee would produce.

The neoclassical vision thus involves economic "agents," be they households or firms, optimizing (doing as well as they can), subject to all relevant constraints. Value is linked to unlimited desires and wants colliding with constraints, or scarcity. The tensions, the decision problems, are worked out in markets. Prices are the signals that tell households and firms whether their conflicting desires can be reconciled.

At some price of cars, for example, I want to buy a new car. At that same price others may also want to buy cars. But manufacturers may not want to produce as many cars as we all want. Our frustration may lead us to "bid up" the price of cars, eliminating some potential buyers and encouraging some marginal producers. As the price changes, the imbalance between buy orders and sell orders is reduced. This is how optimization under constraint and market interdependence lead to an economic equilibrium. This is the neoclassical vision.

Neoclassical economics is what is called a metatheory. That is, it is a set of implicit rules or understandings for constructing satisfactory economic theories. It is a scientific research program that generates economic theories. Its fundamental assumptions are not open to discussion in that they define the shared understandings of those who call themselves neoclassical economists, or economists without any adjective. Those fundamental assumptions include the following:

1. People have rational preferences among outcomes.

2. Individuals maximize utility and firms maximize profits.

3. People act independently on the basis of full and relevant information.

Theories based on, or guided by, these assumptions are neoclassical theories.

Thus, we can speak of a neoclassical theory of profits, or employment, or growth, or money. We can create neoclassical production relationships between inputs and outputs, or neoclassical theories of marriage and divorce and the spacing of births. Consider layoffs, for example. A theory which assumes that a firm's layoff decisions are based on a balance between the benefits of laying off an additional worker and the costs associated with that action will be a neoclassical theory. A theory that explains the layoff decision by the changing tastes of managers for employees with particular characteristics will not be a neoclassical theory.

Neoclassical economics conceptualized the agents, households and firms, as rational actors. Agents were modeled as optimizers who were led to "better" outcomes. The resulting equilibrium was "best" in the sense that any other allocation of goods and services would leave someone worse off. Thus, the social system in the neoclassical vision was free of unresolvable conflict.

The very term "social system" is a measure of the success of neoclassical economics, for the idea of a system, with its interacting components, its variables and parameters and constraints, is the language of mid-nineteenth-century **physics.** This field of rational mechanics was the model for the neoclassical framework. **Agents were like atoms; utility was like energy; utility maximization was like the minimization of potential energy, and so forth.** In this way was the rhetoric of successful science linked to the neoclassical theory, and in this way economics became linked to science itself.

1. **KEYNESIAN ECONOMICS**

Classical/Neoclassical liberal economics had three basic assumptions or pre-suppositions:

1. **Invisible Hand.** Markets are self-regulating. An invisible hand adjusts the functioning of the economy. Therefore, there is no need for governmental regulation as the Mercantilists argued. Economies reach or restore equilibrium automatically.
2. **Rational Economic Man**. All agents functioning in the economy are rational, reasoned people. They plan, calculate, and act within a framework of profit and loss accounting.
3. **Primacy of Real Economy.** Classical and neoclassical economists were certainly aware of the symbolic economy of money and credit. Fluctuations in this realm always affect the real economy. However, they considered the economy of money and credit to be a shadow economy serving the real one. It just reflected what was going on in the real sector.

Keynes countered all these basic assumptions or articles of faith, *without leaving the liberal creed!...* He argued that

1. Markets are not *always* self-regulating.
2. Men are not *always* rational, and not all men are rational.
3. Symbolic economy may, at a certain stage of capitalism, take the central position and affect the real economy more than it has been the other way round.

So influential was John Maynard Keynes in the middle third of the twentieth century that an entire school of modern thought bears his name. Many of his ideas were revolutionary; almost all were controversial. Keynesian Economics serves as a sort of yardstick that can define virtually all economists who came after him.

In the 1920s Keynes was a believer in the quantity theory of money. His writings on the topic were essentially built on the principles he had learned from his neoclassical mentors, Marshall and Pigou. His major policy view was that the way to stabilize the economy is to stabilize the price level, and that to do that the government’s central bank must lower **interest rates** when prices tend to rise and raise them when prices tend to fall.

Keynes’s ideas took a dramatic change, however, as unemployment in Britain dragged on during the interwar period, reaching levels as high as 20 percent. Keynes investigated other causes of Britain’s economic woes, and *The General Theory of Employment, Interest and Money* was the result.

Keynes’s *General Theory* revolutionized the way economists think about economics. It was pathbreaking in several ways, in particular because it introduced the notion of **aggregate demand** as the sum of consumption, investment, and government spending; and because it showed that ***full employment could be maintained only with the help of government spending.***

Why shouldn’t government, thought Keynes, fill the shoes of business by investing in public works and hiring the unemployed? *The General Theory* advocated **deficit spending** during economic downturns to maintain full employment. Keynes’s conclusion initially met with opposition. At the time, balanced budgets were standard practice with the government. But the idea soon took hold and the U.S. government put people back to work on public works projects. Of course, once policymakers had taken deficit spending to heart, they did not let it go.

Contrary to some of his critics’ assertions, Keynes was a relatively strong advocate of free markets. It was Keynes, not Adam Smith, who said, “There is no objection to be raised against the classical analysis of the manner in which private self-interest will determine what in particular is produced, in what proportions the factors of production will be combined to produce it, and how the value of the final product will be distributed between them.” Keynes believed that once full employment had been achieved by **fiscal policy** measures, the market mechanism could then operate freely.

Capitalist economies are not self-adjusting: market forces might *eventually* restore an

economy of full employment, Keynes said, but *in the long run we are all dead.* Keynes proposed clear prescriptions for hard economic times: expansionary monetary and fiscal policy. He thought fiscal policy particularly important in situations where monetary policy was likely to be ineffective. So the visible hand of the state has always to be there to make the necessary corrections in the economy.

1. **FRIEDRICH HAYEK**

Friedrich Hayek made fundamental contributions in political theory, psychology, and economics. In a field in which the relevance of ideas often is eclipsed by expansions on an initial theory, many of his contributions are so remarkable that people still read them more than fifty years after they were written.

Most of Hayek’s work from the 1920s through the 1930s was in the Austrian theory of business cycles, capital theory, and monetary theory. Hayek saw a connection among all three. The major problem for any economy, he argued, is how people’s actions are coordinated. He noticed, as Adam Smith had, that the price system—free markets—did a remarkable job of coordinating people’s actions, even though that coordination was not part of anyone’s intent. The market, said Hayek, was a spontaneous order. By spontaneous Hayek meant unplanned—the market was not designed by anyone but evolved slowly as the result of human actions. But the market does not work perfectly. What causes the market, asked Hayek, to fail to coordinate people’s plans, so that at times large numbers of people are unemployed?

One cause, he said, was increases in the money supply by the central bank. Such increases, he argued*,* would drive down interest rates, making credit artificially cheap. Businessmen would then make capital investments that they would not have made had they understood that they were getting a distorted price signal from the credit market. But capital investments are not homogeneous. Long-term investments are more sensitive to interest rates than short-term ones, just as long-term bonds are more interest-sensitive than treasury bills. Therefore, he concluded, artificially low interest rates not only cause investment to be artificially high, but also cause “malinvestment”—too much investment in long-term projects relative to short-term ones, and the boom turns into a bust. Hayek saw the bust as a healthy and necessary readjustment. The way to avoid the busts, he argued, is to avoid the booms that cause them.

Hayek and Keynes were building their models of the world at the same time. They were familiar with each other’s views and battled over their differences. Most economists believe that Keynes’s *General Theory of Employment, Interest and Money* (1936) won the war. Hayek, until his dying day, never believed that, and neither do other members of the Austrian school. Hayek believed that Keynesian policies to combat unemployment would inevitably cause inflation, and that to keep unemployment low, the central bank would have to increase the money supply faster and faster, causing inflation to get higher and higher. Hayek’s thought, which he expressed as early as 1958, is now accepted by mainstream economists.

In the late 1930s and early 1940s, Hayek turned to the debate about whether socialist planning could work. He argued that it could not. The reason socialist economists thought central planning could work, argued Hayek, was that they thought planners could take the given economic data and allocate resources accordingly. But Hayek pointed out that the data are not “given.” The data do not exist, and cannot exist, in any one mind or small number of minds. Rather, each individual has knowledge about particular resources and potential opportunities for using these resources that a central planner can never have. The virtue of the free market, argued Hayek, is that it gives the maximum latitude for people to use information that only they have. In short, the market process generates the data. Without markets, data are almost nonexistent.

In 1944 Hayek also attacked socialism from a very different angle. From his vantage point in Austria, Hayek had observed Germany very closely in the 1920s and early 1930s. After he moved to Britain, he noticed that many British socialists were advocating some of the same policies for government control of people’s lives that he had seen advocated in Germany in the 1920s. He had also seen that the Nazis really were National Socialists; that is, they were nationalists and socialists. So Hayek wrote *The Road to Serfdom* to warn his fellow British citizens of the dangers of socialism. His basic argument was that government control of our economic lives amounts to totalitarianism. “Economic control is not merely control of a sector of human life which can be separated from the rest,” he wrote, “it is the control of the means for all our ends.”

To the surprise of some, John Maynard Keynes praised the book highly. On the book’s cover, Keynes is quoted as saying: “In my opinion it is a grand book.... Morally and philosophically I find myself in agreement with virtually the whole of it; and not only in agreement with it, but in deeply moved agreement.”

Although Hayek had intended *The Road to Serfdom* only for a British audience, it also sold well in the United States. Indeed, *Reader’s Digest* condensed it. With that book Hayek established himself as the world’s leading classical liberal; today he would be called a libertarian or market liberal.

In 1950 Hayek became professor of social and moral sciences at the University of Chicago, where he stayed until 1962. During that time he worked on methodology, psychology, and political theory. In methodology Hayek attacked “scientism”—the imitation in social science of the methods of the physical sciences. His argument was that because social science, including economics, studies people and not objects, it can do so only by paying attention to human purposes. The Austrian school in the 1870s had already shown that the value of an item derives from its ability to fulfill human purposes. Hayek was arguing that social scientists more generally should take account of human purposes.

In political theory Hayek gave his view of the proper role of government in his book *The Constitution of Liberty.* It is actually a more expansive view of the proper role of government than many of his fellow classical liberals hold. He discussed the principles of freedom and based his policy proposals on those principles. His main objection to progressive taxation, for example, was not that it causes inefficiency but that it violates equality before the law. In the book’s postscript, “Why I Am Not a Conservative,” Hayek distinguished his classical liberalism from conservatism. Among his grounds for rejecting conservatism were that moral and religious ideals are not “proper objects of coercion” and that conservatism is hostile to internationalism and prone to a strident nationalism.