Great Turnabouts in Economics

"There is no harm in being sometimes wrong—especially if one is promptly found out."

—*John Maynard Keynes*

The gradual transformation of Paul Samuelson from Keynesian to classical economics (see my column in the September 1997 *Freeman*) is a major chapter in famous cases of economists changing their minds.

Nobody likes to admit he's wrong. You can probably count on your fingers the number of times scholars have renounced their theories and switched positions. Most academics have a tendency to cling to old dogmas, especially if they have built a reputation on a particular doctrine. We can only admire the scholar who is willing to change when he is convinced by the facts or a new theory. It takes a strong dose of courage and honesty to go against one's vested interest, especially after publishing books and articles on the subject.

Three prominent economists have admitted error and changed their thinking, and we can learn much from their experience.

George Stigler and Antitrust

George Stigler, the towering Chicago professor and Nobel Laureate, was a firm defender of antitrust laws in the 1940s and 1950s. He was influenced by Henry Simon, a leading spokesman for the Chicago School. Simon taught that big business posed a serious problem in the United States and advocated the nationalization of railroads, utilities, and all other "uncompetitive" industries—all in a book ironically entitled *Economic Policy for a Free Society* (University of Chicago, 1948). Stigler moved in a different direction, advocating the breakup of "concentrated" big businesses and punishment of companies engaged in collusion. He appeared before Congress in 1950 and proposed that U.S. Steel Corporation be broken up.

By the early 1970s, however, Stigler had changed his mind. Influenced by the work of Aaron Director and Joseph Schumpeter and a new theory of oligopoly, he found himself shifting his views. "What is still more embarrassing is that I no longer believe the economics I was preaching," he declared.[1] Concluding that concentration did not necessarily lead to monopolistic pricing, Stigler switched positions and actively opposed most antitrust legislation.

Robert Heilbroner and Socialist Planning

For most of his life, Robert Heilbroner, author of *The Worldly Philosophers*, a best-selling history of economics, was a socialist. Under the influence of Adolph Lowe and the New School of Social Research, he became enamored with Marxism. When the Polish economist Oskar Lange assailed Ludwig von Mises's attack on socialist central planning in

Dr. Skousen is an economist at Rollins College, Department of Economics, Winter Park, Florida 32789, and editor of Forecasts & Strategies, *one of the largest investment newsletters in the country.*

the 1930s, Heilbroner joined the rest of the profession and concluded that Mises was wrong and socialism could work.

By the end of the 1980s, however, Heilbroner dramatically altered his views. In a stunning series of articles in *The New Yorker*, he wrote that the long-standing debate between capitalism and socialism was over, and "capitalism has won."[2] In a follow-up article after the demise of the Eastern Bloc, he was even more explicit: "Socialism has been a great tragedy this century.... But collapse! No one expected collapse.... There is no doubt that the collapse marks its end as a model of economic clarity."[3] Furthermore, the debate between Lange and Mises had to be re-examined in light of contemporary events. "It turns out, of course, that Mises was right," declared Heilbroner. Needless to say, Heilbroner's change of heart did little to endear him to the socialist camp.

Lionel Robbins and Austrian Economics

Not every event is positive for free-market economics. The most notorious example of switching sides occurred when Lionel Robbins, a major proponent of the "Austrian" school of free-market economics, converted to Keynesianism in the late 1930s and early 1940s. In the United States, several prominent classical economists had already changed views, especially Harvard's Alvin Hansen. But Robbins's conversion was infamous because, as chairman of the economics department at the London School of Economics, he had brought Friedrich Hayek from Austria to England, and had been instrumental in translating and publishing Hayek's and Mises's works. He also wrote extensively about Austrian economics, including the illuminating *The Great Depression* (Macmillan, 1934).

Editor's Note: Congratulations to Mark Skousen on his debut as a columnist for *Forbes* magazine. (See the September 22, 1997 issue.) Mark will continue to write his monthly column for *The Freeman.*

However, he fell under the trance of John Maynard Keynes during World War II. In his autobiography, he repudiated the Austrian connection: "I shall always regard this aspect of my dispute with Keynes as the greatest mistake of my professional career, and the book, *The Great Depression*, which I subsequently wrote, partly in justification of this attitude, as something which I would willingly see forgotten."[4]

I should hope that if Lionel Robbins were alive today he would reconsider his views and see the Keynesian episode more of a "diversion" from sound classical economics (to use a term created by Leland Yeager) than as a "general" economic theory. □

1. George J. Stigler, *Memoirs of an Unregulated Economist* (Basic Books, 1988), p. 99.
2. Robert Heilbroner, "The Triumph of Capitalism," *The New Yorker*, January 23, 1989, p. 98. Note he wrote this article before the collapse of the Berlin Wall and the Soviet Union.
3. Heilbroner, "Reflections After Communism," *The New Yorker*, September 10, 1990, pp. 91–2.
4. Lionel Robbins, *Autobiography of an Economist* (Macmillan, 1971), p. 154.

BOOKS

Everybody Wins! A Life in Free Enterprise

by Gordon Cain

Chemical Heritage Press • 1997 • 342 pages • $24.95

Reviewed by Robert L. Bradley, Jr.

On the surface, this autobiography describes how an individual well past retirement age restructured major assets in the domestic chemical/petrochemical industry through leveraged buyouts (LBOs) to create several billion dollars of wealth for himself and many associates. This interesting and unique business history aside, Gordon Cain's story has a much deeper message—how a "captain of industry" working in a market setting where political barriers and patronage do not apply can create great wealth and opportunities for thousands of people.

As Cain notes in his introduction, the book was inspired by the need to defend his honor against the commonly portrayed notion that debt-financed buyouts in the 1980s benefited a few quick-buck artists at the expense of displaced workers and the general good. He argues that the failure behind massive business restructuring is prior management, not new management. Draconian layoffs and abrupt change could have been mitigated by better managerial decisions and, in turn, more accountable boards of directors. It is passive boards, Cain contends, that can create the "Imperial CEO," an example of that rare species called market failure. But even when the dirty work must be done, Cain explains, a sound entrepreneurial vision can more than offset the transition costs by empowering remaining workers, freeing marginal workers and other nonspecific assets to find more productive employment, and increasing output and lowering prices to benefit consumers.

Cain orchestrated five major business restructurings in the 1980s, all of them LBOs, that handsomely benefited himself, the institutional investors, over 100 key managers, and some 5,000 employees who received several times their salary in stock participation. His largest deal, circa 1989, was his best. Cain Chemical increased 44 times in value for shareholders in the nine months between when Cain put the company together and Occidental bought it. (Cain did not want to sell, but too many people stood to make significant wealth for the first time.) Soon after, Cain opened up his copy of the *Wall Street Journal* to find a full-page advertisement with a "thank you, Gordon Cain" surrounded by signatures from all 1,337 employees, the lowest paid of whom had received a six-figure payout.

While returns of this magnitude always reflect fortuitous circumstances, Cain clearly was doing some highly innovative things that the incumbents (the asset sellers) were not. One innovation that simultaneously cut costs and enhanced corporate decision-making was to increase the involvement of rank-and-file employees. This was accomplished using Edward Deming's "total quality control" concepts and setting up employee stock ownership and profit-sharing plans. By betting on the collective wisdom and drive of the on-the-spot employees rather than intermediate management, Cain had tapped into the same knowledge dynamo that "Austrian School" economists such as Ludwig von Mises and F.A. Hayek had conclusively shown make market economics inherently more wealth-creating than centrally planned ones.

The double win of reduced management costs and improved decision-making allowed Cain to slash overhead from 15–20 percent of sales to around 5 percent of sales and make innumerable process improvements. This endogenous improvement, leveraged by debt financing, was powerfully joined by improved external factors driving the highly cyclic businesses he invested in. Cain repeatedly demonstrated that he understood where he was in the chemical-petrochemical price cycle better than the prevailing view. It is surprising, in retrospect, that so many companies would sell their assets to Gordon Cain.

The crucial element that put Cain's entrepreneurial vision into play was debt financing—and hence his inspiration to offer a revisionist view of the social beneficence of LBOs. Cain had very limited venture capital but a proven management record. Before, this would not have been enough to compete for corporate control. But in the early 1980s a new investment vehicle came of age—high-risk, high-return "junk" bonds to finance leveraged buyouts. Cain's success belies the widespread idea that "junk bonds" and LBOs were evil and fraudulent.

As unique as Cain's late success in business life was his appreciation and support for consistent free-market public policies. While many business executives typically are strong supporters of the free-market economy in the abstract, very few