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What's the Matter with Economics?

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Seven Bad Ideas: How Mainstream Economists Have Damaged America and the World
by Jeff Madrick
Knopf, 254 pp., $26.95

The Queen of England famously asked British economists why nobody saw the financial crisis coming. Lots of nonroyal people also have a feeling that there's something wrong with economics. Jeff Madrick, an economics journalist of some accomplishment and considerable intelligence, shares his views on what's wrong with economics in this engaging book. But methinks the gentleman doth protest too much.

Dominique Nabokov

Jeff Madrick, New York City, 2010

Madrick really is a gentleman—and something of a scholar, too. Unless you are already steeped in economics, you will learn much from reading *Seven Bad Ideas*, including a lucid exposition of the so-called efficient markets theory and a nice essay on the shortcomings of economics as a science. You will also encounter a few delightful bons mots along the way, such as: "A beautiful idea can be described as one that explains a lot with a little." Madrick knows how to wield a pen.

He is also an important and eloquent voice for what's left of the American left—at least in economic matters. Given the notable rightward shift of the US political spectrum, I'm glad we have Jeff Madrick around. I wish he could clone himself. But parts of *Seven Bad Ideas* constitute serial exaggeration.

The book's main thesis is stated with stark clarity in the very first sentence: "Economists' most fundamental ideas contributed centrally to the financial crisis of 2008 and the Great Recession that followed." Centrally? I don't think so. A more accurate sentence would start, "Some ideas of conservative economists contributed a bit…," but that wouldn't attract attention. Alas, the truth is duller than fiction.

When I hear or read dramatic portrayals of economists' enormous influence on policy, I don't know whether to laugh or cry. On the one hand, it is flattering to be thought so influential. On the other hand, I can't help remembering economist George Stigler's contrary verdict, delivered in 1976: "Economists exert a minor and scarcely detectable influence on the societies in which they live."[1]

Here's a little test. As a general matter, which statement do you think comes closer to the truth?

> (a) The dominant academic thinking, research, and writing on economic policy issues exert a profound, if not dispositive, influence on decisions made by politicians.
>
> (b) Politicians use "research findings the way a drunk uses a lamppost: for support, not for illumination." (The quotation is from economist Jared Bernstein, as cited by Madrick on page 200.)

I suspect you answered (b). If so, you got it right. Madrick's answer seems closer to (a).

My main quarrels with *Seven Bad Ideas* are three, which I'll take up in turn. First, as just mentioned, academic thinking and research don't have nearly as much influence on economic policy as Madrick imagines. Second, his characterization of what constitutes mainstream economics is heavily skewed to the right; it's more about conservative economics. Third, most of what he calls "bad ideas" are either good ideas, straw men, discarded doctrines, or limited to quite conservative economists—the people who build "lampposts" for the political right.

The Influence of Economists

In a book published in 1987, I coined (and provided examples of) what I called Murphy's Law of Economic Policy:

> Economists have the least influence on policy where they know the most and are most agreed; they have the most influence on policy where they

know the least and disagree most vehemently.[2]

It was true then, and it is true now. Just last year, two economists comparing the disparate answers to survey questions from forty-one prominent academic economists versus a representative sample of Americans reached the same conclusion as I did.[3] Which group do you think holds more sway with elected politicians: average Americans or economic experts? (Hint: Which has more votes?)

Not convinced? Then think about how often Congress has enacted or raised a carbon tax. Or reduced the tax advantage for homeownership. Or how many cities charge congestion fees (high tolls in peak hours) on their bridges and tunnels. In each of these cases and many more, a huge majority of economists —Democrats, Republicans, and independents alike—not only favors the indicated policy but thinks it axiomatic. Arthur Okun, who chaired the Council of Economic Advisers under President Lyndon Johnson, wrote forty-four years ago that "on a number of issues, a bipartisan majority of the profession would unite on the opposite side from a bipartisan majority of the Congress."[4] That hasn't changed.

Part of this is our fault. More than half of American voters have been to college, and a large fraction of them took at least one economics course while there. Yet we professors have failed to convince the public of even the most obvious lessons, like the virtues of international trade and the efficacy of fiscal stimulus in a slump. It's pedagogical failure on a grand scale.

Which brings me to another place where economists deserve some blame. While we have rarely convinced the majority of anything, we have managed to convince a determined minority of many things—or perhaps of caricatures of those things. Gordon Gekko's infamous assertion that "greed is good" is not far from the invisible hand doctrine, which is Madrick's first "bad idea." Some of our students grow up to be rich or otherwise powerful and have the ear of politicians far more than their teachers ever did. Some of them wound up doing great damage on Wall Street. They should be ashamed of their actions; but we, their teachers, bear a little of the guilt, too.

To be more concrete, many economists teach—and a number extol—the efficient markets hypothesis, which Madrick offers as another bad idea. That theory undergirded many of the derivatives that did so much harm once the housing bubble burst. If the sins of the sons can be visited on the fathers (yes, they were mostly men), economists bear part of the blame.

Where Is the Mainstream?

Madrick's *j'accuse* subtitle indicts "mainstream economists." But mainstream biologists are not blamed for creationism, and mainstream doctors are not held responsible for homeopathy. Why, then, should mainstream economists be blamed for the extreme economic views of either the left or the right?

The great Milton Friedman of the University of Chicago, a favorite target of Madrick, may have been right or wrong; but he was certainly far to the right. Much the same can be said of several other economists cited by Madrick as representing the mainstream. For example, he quotes John Cochrane, also of the University of Chicago, as saying in 2009 that Keynesian economics is "not part of what anybody has taught graduate students since the 1960s. [Keynesian ideas] are fairy tales that have been proved false." The first statement is demonstrably false; the second is absurd. People can and do argue over the macroeconomic views associated with the so-called Chicago School, but it's clear that the views of that school are far from the mainstream.

You may be thinking that "mainstreaminess," like "truthiness," is in the eye of the beholder. Well, not entirely. The IGM Forum Economic Experts Panel at the University of Chicago's business school regularly surveys a panel of top economists from leading universities on a variety of public policy issues. Its website describes the selection principles for the panel as seeking "distinguished experts with a keen interest in public policy from the major areas of economics, to be geographically diverse, and to include Democrats, Republicans and Independents…." That sounds something like a mainstream.

Disbelief in the efficacy of Keynesian fiscal policy is on Madrick's list of seven bad ideas. But how many disbelievers are there? Last July members of the expert panel were asked whether they agreed or disagreed with two statements about fiscal stimulus. The first was straight Keynes:

> Because of the American Recovery and Reinvestment Act of 2009, the US unemployment rate was lower at the end of 2010 than it would have been without the stimulus bill.

The experts' vote was overwhelming: 82 percent agreed while 2 percent (one person—I'll soon name him) disagreed. The second statement posed a sterner test:

> Taking into account all of the ARRA's economic consequences—including the economic costs of raising taxes to pay for the spending, its effects on future spending, and any other likely future effects—the benefits of the stimulus will end up exceeding its costs.

Even a believer in Keynesian theory might answer "no" to this question, which

draws you deeply into the details of the stimulus package, some of which were not attractive. Accordingly, the vote was closer: just 56 percent to 5 percent. (23 percent were uncertain.) The mainstream is overwhelmingly Keynesian.

But not every economist is. Why not? One reason is that economists come in all political stripes—just like other people. And just like the American body politic, the economics profession has shifted to the right since the Age of Reagan. Therein lies the element of truth in Madrick's critique of mainstream economics, and I share his discomfort. But have economists shifted further to the right than voters at large? I doubt it. The study of the expert panel cited above concluded that the economists were "much more 'liberal' than the American population at large."

One Bad Idea or Seven?

As soon as I noticed that Madrick's first "bad idea" was Adam Smith's invisible hand, I knew I would find much to disagree with. To an economist, even a liberal economist like myself, those are fighting words. I believe *every* mainstream economist sees the invisible hand as one of the great thoughts of the human mind. A "bad idea"? No, a great one.

So was Galileo's idea that bricks and feathers would fall at the same speed in a frictionless environment. But I doubt that Galileo ever applied that abstract idea to a real world rife with frictions. I'm pretty sure he knew the brick would hit the ground first.

That roughly encapsulates the way most mainstream economists teach the invisible hand to our students, though Madrick is right that some treat the frictionless model as a far better approximation to reality than Galileo ever did. Throughout recorded history, there has never been a serious practical alternative to free competitive markets as a mechanism for delivering the right goods and services to the right people at the lowest possible costs. So it is essential that students learn about the virtues of the invisible hand in their first economics course.

However, they also learn, in that same course, about the failings of markets as the result of such "frictions" as less-than-perfect competition (partial monopolies), externalities (of which pollution is the most famous example), inadequate supply of public goods (for Adam Smith, lighthouses), failure to maintain full employment, and inability to limit inequality—to name only the biggest failings. In my own introductory textbook, coauthored with William Baumol, the chapter entitled "The Shortcomings of Free Markets" comes immediately after the chapter called "The Case for Free Markets."[5] Students who continue beyond Economics 101 learn even more about "market failures"

as their education proceeds.

That said, I don't think any mainstream economist doubts that free, competitive markets perform their core functions far better than any alternative mechanism. Adam Smith figured that out in the 1770s. Does Madrick really disagree? He writes, seemingly unhappily, that "my college textbooks, even when they included sections on Keynesian government stimulus, by and large agreed that prosperity is mostly a consequence of the Invisible Hand—that is, a free market." Of course they did; it's true. And those textbooks also agreed, as Madrick writes later, that "the Invisible Hand is an approximation, usually not applicable in the real world without significant modification." What, then, is the quarrel?

Madrick's second bad idea, Say's Law, can be treated more briefly because it really is bad. However, it was also mostly discarded more than seventy-five years ago, a victim of the Great Depression and John Maynard Keynes's intellect. Say's Law, colloquially stated as "supply creates its own demand," means that an economy can never have a generalized insufficiency of demand (and hence mass unemployment) because people always spend what they earn. Therefore: no recessions, no depressions.

The Great Depression sounded the death knell for Say's Law. Then along came Keynes to hammer the intellectual coffin shut. People don't always spend every cent they earn, he explained. Sometimes they save or hoard money. So, at times, the unassisted private sector might not generate enough demand to keep everyone employed. In such cases, Keynes suggested, the government might step into the breach.

Were Say right and Keynes wrong, it would be fruitless to use fiscal stimulus to try to end a recession. Indeed, Say's modern descendants, the so-called "austerians," oppose stimulus (more spending, tax cuts) in a recession, and advocate budgetary austerity (especially less spending) instead. The trouble is, while it's not hard to find austerians among conservative government officials and their advisers, both in the US and Europe, and even among a few conservative economists, it is hard to find many among mainstream economists. The aforementioned sample of experts included exactly one austerian: Alberto Alesina of Harvard. His highly controversial research provided the support for many right-leaning politicians who knew they wanted to cut government spending long before they heard of Alesina.

Madrick also tabs "low inflation is all that matters" as a bad idea, which it is. But again, who believes it? A few academics sound that way at times, but hardly any senior economist in actual policy circles acts that way. So I was

surprised to read that “the only US economic policy of importance since the 1980s has been the effort to keep inflation at the low rate of roughly 2 percent.” Whoa. Didn’t Alan Greenspan experiment by letting the unemployment rate drift below 4 percent in 2000? Didn’t Ben Bernanke devote most of his eight-year tenure to trying to boost the economy any way he could, brushing aside criticisms that his policies would be inflationary? Hasn’t Janet Yellen made it clear that, with inflation so low, the Fed’s main objective today is to tighten labor markets and get real wages rising? So count this one as a bad idea that was not followed.

Madrick calls free-market fundamentalism, another bad idea, “Friedman’s Folly,” after Milton Friedman. You’ve heard the arguments before, and you know that views on whether and how governments should or should not interfere with free markets vary enormously across the political spectrum. So perhaps you can imagine my surprise when I read that “economists in general are Friedman’s handmaidens.”

According to Madrick, “Even politically liberal economists generally argue that government must only correct what they define as market failures.” Well, I’m a “politically liberal economist,” and it just isn’t so. First, as mentioned earlier, some widely accepted reasons for government intervention—such as moderating business cycles and reducing poverty—are not normally termed “market failures.” Second, given how well the invisible hand handles its core functions, governments really shouldn’t muck around with markets without good reason. Of course, it is possible to carry admiration for unfettered markets too far. That makes you a “free market fundamentalist,” not a mainstream economist.

S*even Bad Ideas* hits its stride in Chapter 5, “There Are No Speculative Bubbles.” The chapter title, which is a corollary of the efficient markets hypothesis (EMH), paraphrases Eugene Fama of—as you may have guessed—the University of Chicago, who won a share of the 2013 Nobel Prize for developing the EMH. As Madrick correctly states, the EMH is an example of “how faith in the rationality of free markets was pushed too far.”

According to what’s called the “strong form” of the EMH, hyperrational investors keep asset prices close to fundamental values virtually all the time (hence, there are no bubbles) by incorporating new information into asset prices accurately and instantly (hence, there are no easy profit opportunities). The “weak form” of the EMH makes a more modest claim: that you can’t beat the market. Investors earn higher returns only by taking on more risk. That prediction does tolerably well as a Galilean approximation in major financial

markets, and it basically swept away all competing theories in the 1970s and 1980s. I recently asked a group of Princeton graduate students in finance if they had been exposed to any other theory of financial markets. They hadn't been. And Princeton isn't Chicago.

But what about the strong form of the EMH? This "bad idea" proved pernicious, just as Madrick says. The EMH (plus some financial engineering) gave Wall Street managers the tools with which to build monstrosities like CDOs (collateralized debt obligations) and CDSs (credit default swaps) on top of the rickety foundation of subprime mortgages—and helped give Wall Street salesmen (and rating agencies) the chutzpah to pawn them off as "safe" to credulous investors.

The EMH also handed conservative regulators (such as Alan Greenspan) and conservative politicians (such as George W. Bush) a rationale for minimal financial regulation. After all, if super-smart markets get everything right, regulators can only mess things up. So, for example, as Madrick perceptively states, "under the thrall of efficient markets thinking, derivatives went unregulated, and that was a major cause of the 2008 crash." Amen. I suggest in my book *After the Music Stopped* that the Commodity Futures Modernization Act of 2000, which banned the regulation of derivatives, was probably the most egregious policy error leading up to the financial crisis.[6]

Madrick's wonderful chapter on efficient markets should be required reading for everyone in the financial world. But ask yourself what kind of help the EMH provided to regulators who were predisposed not to regulate anyway. Was it to illuminate, or to support conclusions already reached, perhaps choosing your favorite economists accordingly? Then ask yourself who held the lobbying power, the mighty financial industry that was minting money (which, by the way, contradicts even the weak form of the EMH) and handing some out to politicians, or the spoilsport reformers (some of whom were mainstream economists) who were acting like scolds while the good times rolled?

The last item on Madrick's list of bad ideas is that economics is a true science. This accusation is a little gratuitous, since hardly anyone ever believed it. Like Madrick, I have long been distressed by the high correlation between economists' political views and their allegedly objective research findings. In addition, Madrick points out that "experimentation and empirical proof in economics rarely rise to the standards of true science." Guilty as charged, though I'd plead for a lenient sentence because we economists rarely can conduct controlled experiments.

But look at some of the specific examples of scientific malpractice Madrick uses to make his case. One is the aforementioned work of Alesina—and hardly anyone else—allegedly showing that fiscal austerity promotes growth, even in the short run. Madrick correctly observes that when this doctrine was discredited (by mainstream economists, by the way), conservative policymakers did not change their minds. Well, yes. Right-wing policymakers were looking for support for budget cutting, not for illumination. When the intellectual support crumbled, they didn't much care.

A second prominent example is the famous spreadsheet error made by Harvard's Carmen Reinhart and Kenneth Rogoff in a 2010 paper allegedly showing that economic growth slowed sharply once the national debt topped 90 percent of GDP.[7] Deficit hawks trumpeted the result, making the 90 percent mark something of a mantra. But I know from personal experience that hardly any mainstream economists ever believed in a sharp discontinuity at 90 percent—or any other magic number. And the discovery of the spreadsheet error in 2013 effectively demolished the idea in academia.[8] That seems somewhat scientific to me. Madrick is unhappy that conservative politicians failed to abandon their calls for austerity. But was that a failure of economics as a science or a demonstration of the lamppost theory?

Jeff Madrick is correct that economists should not pretend to be pursuing an exact science like physics. I don't think many of us do. But when he writes that "economic growth is as much the domicile of the historian, the psychologist, the philosopher, the theologian, and the sociologist as it is of the economist," I'm dubious. Psychology and history—not to mention political science—may well be relevant to growth policy. But I'm still putting economics in first chair—bad ideas and all.

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1 George J. Stigler, "Do Economists Matter?," *Southern Economic Journal*, January 1976. ↩

2 Alan S. Blinder, *Hard Heads, Soft Hearts: Tough-Minded Economics for a Just Society* (Addison-Wesley, 1987). ↩

3 Paola Sapienza and Luigi Zingales, "Economic Experts versus Average Americans," *American Economic Review*, Vol. 103, No. 3 (May 2013). ↩

4 Arthur M. Okun, *The Political Economy of Prosperity* (Norton, 1970), p. 1. ↩

5 *Economics: Principles and Policy*, twelfth edition (Cengage Learning, 2012). ↩

6 *After the Music Stopped: The Financial Crisis, the Response, and the Work Ahead* (Penguin, 2013). ↩

7 "Growth in a Time of Debt," *American Economic Review*, Vol. 100, No. 2 (May 2010). ↩

8 Thomas Herndon, Michael Ash, and Robert Pollin, "Does High Public Debt Consistently Stifle Economic Growth? A

Critique of Reinhart and Rogoff," *Cambridge Journal of Economics*, Vol. 38, No. 2 (March 2014). ↩

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