

## ECONOMIC RATIONALISM

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In this paper I try to elucidate some of the semantic confusions associated with the word "rationalism". I then discuss some of the criticisms of mainstream economics made by the anti-rationalists, and offer suggestions as to the source of their hostility to economics and economists. Finally, I offer some criticisms of contemporary economics from what I consider to be a true anti-rationalist position. In this final section I indulge in a degree of self-plagiarism.

### I

The following are excerpts from the entry on "Rationalism" in the *Encyclopedia of the Social Sciences* (Macmillan, New York, 1963).

Rationalism is a comprehensive expression applied to various theoretical and practical tendencies which aim to interpret the universe purely in terms of thought, or which aim to regulate individual and social life in accordance with principles of reason and to eliminate as far as possible or to relegate to the background everything irrational. In individual and social life rationalism seeks to establish universal and self-evidence principles for the regulation of human behaviour.

[Rationalism combats] the instinctive in man and [submits] to criticism everything in social life bearing the character of mere custom and tradition and recalcitrant to generalizing rational reflection.

In the 17th century reason was regarded as a sovereign power not dependent upon individuals and centering in the will of the state. In the 18th century, on the other hand, it was looked upon as a product of the cooperation of free individuals, as a collective expression of all the independent rational manifestation displayed by every member of the state. The private spheres of individuals were not interfered with but were left to the rational self-regulation of the individual himself. Also, whereas in the 17th century far reaching system of regulation was applied to economic life in order to curb individual arbitrariness, in the 18th century the tendency was to grant as much freedom

as possible to the economic activities of individuals so as to enable the individual manifestation of reason to assert themselves to the fullest extent. In this the underlying presupposition was the belief that the various economic activities of individuals tended toward a natural harmony, and it was precisely this harmonization of interest which was regarded in the 17th century as the proper task of political reason, or statesmanship.

There are thus essential differences between the rationalism of the 17th century and that of the 18th century. In the former period reason was regarded as a compulsory force applied from above: its task was to curb the various irrational and instinctive manifestations of individual life and to coordinate them in such a way as to make social life possible.

In the latter period the prevailing attitude was that of confidence in the rational endowments which were proper to every individual and which were to be developed through education and enlightenment.

[In the 20th century] ... there was an undermining of the trust in a "natural harmony" of interests, uncontrolled from above and guided only by the autonomous reason of individual members of society. The emphasis now seemed to be placed rather on attempts to rationalize the relations between the various individual economic activities. This active rationalism is reminiscent of the rational tendencies of the 17th century which sought to organize and control economic life, rather than of the liberal rationalism of the 18th century. Great significance, however, was now attached to the 18th century idea of an economic interdependence upon an international basis. But it is important to note that this international relationship was not expected to emerge spontaneously on the basis of a natural order; it was rather to result from an active rationalization of the economic order.

It is evident that the "economic rationalism" as understood by its critics is the 18th century variety. It is also evident, though not generally appreciated, that the critics are themselves rationalists of the 17th century sort; that is, they regard the outcomes of the operation of the invisible hand as unsatisfactory, or as having no particular authority, and think that the superior reason of the state should be imposed by means of regulations and other forms of intervention, especially tariffs.

Use of the term "rationalism" , in a pejorative sense is, in this century, associated especially with two names, Michael Oakeshott and Friedrich Hayek. Oakeshott was a political philosopher who attacked the notion that "... a political ideology is the product of intellectual

premeditation and that, because it is a body of principles not in itself in debt to the activity of attending to the arrangements of a society, is able to determine and guide the direction of that activity". He argued, that, on the contrary, "(s)o far from a political ideology being the quasi-divine parent of political activity, it turns out to be its earthly stepchild. Instead of an independently premeditated scheme of ends to be pursued, it is a system of ideas abstracted from the manner in which people have become accustomed to go about the business of attending to the arrangements of their societies". By way of illustration, he argued that the political ideology embodied in the French revolutionaries' Declaration of the Rights of Man - "a system of rights and duties, a scheme of ends - justice, freedom, equality, security, property, and the rest - ... no more existed in advance of political practice than a cookery book exists in advance of knowing how to cook. Certainly it was the product of somebody's reflection, but it was not the product of reflection in advance of political activity. For here, in fact, are disclosed, abstracted and abridged, the common law rights of Englishmen, the gift not of independent premeditation or divine munificence, but of centuries of the day-to-day attending to the arrangements of an historic society". (Oakeshott, 1962, pp.118-127)

A similar view of the primacy of practice over pure reason is found in Hayek, as is indicated by a heading of a section of his book *The Fatal Conceit: The Errors of Socialism*: "Mind is not a Guide but a Product of Cultural Evolution, and is Based More on Imitation than on Insight or Reason". More specifically, Hayek directs his criticism at what he calls "constructivist rationalism", a view which "holds that human institutions will serve human purposes only if they have been deliberately designed for these purposes, often also that the fact that an institution exists is evidence of it having been created for a purpose, and always that we should so re-design society and its institutions that all our actions will be wholly guided by known purposes".

"The other view" - to quote Hayek further - "which has slowly and gradually advanced since antiquity but for some time was almost entirely overwhelmed by the more glamorous constructivist view, was that that orderliness of society which greatly increased the effectiveness of individual action was not due solely to institutions and practices which had been invented or designed for that purpose, but was largely due to a process described at first as 'growth' and later as 'evolution', a process in which practices which had first been adopted for other reasons, or even purely accidentally, were preserved because they enabled the group in which they had arisen to prevail over others". (Hayek, 1988, pp.8-9)

The rationalism criticised by Oakeshott and Hayek is that which rejects as unreasonable "whatever is not scientifically proven, or not fully understood, or lacks a fully specified purpose, or has some unknown effect" (Hayek, 1988, p.66). Both opposed social engineering or planning in the sense of the attempt to impose some rational design on human behaviour, essentially on the grounds **that those who seek to do so do not understand the nature of the society or the policy and hence fail in what they set out to do**. Both stressed the importance of habits, manners, traditional morality, and long-established institutions in providing a cohesive social framework and environment in which people could pursue their interests and exercise their freedom. Traditional values and institutions should not be rejected or replaced simply because they may lack an obvious rational justification.

There are obviously strong rationalist elements in mainstream economics theory and practice. However, the policy elements singled out for criticism by the Australian anti-rationalists cannot with propriety be called rationalist in the Hayek-Oakeshott sense of the term. On the contrary, deregulation and the phasing out of tariff protection represent the dismantling of policies which were rationalist in the sense of attempting to impose some sort of design on the economy. Thus the term "rationalist", used in a pejorative sense, has been turned through

180 degrees by the critics of "economic rationalists". This usage is bound to create semantic confusion, and one could only wish that people would be more careful in their use of language.

## II

The critics of economic rationalism are somewhat diverse in their views, but, as noted above, the policies they most commonly attack are deregulation and the reduction in tariff protection. The consequences imputed to these policies are foreign debt and unemployment. (Note that deregulation seems to mean exclusively financial deregulation: none of the critics, so far as I am aware, wants a return to the two-airline policy.) More generally, the critics are uncomfortable with the widespread acceptance among Australian elites, especially the higher bureaucracy of "economism", i.e. the economist's view of the world. Along with this goes routine condemnation of the "greed factor", "dryness", "uncaringness", etc.

The primacy of protectionist sentiment among the critics is of interest, since one would have thought that the arguments for gains from voluntary exchange, and the principle of comparative advantage, were among the most basic and widely-accepted tenets of economic theory. Their implied rejection by the critics suggests either considerable ignorance, or alternatively, a well-developed instinct to "go for the jugular", since the proposition that voluntary exchange is mutually beneficial lies at the very core of economic theory.

Economists recognize several respectable arguments for protection, including the "optimal tariff" argument; the "infant industry" argument; the "distributional effects" argument (as exemplified by the Brigden Report); and non-economic arguments, e.g. the provision of industries vital to defence, and the protection of "national culture". Economists also realize

that the structural changes associated with reduced protection involve costs, and that these costs are likely to be lower (or, at least, less obtrusive) if tariff reductions are phased in, rather than taken "cold turkey". In this connection an argument could be made for slowing the rate of change, or suspending it temporarily, at a time of high unemployment. It is significant that none of the critics - so far as I am aware - relies on this "costs of adjustment" argument: they favour protection as a permanent policy.

The protectionist arguments put forward by the anti-rationalists include the following:

1. Appeal to historical episodes (eg Imperial Germany, contemporary Japan) in which rapid economic growth coincided with a good deal of protection and/or *dirigisme*<sup>1</sup> (Manne, 1992 p.51 and Carroll and Manne, 1992, p.55). Since trade policy is only one of many factors affecting economic performance, it is obvious that such instances are of very limited evidential value. It has been argued, for example, that Japan had so many advantages, such as a cohesive society, a docile workforce, and a high rate of savings, that it would be surprising if its economic performance was not very good, even if its trade policies were counterproductive.

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<sup>1</sup> The quality of Manne's argument is conveyed by the following passage:

"We are frequently informed that the McEwenite policy of 'protection all-round' was a logical absurdity. We are not told, however, that the most successful European economy in the four decades before the First World War (Imperial Germany) based itself precisely upon this logical absurdity, using tariffs to protect both grain and heavy industry, a policy known as 'the alliance of rye and iron'."

Clearly protection of grain and heavy industry is not 'protection all-round' and if it had been, it would have been free-trade-equivalent (or near equivalent) policy that was associated with "the most successful European economy"!

2. "Other countries do it, therefore so should we." Sometimes put as baldly as this - as, for example, by Mr. B.A. Santamaria with respect to the protection of the sugar industry (in *Newsweek*, May 24, 1992, p.24ff) - but more often by implication. The underlying assumption is that to be beneficial, free trade must be reciprocal. But the case for our adoption of free - or freer - trade policies does not depend on our trading partners doing the same. Admittedly there may be some scope for us to retain some trade barriers to use as bargaining counters in the game of negotiating reciprocal "concessions", but considering our small size this scope is small. The reciprocity fallacy underlies much popular rejection of the 'level playing field' metaphor.
  
3. Our manufacturing industries require protection and we require our manufacturing industries, because the making of tangible objects is more satisfying than providing intangible services; and because our working class youth are only capable of factory work, and hence will be unemployed if factories close down (Carroll, 1991, p. ). This argument displays extreme pessimism about the adaptability of our entrepreneurs and our workforce. Many manufacturers have survived and will survive the reduction in protection and others, suffering anti-protection in the previous regime, will expand. Are there really large numbers of young people suited only to be "factory fodder"?
  
4. Gregory Clark rejects conventional trade theory and policy on the grounds that manufacturing industry today is characterized by great economies of scale and of scope. The Australian market, he says, is not large enough to sustain more than one manufacturer of, for example, motor cars or consumer electronic goods. Hence his policy prescription is for the government to call tenders from foreign or Australian companies to acquire monopoly rights to the Australian market for particular goods.

(Clark, in Carroll & Manne (eds), 1992, pp.123-131) This proposal seems to me to suffer from two serious objections: (1) it assumes an unrealistically high degree of wisdom and incorruptibility on the part of the bureaucracy; and (2) it ignores the possibility of obtaining sufficient scale of operations for efficient production and distribution by developing export markets.

My overall impression is that the arguments of the local protectionists, while containing some economic insights, are not very cogent, and are informed in large measure by economic naivety (e.g. appreciation only of first-round effects of policies), mercantilism, and a lack of understanding of the gains from trade. They show a high degree of pessimism about the possibilities of structural change, and perhaps in this respect, if in no other, they can properly be called conservative. There is also more than a hint of a belief in the virtue of manufacturing per se, and of its superiority as a human activity over the provision of intangible services. But apart from this bit of sociology, the critics rely on economic arguments and economic criteria. Since their ranks comprise few if any professional economists it is not surprising that their analyses are amateurish. They could also be criticised for displaying hubris - but the fact that anyone thinks he can do economics is one of the irritations which our profession has long endured, but which may be all to the good since it challenges us to explain ourselves in non-technical terms.

The attacks on economic rationalism are notable for their virulence and intemperateness. This suggests a strong emotional content. Perhaps they represent a cry of pain from those left behind by the tide of opinion. For there has been a substantial shift in informed opinion over the last 10 years - a movement that may be less evident to one involved in it than it is to outside observers. Here is a precis of part of what I wrote ten years ago on the subject *Government and Economic Management*:



Most government economic management was mismanagement, i.e. it was not designed to promote economic efficiency, or even to improve the distribution of income according to egalitarian criteria. Among the examples I cited in support of this view were:

- the support of marketing cartels in agriculture
- made-to-measure tariffs and quotas, which foster an isolationist and dependent attitude among the favoured industries
- the legitimisation of forms of coercion which if practised by any group other than trades unions would be suppressed
- the countenancing and facilitation of the development of dual labour markets (protected and unprotected sectors) and consequent growth in unemployment
- the fostering of industrial disputes by the Arbitration Commission
- cross-subsidisation by public enterprises
- the withholding rather than the upholding of property rights in natural resources

I argued that most of these policies seemed consistent with the "interest-group" theory of politics and that the circumstances that allowed interest groups to dominate the consumer or the public interest were explicable in terms of public choice theory. I also noted that much recent intervention, especially of a regulatory nature, was not directed at traditional interest groups at all, but at groups advocating various forms of "social engineering", such as consumer protection, safety, women's rights, environmental protection, etc. The effects of these interventions are sometimes perverse, and often small in relation to their costs, but are judged more by their intentions than by their effects. That this is the case is not surprising since the effects of these social interventions, perhaps even more so than those favouring traditional economic interest groups, are difficult or impossible to perceive, being dispersed and hidden in the flux and complexity of economic events. (Parish, 1982, pp.2-6)

Even allowing for an element of caricature in what I wrote in 1982, I think there has been a big change in our attitude to government economic intervention in the intervening ten years. This I attribute partly to disillusionment but mainly to the acceptance of the public choice paradigm. Government policies have changed - *vide* tariff policy, deregulation, microeconomic reform, privatisation - but an even greater change has occurred in expectations as to what government intervention can achieve. The vision of the state as Utopian *deus-ex-machina* correcting the imperfections and failures of the market has faded almost to vanishing point. And **this** is what I think accounts for the hostility of the anti-rationalists. Public choice theory has delegitimized democratic politics as the basis of

economic management - a very unpalatable development to those non-economist social scientists who would assert the primacy of politics over economics. (I can't resist the thought that envy of economists for their success in capturing the top echelons of its public service is also an element in anti-rationalist hostility.)

In 1986 John Gray wrote that public choice theory has made anti-liberal or statist conservatism a very difficult intellectual position to hold (Minogue & Gray, 1986). Our intellectuals associated with **Quadrant** do not seem aware of the difficulty, or, if they do, seem determined to ignore it. Much of the Left, it seems to me, have given up on economic intervention, perhaps because they have seen their intellectual investment in socialism become worthless, but perhaps also because they have been able to shift into more glamorous social engineering causes such as feminism, environmentalism, multiculturalism, etc.

### III

I now wish to consider some criticism of contemporary economics that anti-rationalists (in the Hayek-Oakeshott sense) might make.<sup>2</sup> An appropriate text for my remarks would be the title of Hayek's Nobel Lecture: "The Pretence of Knowledge", since it seems to me that in a good deal of our practice we pretend to greater knowledge or confidence or judgement than is justifiable. This natural human failing is accentuated by most of us working for the government either directly, or indirectly, in helping private organisations deal with governments. Politicians like easy answers, or, at any rate, answers. The complexity of the world is such that sometimes we do not have any answers, easy or otherwise. But we can rationalise our giving dubious answers on the grounds that politicians will seek even less well-

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<sup>2</sup>

Most of this section is taken from Parish, 1988.

founded advice from others if we are not forthcoming. The same can be said of our response to businessmen's demand for macroeconomic forecasts.

One way in which we pretend - as much to ourselves as to others - to greater expertise than we really have is to analyse  $n^{\text{th}}$ -best situations using first-best models. Adherence to this convention has the advantage of producing more agreement among different analysts than if the much messier analysis, appropriate to  $n^{\text{th}}$ -best situations, and involving numerous empirical judgements, were undertaken. But it is still wrong: it is like using a map which may bear only a passing resemblance to the terrain over which we are passing.

Another type of corner-cutting in policy analysis is the proffering of advice in terms of variables that are not observable. Many of the key variables of microeconomics - such as cost, profit and rent - are in this category. We often confuse them with their accounting counterparts which are observable, or, if we do not, others do. A most egregious example of this sort of thing comes from the Report of the Commission of Inquiry into Land Tenures which recommended the expropriation from landowners not merely of one unobservable quantity, but of the difference between two unobservable quantities. (Parish, 1977)

In order to achieve a more complete taxonomy, or for some similar rationalist purpose, economists often mix items which cannot be valued according to economic criteria - willingness to pay, and opportunity cost - with those that can. For example, national accounting aggregates consist of items whose value is established by voluntary exchange and of items produced by means of the involuntary tax system. The resulting mixture lacks clarity of meaning and is the source of some confusion. Another example is the concept of "merit goods", added by public finance theorists to "private goods" and "public goods" to produce an all-inclusive classification scheme. But whereas the distinction between private and public

goods is based on relevant economic differences between them, the notion of merit goods is based solely on political considerations, and serves only to rationalize an arbitrary choice by giving it a respectable name. Some theorists would incorporate distributional or other political value judgement into cost-benefit analysis by means of some grand optimizing framework involving explicit rates of substitution between different values. I have criticised this approach - and quoted other critics as well - in *The Scope of Benefit Cost Analysis*, (Parish, 1976) and will not pursue it here. I suppose the most extreme example of rationalism is utilitarianism, in which all decisions are sought to be made according to the calculus of pleasure and pain.

Historically, economists have paid little attention to the costs of change. Indeed some have positively revelled in contemplating the "gales of creative destruction" which, in Schumpeter's view, characterised modern capitalism; others, occupying positions of political power and influence, have certainly taken pleasure in exercising that power, and shaking things up. But, *most characteristically, we have taken a neutral attitude to change, regarding it as neither good nor bad.* It is true that every now and then we get concerned with the adjustment costs of certain policies, but tend to push them aside in favour of more tractable problems.

This basically indifferent attitude to change stems from two ingrained habits of economic analysis. First, and most obvious, comparative statics ignores the costs of transition from one equilibrium to another. Second, we tend to judge policy changes by reference to some ideal configuration of the economy, frequently a model based on first-best assumptions, rather than by reference to the status quo. Hence we judge changes by how close they take us toward the ideal, rather than how far from the here and now. I think that the Australian debate on tax reform has been impaired on account of this habit, and that insufficient attention has been given to the proverbial wisdom that "an old tax is a good tax".

Economists' neutral attitude toward change is exemplified by a common mode of analysis in which a policy change is judged according to its aggregate costs and benefits. In such an "efficiency" analysis, the transfers that the policy engenders among producers, consumers, taxpayers, etc., simply wash out, their significance being confined to the topic of distribution, which, since it is properly the concern of politicians, is of limited interests to economists.

However, the limitations of this mode of analysis are becoming more apparent as a result of recent developments in political economy. More attention is being paid to those efficiency costs of transfers that are additional to the more widely recognised deadweight losses. There are at least three of these, viz.:

- Administrative costs, which can range from the trivial to the substantial.
- Real costs incurred by interested parties attempting to ensure the adoption of favourable policies or favourable treatment under existing policies, i.e. "rent-seeking" costs. Rent-seeking costs can vary enormously depending on the institutional environment and the nature of the transfer, but, *ceteris paribus*, will be positively related to the size of the transfer.
- Adjustment costs; as mentioned earlier, economists have tended to shy away from these. However, there are indications that these costs can be quite high: for example, the failure of people to change their jobs or places of abode despite the *apparently* very high returns from doing so.

It is obvious that the costs associated with transfers can easily overwhelm the efficiency gains or losses on which we commonly concentrate. The fact that the efficiency gains or losses often did not amount to much was always a source of some embarrassment to the profession;

and attempts have been made to reinforce the standard prescriptions for "removing distortions" by appealing to dynamic factors that were not captured by the standard analysis. Considerations of the costs of transfer can only exacerbate the embarrassment we might feel at the puniness of the efficiency gains and losses, and bring comfort to the conservative, by providing him with solid, hard-headed arguments of a cost-benefit sort in favour of his ingrained suspicion of change *per se*.

The conservative position is further supported by the consequences of the market's tendency to capitalise the gains and losses attendant upon a policy change. To the extent that this occurs, the expected flow of benefits or costs is received or borne in its entirety by those initially affected. They have no option in the matter: the price of the relevant asset rises or falls accordingly. Future entrants to the activity concerned pay, or are compensated, in advance for the continuing flow of benefits or costs and hence do not gain or lose. **If the government subsequently reverses its policy, it does not take back a benefit previously given, or cancel a cost previously incurred: these have already been absorbed by the capital market.** What it does is impose new costs or benefits on the new asset owners. This of course is the reason why it is so difficult to reverse policies which are subsequently deemed to be inappropriate: the withdrawal of a privilege genuinely harms those who have already paid for it. The moral, very palatable to conservatives, is to be very careful about what you do, since it may be impossible to undo it.

This moral also emerges from a consideration of the frequent irreversibility of rent-seeking costs. It has recently been pointed out that when rent-seeking activities occur prior to a single relevant political/bureaucratic decision (in contrast to situations where they occur continuously or periodically because of an ongoing need to protect one's position), then they are sunk costs, and cannot be avoided or reduced by a subsequent revocation of the rent-

creating policy. It follows that the gains from deregulation may be much smaller than the costs of the initial regulation (McCormick, Shughart II, & Tollison, 1984).

The tendency for surpluses to be eliminated by competitive markets, whether by the ordinary processes of competition in product and factor markets, or by their dissipation via rent seeking, or by their being embodied in asset values and hence turned into costs, has a consequence which seems to be little appreciated, certainly by the general public, and, probably, I suspect, by the profession. The consequence is that the market tends to eliminate "horizontal inequities".

If the invisible hand's propensity to remove horizontal inequities was better understood we might be spared a good deal of silly and soppy rhetoric about the inequity of this or that tax, and confident legal trumpetings about the unconscionability of this or that law. Reform would have to be sold on the basis of substantial efficiency benefits. The spread of enlightenment on this matter is most unlikely, however, Politicians are much happier selling justice than efficiency, and most economic reformers genuinely believe that "correcting distortions" (e.g. removing tariffs and tax loopholes) promotes both efficiency and equity. Furthermore, intellectual confusion between the two goals is compounded by semantic confusion. Consider, for example, the metaphor of the "level playing field" - an image that is most commonly given a "fairness" interpretation.

The preceding discussion also relates to the distinction between the **design** and **reform** of economic policies. To design a theoretically perfect - or perhaps, more reasonably, a very good - tax system is one thing; to reform some part of an existing one is another. In the second case one is bound to inflict windfall losses on some and confer gains on others, that is, on those whose expectations were based on the continued operation of the existing system.

The fact that these gains and losses will be considered to be inequitable - and indeed are inequitable - will constrain what one can reasonably do. One's actions are also constrained by the limits of one's writ and the interaction between one's "control area" and the rest of the system which one has to take as given. Design is always easier than reform, but, unfortunately, is something that we seldom have the opportunity of doing. Reform is always messy and involves many compromises and subjective judgements. The economist's lot is not that different from the politician's, as described by Oakeshott in what is probably the most quoted piece of modern political philosophy:

"In political activity, then, men sail a boundless and bottomless sea; there is neither harbour for shelter nor floor for anchorage, neither starting-place nor appointed destination. The enterprise is to keep afloat on an even keel; the sea is both friend and enemy; and the seamanship consists in using the resources of a traditional manner of behaviour in order to make a friend of every hostile occasion."

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