Theory and Morality in the New Economy

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The indispensable economist of the moment is clearly John Maynard Keynes. Keynes's prescription for financial crises — aggressive government action and, by definition, big budget deficits — has been Washington's basic approach since Lehman Brothers collapsed last September. Eleven months later, the economy remains deeply troubled, and it probably will be for some time. But our Great Recession seems unlikely to turn into another Great Depression.

It is impossible to know just how much credit the Keynesian approach deserves, because we can't rerun the past year with a Hooverite economic strategy and see what would happen. Still, history seems to have vindicated Keynes. Likewise, it has indicted the laissez-faire philosophy that had been ascendant for most of the last three decades.

The indispensable economist of that philosophy, of course, is Adam Smith. Smith's invisible hand — which, in his description, guides an individual to promote the interests of society more effectually than he intends — has not looked so effectual lately. In Obama's Washington, understandably enough, Keynes seems to be in and Smith out.

Yet here is where the story becomes a little complicated. Six years ago, Bantam Classic published a mass-market volume of Smith's 1776 masterwork, "The Wealth of Nations," with an introduction by Alan B. Krueger, an economics professor at Princeton. Krueger argued that Smith's modern image had become unhinged from his actual writings. "Smith was a nuanced thinker. He was not nearly as doctrinaire a defender of unfettered free enterprise as many of his late-20th-century followers have made him out to be," Krueger wrote. "He recognized that human judgment was not infallible."

Smith was indeed a champion of individual liberty and worried about how governments might muck up an economy. But he also wrote that the goal of employers, "always and everywhere," was to keep wages as low as possible. "When the regulation, therefore, is in favor of the workmen, it is always just and equitable; but it is sometimes otherwise when in favor of the masters," he

concluded. He supported a tax on luxury carriages and taxes on alcohol, sugar and tobacco. He said that "negligence and profusion" inevitably occur when corporate managers control shareholders' money. And as the historian Emma Rothschild has noted, "The Wealth of Nations" uses the phrase "invisible hand" precisely once. In the 1,231-page Bantam edition, it appears on Page 572.

I stumbled on that edition earlier this year in my local bookstore and was struck by Krueger's name on the cover. These days, he is the chief economist in the Obama Treasury Department, the lead agency in the administration's efforts to halt the economic crisis. The ideas of Keynes, surely, are central to those efforts. But the ideas of Smith are not anathema to the administration. In fact, Smith turns out to be a useful guide to the ways Obama is and is not trying to reshape the American economy. Smith also lurks, often unnamed, in some of the most thoughtful early books to have been published on the Great Recession.

Beyond the immediate crisis, today's overarching economic challenge is figuring out how the country can reap the benefits of Smith's market-based system without experiencing the worst of its downsides. In the decades after World War II, the Keynesians who descended on Washington thought they had solved this problem. With the right mix of spending, regulation and interest rates, they believed, the business cycle could be tamed and unemployment largely eliminated. "This was hubris," Paul Krugman, the Nobel laureate and liberal Times Op-Ed columnist, writes in "The Return of Depression Economics and the Crisis of 2008." Technocrats overestimated how many jobs they could create without aggravating inflation, and aggravate inflation they did.

Their failures, combined with the greater failure of socialist economies, set the stage for the ascendancy of laissez-faire economics. Much of Asia moved to a market-based system and experienced stunning improvements in living conditions. As Krugman writes, "capitalism could with considerable justification claim the credit." These successes, however, created their own excesses. The principles of laissez-faire capitalism were elevated to the status of religious scripture, with Alan Greenspan as high priest. In "The Cost of Capitalism," Robert J. Barbera, a longtime Wall Street economist, notes that Greenspan and others confused the fact that market capitalism was the best economic system with the misguided notion that it was the perfect system.

Barbera calls instead for “an enlightened synthesis.” Such a synthesis — one that takes Smith at his word rather than his caricature — is at the core of almost every serious vision of a post-crisis American economy. For Barbera, it means the Federal Reserve should recognize that bubbles are the norm and that preventing them is its job. For the conservative appellate judge and law professor Richard A. Posner, it means seeing the crisis as “A Failure of Capitalism,” as he titled his latest book. Among other things, Posner suggests a modern-day version of Smith’s tax on luxury carriages: “increasing the marginal income tax rate of persons who have very high incomes, in order to reduce their appetite for risk-taking.” And in “Animal Spirits,” George A. Akerlof (another Nobel laureate) and Robert J. Shiller (who issued early warnings about the dot-com and housing bubbles) say the synthesis must take into account the many ways in which people are not the coldly rational, utility-maximizing beings that laissez-faire economic models imagine.

Smith, as it happens, would have been quite comfortable with this notion. At the University of Glasgow he held the chair of moral philosophy, and his second most famous book was titled “The Theory of Moral Sentiments.” In “The Wealth of Nations,” he wrote of the ways that pride, envy, respect and other emotions influenced decisions. Intriguingly, this is the version of Smith that Obama likes to recall.

Last summer, during an interview shortly before the Democratic National Convention, I was asking Obama about the benefits and limits of a market economy, when he brought up Smith. “Adam Smith, at the same time as he was writing about the invisible hand, he was also writing about that moral sense — that human ecology — that allows a market to work: the sense that if I bring my goods into the market, someone is not going to hit me over the head; the sense that because I am trading with this guy often enough, that I know that the scales aren’t tampered with,” Obama said. “That compact that we make is not just legalistic. It has to do also with our politics and our culture, and when that starts eroding it inhibits economic growth as well.”

You can make a good case that, for all the talk-show chatter about whether Obama is a socialist, his agenda is in fact tinged with Smith. The administration’s various attempts to reduce inequality are meant, at their core, to make Americans

feel as if the economic system is fair — that the scales haven't been tampered with. In responding to the financial crisis, Obama eschewed the left's calls for nationalizing the banks and instead kept them in private hands, albeit with public assistance. To reduce health care costs, he favors moving away from a fee-for-service system, which has the same perverse incentives Smith liked to denounce.

Economic historians could doubtless have a spirited debate about whether Smith would have supported or disdained the White House's agenda. But it's reasonable to think that, either way, he would have had something trenchant to say about its chances of success. Among his more radical observations was that legislators tended to defer to those "masters" of industry, even when their aims would hurt the citizenry. To put it another way, economic theory can do only so much for a president. The rest falls to politics.

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