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Economic Theory and Its Discontents

By VERNON L. SMITH*

The critics of economic theory charge that, while theorists fiddle, the empire burns. We are urged to abandon what we have considered to be economic science and rise to an attack upon the agonizing social problems of the day. Ultimately, I believe, there is only one way to change the course of economic analysis, and that is for its disheartened critics, or others, to chart and pursue a new direction. If it leads to something insightful, it will command a respectable following. But generally the critics have not chosen to change the course of economics in this manner. Instead, they have paid us the high compliment of attacking what we have done and urging us to turn our efforts to the ends which they seek. Unfortunately, most of us have remained stonily silent about what they have said.

Although it may be uncomfortable for some, I think it is important to listen carefully to these critics. Amidst the fulminations of emotional rhetoric there is perhaps a suggestion of deeper issues. If there are indeed scientific issues contained in the bluster, they should command professional attention. I am particularly convinced of this after reading the *Proceedings* of the year before last which—apart from some improvements over previous such efforts—do not inspire confidence that the messengers of alarm can build a theoretical foundation in any direction. They are good at expounding alleged faults, but bad, on the whole, at correcting them; good at suggesting new directions, but bad at charting them. If there is a new economics in the future (and I predict that there is) it will

not be born of sloppy new theory, any more than it will be born of old textbook theory, although such a poor start could well motivate new and more interesting efforts. I hope that it does. But neither will new and novel economics be born of an attack upon the scientific ideals of economic theory. It may indeed be true that those of us who try hardest to maintain scientific objectivity will sometimes find that our product is more infected by our values than we would wish. But that hardly provides license for us all to start raking the same muck together. The process of professional evaluation of scientific results, refereeing, e.g., is the only means by which the relationship between values and research can be disciplined. Yet, oddly, it is those who ridicule the ideal of a value-free core of economic methodology who are the most cynical about this process. Such processes are many times imperfect and frustrating, particularly to the innovator, but they are the bedrock of community. Had men never developed the sensitivities that support scientific ideals and professional processes, I fear that we would still be eating each other and justifying it on grounds of relevance.

Our business is the study of mechanisms and institutions for the creation as well as control of individual and social opportunities. This is what markets, voting, courts, legislatures, committees, clubs, associations, and contractual agreements are all about. Man's propensity to truck, barter, and exchange is but a special case of his propensity for social exchange in nonmarket and institutionally constrained market contexts. Perhaps the signal in the critics' outrage is that economic relevance

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can be expanded if we examine such cultural problems as racial discrimination, female servitude, poverty, and pollution. But to suggest that economic analysis will be found relevant to these problems is not to assert that economics can necessarily be used to cure such social ills. Sometimes one of the important functions of dispassionate economic analysis is to make clear that certain social problems may not have a solution. Economics is relevant to the study of inflation and unemployment, but these social problems would seem to be utterly insolvable short of total regimentation if society insists that their "solution" must mean zero percent rates for each. Gary Becker has shown that economics may be relevant to the institution of marriage, but, if divorce is thought to be a social problem, I doubt that it will be solved by use of his theory of marriage. I happen to believe that economics is relevant to the great animal extinctions of ten to fifteen thousand years ago during the age of Paleolithic big game hunting, but the theory of common property resources by itself is unlikely to solve the problem of species extinction in, say, international waters. In fact the theory makes plain the enormous poaching incentives that undermine repeated efforts to regulate the harvesting of prey.

Some of the great social problems about which the radicals are bouncing off the walls have scientific content which in stylized form almost certainly will be found to be capable of economic analysis. To the extent that such problems are rooted in the way institutions have been designed, the right kind of analysis may suggest new and more flexible organizations, but to the extent that such problems are rooted in the human condition, cures may not be forthcoming.

I believe that the microeconomic theory of the pre-1960's is a dead end. I would describe that theory as the economics of

individual and social choice in which it was assumed implicitly that certain conveniently chosen activities had infinite information and/or transactions cost, while certain other conveniently chosen activities had zero information and/or transactions cost. Where these costs were infinite, we named the associated activities "externalities," and we cringed or naively called for government intervention; where these costs were zero, we named the activities "markets," and we said "God Bless." That paradigm of thought goes a long way toward explaining why so many good theorists think with their heads when teaching or writing about theory, but with their guts when talking about policy. The paradigm had to end, if not through vision, then through the utter boredom caused by continual work on the same problem in different disguises. The new microtheory will, and should, deal with the economic foundations of organization and institution, and this will require us to have an economics of information and a more sophisticated treatment of the technology of transacting. In the meantime, otherwise good economists will continue to make meaningless assertions to the effect that there is some degree of failure in all real markets because of the ubiquitous presence of transactions cost, or to the effect that in certain situations (characterized by prohibitive transactions cost) the problem is one of "not enough markets." As long as market failure is defined in terms of failure to achieve costless Pareto-efficient allocations, every real world institution, whether decentralized or centralized, is in danger of "failure." Fortunately for the economy, but unfortunately for academic economics, this formulation of the problem of Pareto efficiency is not the problem that real markets and other allocative institutions attempt to solve.

I also believe that, as an intellectual movement in economic theory, radical

economics is a dead end. But as a political movement it may have an indefinite life, and I suppose there will always be clever academic demagogues who will confuse these ends. The great American radical, the charismatic Eugene Debs, was sensitive to this problem when he told his followers that he would not lead them from bondage, for if he could lead them from bondage he could lead them into bondage. As one who was attracted to the study of economics as a young socialist, radical economics provides a certain umbilical appeal to me. But long ago I learned something important about radicals and social change. It is best illustrated by the perceptive story of the lone picket outside the

gate of a state prison carrying a poster denouncing capital punishment. A guard offering the demonstrator a cigarette said to him, "Mister, don't you know that you can't change the world by carrying that sign?" Whereupon the picket replied, "I'm not trying to change the world. I'm just trying to keep the world from changing me." Radicals are among the most fiercely independent people I know. They would be the first to rise in revolt against the reality of the very systems they idealize and promote.

REFERENCE

- G. S. Becker, "A Theory of Marriage: Part I," *J. of Polit. Econ.*, Aug. 1973, 81.