



Department  
of Economics



Department of Economics and Centre For Macroeconomics public lecture

# Economics Rules: the rights and wrongs of the dismal science

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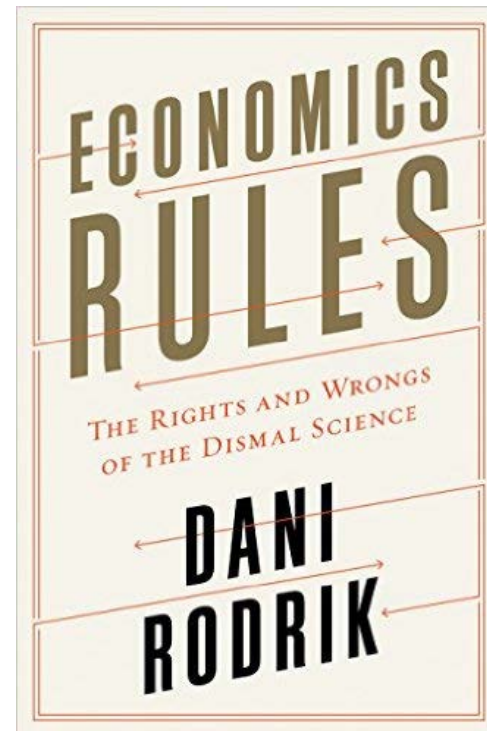
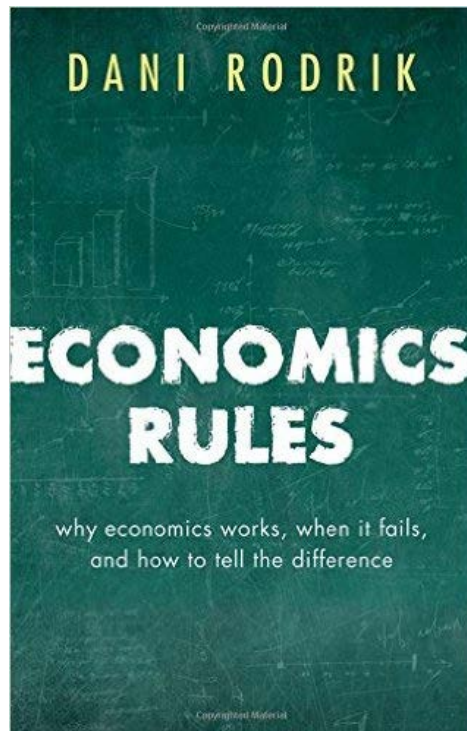
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Suggested hashtag for Twitter users: **#LSEecon**



# ECONOMICS RULES: THE RIGHTS AND WRONGS OF THE DISMAL SCIENCE



# What is the Nobel committee thinking?

- What's the big idea?



- Can they both possibly be right?



# In a nutshell...

“Economics is a science of thinking in terms of models joined to the art of choosing models which are relevant...”

Keynes (1938)

# In the land of the Econ ...where “modls” rule

## LIFE AMONG THE ECON\*

AXEL LEIJONHUFVUD  
University of California, Los Angeles

A comparison of status relationships in the different “fields” shows a definite common pattern. The dominant feature, which makes status relations among the Econ of unique interest to the serious student, is the way that ~~status~~ is tied to the manufacture of certain types of implements, called “modls.” The status of the adult male is determined by his skill at making the “modl” of his “field.” The facts (a) that the Econ are highly status-motivated, (b) that status is only to be achieved by making “modls,” and (c) that most of these “modls” seem to be of little or no practical use, probably accounts for the backwardness and abject cultural poverty of the tribe. Both the tight linkage between status in the tribe and modl-making and the trend toward making modls more for ceremonial than

## ... and determine status

While in origin the word “modl” is simply a term for a concrete implement, looking at it only in these terms will blind the student to key aspects of Econ social structure. “Modl” has evolved into an abstract concept which dominates the Econ’s perception of virtually all social relationships—whether these be relations to other tribes, to other castes, or status relations within his caste. Thus, in explaining to a stranger, for example, why he holds the Sociogs or the Polscis in such low regard, the Econ will say that “they do not make modls” and leave it at that.

... though even the natives cannot agree which “modl” to use

two largest of the Econ castes, the “Micro” and the “Macro.” Each caste has a basic modl of simple pattern and the modls made by individual members will be variations on the theme set by the basic modl of the caste. Again, one finds that the Econ define the social relationship, in this instance between two castes, in terms of the respective modl. Thus if a Micro-Econ is asked why the Micro do not intermarry with the Macro, he will answer: “They make a different modl,” or “They do not know the Micro modl.” (In this, moreover, he would be perfectly correct, but then neither, of course, would he know the Macro modl.)

# But why models: Borges on scientific method

## **On Exactitude in Science**

Jorge Luis Borges, *Collected Fictions*, translated by Andrew Hurley.

...In that Empire, the Art of Cartography attained such Perfection that the map of a single Province occupied the entirety of a City, and the map of the Empire, the entirety of a Province. In time, those Unconscionable Maps no longer satisfied, and the Cartographers Guilds struck a Map of the Empire whose size was that of the Empire, and which coincided point for point with it. The following Generations, who were not so fond of the Study of Cartography as their Forebears had been, saw that that vast Map was Useless, and not without some Pitilessness was it, that they delivered it up to the Inclemencies of Sun and Winters. In the Deserts of the West, still today, there are Tattered Ruins of that Map, inhabited by Animals and Beggars; in all the Land there is no other Relic of the Disciplines of Geography.

—Suarez Miranda, *Viajes de varones prudentes*, Libro IV, Cap. XLV, Lerida, 1658



# Argument

- Models are key to the “scientific” nature of economics
  - understand complex social reality by laying bare a very large variety of causal relationships, one at a time
- Economics advances not by settling on “the model,” but by generating useful collection of models
  - an inventory of partial explanations
  - non-universality and context-specificity
- This view of economics counters typical critiques of economics
  - as well as economists’ own description of their practice
- Economists are good at making models, but poor at navigating among them

# Models at work: what does economics have to say on the effects of

- minimum wages on employment?
- expansionary fiscal policy on economic activity?
- capital inflows on economic growth?
- trade liberalization on economic performance?
- ....

Different models, different results

(and empirical analysis rarely ever conclusive, often pointing to different outcomes for different places and times)

# How to figure out the relevant model – the craft of economics

- Verify critical assumptions (cf. M. Friedman)
  - entry, size of firms, technology, etc...
  - insensitive investment, adequate domestic finance/savings
  - (note: always need to ask if omitted real-world features would alter conclusions)
- Verify mechanisms
  - do firms behave in posited way?
  - does exchange rate respond to capital inflows?
- Verify direct implications
  - does employment really respond negatively to (exogenous) increases in wages?
  - does investment rise with capital-account liberalization?
- Verify incidental implications (comparative statics)
  - e.g., do firms pass on cost increases in full?
  - e.g., does investment respond to exogenous flows from abroad (aid, remittances)?
- Note parallels to external validity in randomized controlled trials

# Side note 1: the role of math in economic models

- Models do not require math, in principle
  - any causal statement contains an implicit model
- In practice, math often useful to
  - clarify (and make explicit) the nature of assumptions, relationships, conclusions
  - ensure conclusions follow logically from assumptions
    - “economists use math not because they are smart, but because they recognize they are not smart enough”

## Side note 2: the role of rationality and self-interest in economic models

- Rationality, self-interest, or material motives are not essential, or required ingredients of models
  - though they are typically assumed
- Other variants can, and have been, accommodated in economic models
  - other-regarding behavior versus “self-interest”
  - considerations such as status versus “material motives”
  - endogenous preferences
  - behavioral economics versus “rationality”
- In real-world applications, the rationality postulate is as contestable as any other feature of an economic model

# Re-evaluating critiques of economics

- Simplistic/reductionist theories
- Inappropriate universalistic claims
- Reification of markets and material incentives
- “Conservative bias”
- Disregard of social/political embeddedness
- Failure to predict
- Methodological biases
  - that crowd out new ideas
- Loss of ambition
  - from a program to transform society to merely understanding how a particular form of market society works
- ...

# Real failings originate from behavioral and sociological aspects of profession

- Mistaking a model for reality
  - over-confidence, hubris
- Mistaking a model for *the* model
  - expecting the same model works all the time
  - overlooking alternative models with different implications
- Categorical preference for certain axioms
  - assumption of rational, forward-looking individuals operating in perfectly competitive markets
- Preference for questions that are amenable to available tools of analysis
  - substantive implications of common tractability assumptions
  - neglect of issues involving scale economies until analytical tools were developed
- Implicit political-economy theorizing in policy discussions
  - economists' training endows them with no way to evaluate alternative social states other than through lens of allocative efficiency

# Final word

Recognition of economics as portfolio of models:

- forces economists to be more humble about how much they really know
  - financial crisis
  - Washington Consensus
- enables greater understanding of the variety of social phenomena
  - where such understanding is possible
- closes some of the gap with other traditions in social sciences (cultural, humanist, constructivist, interpretive)
  - an economist's answer to "what about x which you left out of your model...?" is/should be "OK, let's write down a model of it..."



### Ten commandments for economists

1. Economics is a collection of models; cherish the diversity.
2. Remember: it's a model, not the model.
3. Make your model simple enough to isolate how specific causes work, but not so simple as to leave out key interactions among causes.
4. Unrealistic assumptions are OK; unrealistic critical assumptions are not OK.
5. The world is (almost) always second-best; ignore it at your peril.
6. Mapping models to real-world settings requires explicit empirical diagnostics, which is more craft than science.
7. Do not confuse agreement among economists for certainty about how the world works.
8. It's OK to say "I don't know" or express range of views when asked about the economy or policy
9. Do not forget that efficiency is not everything.
10. Do not abuse your expertise by substituting your values for the public's.

### Ten commandments for non-economists

1. Economics is a collection of models with no predetermined conclusions; do not let anyone tell you otherwise.
2. Do not criticize an economist's model because of its assumptions; ask how the results would be changed if the assumptions that seem problematic were more realistic.
3. Analysis requires simplicity; beware of incoherence that passes itself off as complexity.
4. Do not be put off by the math; remember economists use math not because they are smart, but because they are not smart enough.
5. When an economist makes a recommendation, ask what makes him/her sure the underlying model applies to the case at hand.
6. When an economist uses the term "economic welfare," ask what s/he means by it.
7. Do not assume what an economist says in public is the same as what he says in the seminar room.
8. Economists don't (all) worship markets; if they seem like they do, it's probably because they know better how they work than you do.
9. If you think all economists think alike, do attend one of their seminars.
10. If you think economists are especially rude to non-economists, do attend one of their seminars.