Common strands in the work of Armen Alchian and Jack Hirshleifer

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I have been asked to compare Armen and my dad. Both Armen and my dad loved simple insights that play out with a twist. This is reflected in some of their discoveries, such as Alchian and Allen’s explanation for why it is harder to find good apples for sale in the location where apples are grown and why a per-unit tax will cause a shift toward consumption of higher quality (Alchian and Allen 1983); and Hirshleifer’s findings that the public revelation of information can make everyone worse off, and that when inventors can speculate in asset markets, there can be too much incentive to engage in inventive activity (in contrast with the usual presumption of too little; Hirshleifer 1971).

However, what mattered most to them was not the twist, but whether the simple insight was powerful. Both believed in taking great pains to get fundamentals right. They recognized that digging down to a simple, far-reaching insight is often more fruitful than trying to build without firm foundation. Neither of them was impressed by elaborate flourishing of theoretical complexity as a substitute for clear thinking.

One difference between them is that Armen’s style was mostly nonmathematical, whereas my dad strongly believed that mathematical modeling is a valuable tool for distilling the essence of a problem. Indeed, early in his career my dad was at the mathematical end of the profession. In relative terms he ended up toward the less mathematical end in later years, as his research style held steady while the profession migrated toward greater formalism.

Both Armen and my dad believed that simple fundamental insights could make sense out of an enormous range of applications. This is perhaps why both chose to write textbooks, and why both were innovative in this endeavor. The Alchian and Allen text is noted for its wit and lucid writing style. I’ll say the same for Hirshleifer, Glazer and Hirshleifer (2005), though as his son (and now a coauthor of the text) my assessment is hardly credible.¹

The epitome of a simple yet far-reaching idea is evolution by means of natural selection, and Armen wrote a seminal early work (Alchian 1950) on applying this concept to economics. He argued that when firms faced uncertainty, it becomes almost impossible for them to solve for an optimal policy as part of a profit maximization problem. Instead, when different firms vary arbitrarily in characteristics and policies, some characteristics promote success more than do others. Thus, natural selection leads to the survival of firms whose policies help increase profits.

¹ At the time of the introduction of Price Theory and Applications (which was initially its full title), intermediate economics textbooks were arid summaries of theory; an innovative feature of PTA was its integration of theory with interesting real world applications. This feature is now uniform in this market; some imitators literally borrowed the entire title of the text verbatim!
Starting in the 1970s, my dad devoted many years to what he called bioeconomics, and in choosing this direction he must have been influenced by Armen's classic paper and, no doubt, personal discussion as well. My dad emphasized that just as economics is at heart a biological science, biology is at heart an economic one. Natural selection leads to adaptation, so that morphology or behaviors are optimal subject to constraints. So natural selection provides the underpinning for the assumption in economics that individuals optimize, and economic optimization provides a key analytical tool for studying biological evolutionary and ecological issues. These ideas can be viewed as completing the parallelism between economics and biology initially drawn by Armen.

In his paper, "Natural economy versus political economy," Hirshleifer (1978) also emphasized that there was no discontinuity between competition and conflict among humans and competition in other parts of nature. Economic models in which legal constraints work perfectly, so that people engage only in voluntary exchange, not scramble appropriation or coercive expropriation, are useful as a stylized extreme, but ultimately we all live in a natural economy in which exchange and appropriation occur. He therefore believed that to understand resource allocation we need to understand the interplay of conflict and exchange (Hirshleifer 2001).

These directions illustrate that digging to the bottom of things in search of underlying simplicity opens the way to new fields of study, and encourages crossing arbitrary disciplinary boundaries. Together with Harold Demsetz and others, Armen’s studies of the economics of incentives and property rights (Alchian 1965; Alchian and Demsetz 1972; Alchian, Crawford, and Klein 1978) helped initiate the law and economics field, the economic theory of organizations, and the study of how problems of agency and institutions shape economic behavior. My dad’s studies of bioeconomics and economics of conflict reflected his view, expressed in his 1985 paper, “The Expanding Domain of Economics,” that “there is only one social science...,” and he believed that in this science the economic concepts of optimization and equilibrium play a crucial role.

This discussion does not exhaust the parallels in their thinking. For example, both believed that it was important to understand the process of exchange as a costly activity, an interest also shared by Harold Demsetz (Demsetz 1968). This led Armen to help initiate search theory (Alchian 1969), and for my dad to refer to the theory of exchange as the great missing chapter in price theory (Hirshleifer 1973). The importance of these issues is confirmed by the large literatures on search and on market microstructure that subsequently developed.

I’ll close by mentioning my dad’s great admiration for Armen’s method of disagreeing. At a lunch table conversation early in my dad’s career, people were discussing how inflation hurts lenders. Armen responded, “I don’t understand that.” Puzzled that Armen would miss such an obvious point, my dad explained it to him. Armen said that he still did not understand, so my dad tried again. Again Armen was puzzled, so my dad started to explain a third time, and then stopped in mid-sentence—suddenly realizing that if lenders foresee inflation, in equilibrium the interest rate will compensate them
accordingly. This ultra-Socratic approach (no leading questions!) may not always work, but clearly my dad thought Armen had provided a great lesson in how to think.


