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Economics and Its Discontents

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Abstract

In contrast to its historical origins as a part of moral philosophy, and subsequent evolution as "political economy", economics in recent decades has self-defined its scope of inquiry increasingly narrowly. And, as is well known, over time the field has imposed on itself ever more rigorous standards of analytical formalization. Both trends are understandable, but each comes at high cost. Moreover, the formalization requirement is often imposed arbitrarily, excluding some dimensions from the analysis because they are hard to formalize while admitting others without question. As a result, the field has been largely unable to address some of the first-magnitude problems the Western economies now face.

Zusammenfassung

Im Gegensatz zu seinen historischen Ursprüngen zunächst als Teil der Moralphilosophie und dann in ihrer Entwicklung zur ‚Politischen Ökonomie' hat die Wirtschaftswissenschaft ihr selbstdefiniertes Erkenntnisfeld zunehmend eingeengt. Auch hat sie sich, wie allgemein bekannt, immer rigorosere formal-analytische Standards gegeben. Beide Entwicklungen sind nachvollziehbar, aber mit Kosten verbunden. Außerdem werden die formalen Anforderungen häufig willkürlich aufgezwungen, womit einige Analysedimensionen nur deshalb ausgeschlossen werden, weil sie schwer zu formalisieren sind, während andere Dimensionen ohne weiteres Hinterfragen akzeptiert werden. Das Ergebnis ist, dass die Wirtschaftswissenschaften sich als weitgehend unfähig erwiesen haben, einige der drängendsten Probleme westlicher Volkswirtschaften zu adressieren.

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On June 27, 1772, as Scotland was experiencing its worst banking crisis in two generations, David Hume wrote to his friend Adam Smith, who he knew was then writing a major work. After recounting the bank failures, industrial bankruptcies, widespread unemployment, and even "Suspicion" of the sound-

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ness of the Bank of England, Hume asked Smith, "Do these Events any-wise affect your Theory?"

They certainly did. In the *Wealth of Nations*, published four years later, Smith expounded at length on the risks inherent in allowing banks to finance entrepreneurial "projectors" too readily and without sufficient assurance of repayment. Smith went on to argue for a cap of 5 percent on the interest rate banks could charge (on the ground that only the most speculative "projectors" would be willing to pay more), as well as for strict limits on banks' ability to fund their lending by issuing small-denomination liabilities. Demonstrating a clear understanding of what economists now call "externalities" (though without using that label), he explained that he favored these restrictions for the same reason he favored the laws requiring fire walls between the row houses in Edinburgh.

Today, in the aftermath of the worst banking crisis and the deepest and most protracted economic downturn the United States has experienced in two generations, many thoughtful observers of modern economics believe that these events similarly ought to affect economic theory, but have yet to do so. The view has merit.

To be sure, many of the criticisms that economics faces today – and did before the recent financial crisis too – are unpersuasive. It is true that sometimes economics delivers conclusions that people don't like; so does medical diagnosis. It is true that economists, by and large, did not predict the financial crisis; but prediction, much as the public may crave it, is not really the aim of economic science in general, much less of economic theory, and rare events are notoriously difficult to predict in any case. It is true that the recovery from the post-crisis downturn has been slow and uneven, in the United States and even more so elsewhere; but this painful experience has been partly the inevitable consequence of the financial excesses that led to the crisis, and the policy mistakes made since have largely been the fault of politicians, not economists. None of these objections is ground for thinking there is something wrong with *economics*.

A more serious line of argument stems from the fact that economists so often disagree. Here too, however, part of the public perception is misplaced. The popular press systematically exaggerates the extent of disagreement because that is what makes interesting reading, and for purposes of politics as well as business and markets, areas of disagreement are rightly what attract attention in any case. Especially in speculative asset markets, profits are made or lost by taking a position on the margin of uncertainty, not what is widely agreed to. Still, there is something about the nature of economists' disagreement that does undermine confidence. Too often, the disagreement turns out to be about the assumptions made, not the reasoning used or the evidence adduced, and perhaps for this reason disagreements in many cases go on indefinitely without reaching resolution. (Economics is not the only intellectual endeavor to suffer

this problem; Planck famously quipped that science advances funeral to funeral.) Moreover, again probably because disagreement so often stems from assumptions made rather than analysis carried out, it is easy to predict which economists will be on which side of any given question. The same is true for Supreme Court justices, for example; but they are understood to be political appointees, not participants in a scientific inquiry.

The more important reason for discontent with economics today is simply that our economy has serious problems and on all too many fronts economists have little to say about what to do to correct them. Sluggish recovery of output and employment from the downturn triggered by the financial crisis, stagnant incomes and living standards for the majority of American families and in many other countries too, the rising burdens of medical care for an aging population, the technologically driven prospect of increasing difficulty in providing worthwhile employment opportunities for large numbers of citizens – all are first-magnitude challenges facing the United States and, in varying respects, many other high-income Western countries. On none of them do economists seem able to chart a clear direction forward.

There are reasons. One, which is no fault of economics, is that while the subject may be a science it is not a laboratory science. Especially in areas that bear on public policy, experiments are difficult and controlled experiments are impossible. But other limitations on the discipline are self-imposed. Economists' fetish for formalization and quantification – despite the fact that much of what is important is hard to formalize and impossible to quantify – is the stock fodder of jokes; but it is real nonetheless. Further, even apart from the shackles created by the self-imposed quest to formalize and quantify, over time economists have adopted an increasingly confining range of the field's focus. The restriction of economics to efficiency and exclusion of questions of fairness happened long ago. The exclusion of matters of distribution is more recent (although in the context of persistently widening inequality this one is giving way to some extent). So too is the usual exclusion of any analysis of entities like large business corporations, or trade unions, as more than purely formal coalitions of otherwise atomistic agents. All this is not just a matter of the easily understood need for a limited focus in order to make progress in any one piece of analysis taken by itself. The issue here is the limited range of the discipline as a whole.

To make matters worse, experience especially within macroeconomics (the area concerned with the behavior of whole economies, and policies to guide them) reveals that the scientific aspiration that leads toward formalization and quantification is often applied, or not, with shocking arbitrariness. Examples are numerous:

- Not so long ago, the economics of monetary policy was guided by the principle that if a model was to address this traditional area of economic analysis it had to include a self-contained model, with rigorous microeconomic foun-

dations, explaining why people hold money in the first place. So far, so good (except that making such rigorous explanations conform to modern-day financial institutions is notoriously difficult analytically). But in many cases, the resulting model's intended application was to address normative issues surrounding price inflation, and there was no parallel requirement that the model include any explanation whatever of why inflation is bad (also an analytically difficult matter). That inflation is bad for the economy was simply assumed.

- Similarly, the convention in models evaluating the trade-off between costly inflation and costly loss of output is normally to treat inflation as a phenomenon with a permanent component but any loss of output, or unemployment, as strictly temporary. The result is, of course, to bias the implied optimal policy choice toward combating unwanted inflation at the expense of accepting unemployment and loss of output, and the more so as the discount applied to future outcomes is smaller. But there is ample evidence that output loss and unemployment also have permanent components. Foregone investment is sometimes never made up, and workers who enter the labor force during a time of severe unemployment exhibit permanently lower wage trajectories, and less labor force attachment, than their luckier peers. The choice to admit to the analysis permanent effects of inflation, but not of output or unemployment, is merely arbitrary.
- With the rise of the modern business corporation, and especially with the enormous growth in the compensation of top executives in recent years, much analysis within the area of economics called "corporate finance" has focused on how to design compensation contracts so as to align the incentives motivating a firm's executive-level employees with the interests of its owners. But despite the scandals of a decade and a half ago surrounding Enron, World Com and other now-notorious firms, the incentive for executives to falsify the firm's earnings remains mostly missing from the analysis.
- Many lines of economic analysis represent the private individuals inhabiting an economy and their government as making decisions differently – hardly a bad assumption in light of the obvious differences between individual and collective action (including the often fraught politics of the latter). Often, however, the assumption, typically made without attempted justification, is that while government decision-making is short-sighted, individuals belong to dynastic families and care about their progeny as about themselves – so that individuals, but not government, make decisions with the infinite future in mind (properly discounted, of course). The consequence is, naturally, to bias the analysis toward the conclusion that having more economic decision-making done by individuals, and less by government, systematically leads to superior outcomes. Given the asymmetric assumption, the conclusion follows; but the model could just as well be set up in the opposite way.

- In a similar vein, in many treatments of financial regulation before the recent financial crisis – most visibly in the public statements of Alan Greenspan as chairman of the Federal Reserve System, but by many others as well – the assumption was that government regulators do a poor job of monitoring the risk taken on by banks and other financial institutions while private-sector investors have a strong incentive to monitor efficiently the firms to which they lend, and therefore do so. The consequence was to conclude that government regulation is unnecessary because private credit markets are self-regulating. As Greenspan and others acknowledged after the crisis, the assumption was "mistaken". So too, therefore, was the conclusion.

Why does all this matter? For the majority of citizens, who are not economists, what difference does it make whether those who are constrain their analysis in sensible ways or not? Or whether they apply whatever constraining conventions they choose even-handedly or arbitrarily?

The reason is that our economy confronts important challenges that over time threaten the material well-being of the citizenry at large, and we should be able to look to economics both to provide a better understanding of these challenges and to suggest policies to mitigate them.

One example is the threat of technological unemployment. Ever since the early nineteenth century, people have feared that increasingly sophisticated machines (in the Luddites' case, textile looms) would render various forms of labor unnecessary and thereby lead to widespread unemployment or, at the very least, the demotion of skilled workers to jobs requiring fewer skills and accordingly paying lower wages. Nor have such fears been the exclusive domain of the economically unsophisticated. Over the years thoughtful economists, including both John Maynard Keynes and James Meade, have voiced them as well. But while there have been many instances of technological displacement of specific groups of workers, *in the aggregate* these fears have thus far proved misplaced. For the workforce taken as a whole, application of new technologies has instead created ample new job opportunities to replace those it has destroyed, and, moreover, in a way that has kept the population not only working but at ever higher wages. The introduction of the automobile eliminated jobs for saddlemakers and stable boys (and for whoever had to remove the once-ubiquitous manure from city streets), but it provided new ones in auto assembly lines, gas stations and repair shops.

Today, however, there is serious ground to think the coming decades may be different. As economists like Erik Brynjolfsson and Andrew McAfee have explained, the accelerating advance of electronic technology holds out the prospect of eliminating the need for human labor across a much wider and deeper range of workforce activity than ever before. In the fullness of time, whole new activities that are not now part of economic production, and not even yet foreseen, may emerge to offer new and perhaps even more rewarding opportunities

for gainful employment for large numbers of the truck drivers and manufacturing workers and medical diagnosticians and data managers who will longer do what they are currently doing. This is how the process has worked in the past. But timing matters too. Over a horizon that plausibly may extend to decades – certainly long enough to have highly significant social consequences – there is nothing to guarantee such a favorable outcome.

Two additional factors compound the threat. First, again mostly for technological reasons, an ever expanding variety of not only goods but services is becoming part of what economists call the "tradable" sector, regularly exchanged across international borders. Moreover, among services it is no longer just call-center jobs and other low-wage activities that are part of this phenomenon. Radiology, corporate accounting and legal research are all traditionally higher-wage jobs; today each is increasingly performed remotely, including overseas. And second, especially in the United States but to some extent in Europe as well, the lower-wage jobs that must be performed on site (giving haircuts, mowing lawns, trimming trees) are increasingly performed by immigrants eager to work at wages far below what has been the prevailing domestic standard. Not only will the incremental output that the high-income countries consume require little additional labor input, therefore, but the labor input that is required – even that part of it that must be performed on site – is likely no longer to provide job opportunities for these countries' own citizens.

The threat is obviously an economic one. What have economists had to offer by way of proposed solutions? Very little. The standard economic analysis of widening inequality, which emphasizes how education and training can lag behind the force of changing technology in increasing the labor market's demand for some skills while reducing the demand for others, is surely relevant. But this analysis has less bearing on questions of *aggregate* labor demand, and the usually proposed remedy of additional education as we know it is probably not an adequate answer in any case. Cutting off immigration would help in some areas, but not others, and would have mostly damaging effects in yet other ways. Calls for stimulation of new research, or the creation of new industries, are mostly empty. Why are economists so silent on the subject?

One root of the problem, given the constraints under which economists now work, is the analytical difficulty of dealing formally with markets that do not clear – in this case, the market for labor. "Involuntary unemployment", to use a term that has mostly passed out of economists' lexicon, is simply missing in most modern economic analysis, a consequence of the assumption of market clearing imposed to meet the requirements of the formal methodology. (A parallel consequence of the market clearing assumption is the systematic over-estimation of price elasticities, like those determining the effects of tax incentives to work or save, and the corresponding under-estimation of quantity elasticities, like those involved in the effect of fiscal expansion during a business recession.)

A further restrictive element that matters for this purpose is economists' inability/unwillingness, evident in many other applications as well, to incorporate heterogeneity within their analysis. Workers are not all alike, and just as inequality emerges even in a fully employed economy, the problem of technological *un*employment will not affect all workers equally. Finally, the restriction of the field's range to concepts that are formalizable and even quantifiable also renders economists unwilling/unable to entertain the difference between a job and a "good job". Everyone understands that if wages fall enough, so that most citizens of what are now considered high-income countries are forced to work for wages at or below what workers in today's developing world and the immigrants who come from there are willing to accept, much of the technological *unemployment* problem will go away. But that is not a solution to anything.

A second example of a first-magnitude economic issue on which today's economists are mostly silent is the functioning of our financial system – not in the sense of the risk of crisis (which, not surprisingly, has received substantial attention in response to the events of just a few years ago) but rather the ongoing ability of the financial system to perform the function for which it is primarily there.

The essential role of the private financial system, in a free-enterprise economy like that of the United States, is to allocate the economy's scarce investment capital. We have adequate public utility models for carrying out all of the other functions we expect our financial system to serve: operating the payments mechanism, providing liquid savings instruments and vehicles for retirement saving, creating insurance products for both households and businesses, and so on. But no publicly provided mechanism is capable of satisfactorily determining what share of the economy's total output will go into new plant and equipment, or new office buildings, or new houses for the growing population. Still less is any public mechanism able to determine how much new plant and equipment, and what kind, each industry should have. And, even less, which firms within each industry. Each of these allocations is the result of an uncountable number of private decisions and transactions executed in the private financial markets every day. That is these markets' principal function.

One is entitled to ask, however – indeed, one should ask – how well our financial system performs this essential function. And at what cost. What has already attracted substantial attention, at least in the United States, is the substantial increase in recent decades in the share of total corporate profits that accrue to financial-sector firms: from roughly one-tenth in the quarter-century or so after World War II to more than one-third in the years leading up to the financial crisis. Taking corporate profits as a plausible aggregate measure of the return to capital invested in the corporate sector, figuring one-third of the total return as the cost of allocating the capital makes the allocation mechanism look quite expensive. But the all-in cost of operating this mechanism is more than just the profits earned by financial firms; it also includes the wages they

pay to their employees and the rents they pay for their offices (or the equivalent imputed cost to firms that own their own buildings), as well as the associated utility bills, the advertising and travel budgets, and all of the other expenses associated with operating these businesses. (Conceptually equivalent, but presumably impossible operationally, one could instead figure the opportunity cost of the resources these firms use: what would all those bright and energetic graduates of the country's elite universities be doing if they were not working at private equity firms? what use would be made of the prime real estate along Park Avenue and LaSalle Street if it were not occupied by banks?) To date, no one has calculated the all-in cost of operating the economy's capital allocation mechanism – a lacuna that is itself indicative.

Against this mechanism's cost, which is therefore not known with precision but clearly must be very large, there is increasing evidence of less-than-desirable results – again, not in the now-familiar sense of exposing the rest of the economy to occasional instability such as the recent crisis, but rather in the regular ongoing performance of the basic function of allocating scarce capital. Once the financial crisis began, most of the attention focused on the losses that banks and other investors took on the mortgage-backed securities they held. But these losses were merely the paper reflection of real resource costs from poor allocation of investment: the wasted labor and materials that went into building millions of houses that, it turned out, no one wanted to occupy. Similarly, when the "dot com" bubble of the late 1990s broke, most of the attention focused on the losses investors took on high-tech stocks, especially in the telecom industry. Those losses too were the reflection of real resource costs from poor allocation of investment: in that case, laying hundreds of millions of miles of fiber-optic cable that never were lit.

The key impediment to economic analysis in this case is the difficulty of establishing a benchmark against which to assess the results achieved. To repeat, no one has ever identified a mechanism for allocating an economy's scarce investment capital that approaches even the demonstrably limited efficiency of private, decentralized, competitive markets. But the resulting analytical vacuum is no reason not to evaluate potential alternatives at the margin. To take again the example at the heart of the recent crisis, how would the economy's investment allocation have differed if there had been no securitization of mortgages? Or no market for single-name corporate credit default swaps? Are these instruments adding anything to the ability of the financial system to carry out its basic function? If so, are they adding enough to justify the obvious (in hindsight) exposure of the rest of the economy to the risk of a substantial interruption of ordinary economic activity? As with the failure to measure the all-in cost of operating the financial system, no one knows. And most economists are not asking the question.

The example of the economy's capital allocation mechanism illustrates an important final point that bears on the broader discussion surrounding the disci-

pline of economics today. As is so often the case, it's impossible to beat something with nothing. Criticizing economics as currently studied and practiced is useful, but it goes only so far. What matters is conceiving and articulating an implementable alternative. Moreover, to be persuasive it is then necessary to demonstrate that the proposed alternative is analytically cogent, and that it is capable of producing useful policy conclusions.

In the end, it is the voters who decide public policy, including economic policy. Keynes famously wrote that "practical men who believe themselves to be quite exempt from any intellectual influence are usually the slaves of some defunct economist", and even that "madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back". If Keynes was right, it is ultimately the public to whom economists must appeal, and whom, in the long run, they must convince.