There is much to be criticized with economics. Economists should focus more closely on political issues and stop beat- ing 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 misun- derstandings and ignorance.

1. The Invisible Hand

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

That sounds like economists are naive 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, econom- ists search the economy for market failures and ponder how these failures can be corrected through intelligent state inter- vention. 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 mar- ket failure that he wishes to cor- rect. The motto “As much mar- ket 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 ther- apy. A good doctor does not in- tervene arbitrarily in the body’s processes, but only in cases where there is objective proof of a disease in the sense of a devi- ation 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 com- panies correctly reflect all the ad- vantages, while the costs reflect all disadvantages affecting third parties. In this case, maximising pro- fit leads to maximising so- cial welfare. If part of the nega- tive side-effects of production are environmental damages for which companies do not have to pay anything, incentives are dis- torped and companies become rank polluters; they may turn a profit, but function inefficient- ly in economic terms. Charging fines for environmental damages or issuing bans are ways of ad- dressing this matter.

The focus of economic theory on the environment predates by a large margin the founda- tion 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 econ- ology 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 Brit- ish 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 medi- cine in mainstream economics today – but such medicine can- not be seen as a universal rem- edy. Many of the ailments that may afflict an economy are of a longer-term, structural na- ture and call for other types of treatment. Neoclassical theory provides a comprehensive frame- work for analysing ailments like, for example, the structural prob- lems currently affecting the coun- tries 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 oligopo- lies exploit consumers and re- strict production. However, only competition between providers of similar services is good. Com- petition between providers that offer complimentary services is harmful, and can even worse than a monopoly. This is illus- trated by competition between unions that represent the same professional within a company. Such unions damage not only the company and its customers, but also their employees, as they saw off the branch they are sit- ting 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 fail- ures that initially give rise to public sector intervention tend to recur as well at the level of competition between states (see- \n
5. Neo-liberalism

Left-wingers use the expression neo-liberalism as a term of in- vective. They assume that neo- liberalism is the doctrine of de- regulating 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 neo-liberals, 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 Econ- omists) 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 con- ference held in Paris in 1938 in which Rüstow participated. The term has the same meaning as what Walter Eucken later called ordoliberalism. The misinterpre- tation of the term neoliberalism by the media was also recently critised by Germany’s Federal President Joachim Gauck.

6. Homo economicus.

Homo economicus, the rational- ly 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 economicus is not meant to be used for fore- casting, but to make it easier to separate failures in markets from failures in minds. Econo- mists seek to detect collective irrationality, and that is easiest to achieve in economic models if one assumes that each individ- ual acts rationally. This “method- ological individualism” ensures that measures taken by politics are never due to the fallibility of individuals and their irrational- ity, but always, and solely, to failures in the rules of the game under which individuals act. It prevents us from sliding into dic- tatorial paternalism.

The analytical value of homo economicus is illustrated par- ticularly 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 profit- able in business terms but are economically damaging. The problem is not caused by human irrationality, but, on the con- trary, 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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In Defence of the Profession* Hans-Werner Sinn