AIER | Economic Bulletin

AMERICAN INSTITUTE *for* ECONOMIC RESEARCH www.aier.org Vol. XLIX, April 2009

The Value of Economic Advice

When economists leave the academy for Washington, they often change their tunes.

by John H. Wood, AIER Visiting Research Fellow

The reputations of economic experts are in tatters. They failed to predict the recent housing and credit crises, which their regulations did nothing to prevent. But their self-confidence is unaffected. Admitting that the Federal Reserve could have done more to discourage speculation in the past, Chairman Ben Bernanke nevertheless assures us that his new policies will work. The new chair of the president's Council of Economic Advisors, Christina Romer, has announced that "we are staging a wonderful battle" that will "put us back in a good place," flying in the face of a history of stimulus packages that failed because government spending was too late as well as misdirected and tax rebates were folded into the long-run plans of rational agents.

Some have remarked on the decline of economic expertise, but none of this is new. Economists' eagerness to accommodate their employers is of long standing, and was the subject of an article that we published in 1998, reproduced below. Only the names have changed.

The prestige of economists and the demand for their advice are based on the reputation of economics as the most "scientific" of the social sciences. That reputation stems almost entirely from the rigorous confirmation of Adam Smith's insight that an uncontrolled market economy is not only feasible, but to a considerable extent operates in the interests of producers and consumers.

The prestige of economists stems from the rigorous confirmation of Adam Smith's insight that an uncontrolled market economy is not only feasible, but to a considerable extent operates in the interests of producers and consumers.

Kenneth J. Arrow and F. H. Hahn, two of the foremost contributors to the theory of general equilibrium, as this field of study is called, described the premier question of mainstream economics and its answer as follows:

> There is by now a long and fairly imposing line of economists from Adam Smith to the present who have sought to show that a decentralized economy motivated by self-interest and guided by price signals would be compatible with a coherent disposition of economic resources that could be regarded, in a well-defined sense, as superior to a large class of possible alternative dispositions. Moreover, the price signals would operate in a way to establish this degree of coherence. It is important to understand how surprising this claim must be to anyone not exposed to this tradition. The immediate "common sense" answer to the question "What will an economy motivated by individual greed and controlled by a very large number of different agents look like?" is probably: "There will be chaos." That quite a different answer has long been claimed true and has indeed permeated the economic thinking of a large number of people who are in no way economists is itself sufficient grounds for investigating it seriously.

All that we need to know other than our own talents and preferences are prices and wages. No more information or special pleadings are required. In *Wealth of Nations*, Adam Smith himself expressed the fundamental principle succinctly and picturesquely as follows:

> It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest.

"And it will be a better dinner

than the government could provide" is a short way of stating the other part of Smith's message. Subscription to these conclusions is the necessary and sufficient condition — the Hippocratic Oath — of economic orthodoxy in colleges and universities in the United States and most other countries. It identifies the mainstream academic economist.

Yet no government intervention lacks the support of economists who earned their Ph.D.'s by demonstrating adherence to and some facility in the economics of Adam Smith. This raises two questions: Why do we often find acceptance of laissez-faire in principle and the advocacy of central planning in practice in the same economist? And what is the effect of this double intellectual life on public policy?

The answer to the first question is found in mainstream economics. Economists may not really believe that their theory applies to real-world problems, but it explains their own behavior. Their double lives are not schizophrenic or Jekyll-and-Hyde, but represent sane and informed adjustments to economic rewards. The answer to the second question is: "Very little, and what effect there is probably bad."

It was not surprising that in the election-year 1996 President Clinton proposed and the Republican Congress passed an increase in the minimum wage. More noteworthy was the position of Joseph Stiglitz, the distinguished economic theorist (who would win the Nobel Prize in 2001) and who served as chairman of President Clinton's Council of Economic Advisors from 1995-97. His economics textbook published in 1993 had taken the orthodox line that minimum wages, like other wage and price controls, were bad because they interfered with the operation of the price system as a communicator of costs and benefits, and in this particular case tended to raise unemployment among low-skilled workers. However, by 1996 he had been persuaded that the benefits to those who kept their jobs would exceed the deprivations of those priced out of their jobs by the government's policy; and anyway, job losses were likely to be small.

Professor Stiglitz's change of mind was nothing new, and had been preceded by the wage-price guideposts of President Johnson's Council of Economic Advisors and the more stringent controls of President Nixon's New Economic Policy. The latter case is particularly interesting. On July 28, 1971, Council Chairman Paul McCracken of the University of Michigan responded in *The Washington Post* to John Kenneth Galbraith's proposal to the Joint Economic Committee of Congress that prices be controlled because they were inadequate signals of costs and benefits and served primarily to extract income from consumers. Professor McCracken argued that unrestricted price changes were essential to the efficient satisfaction of consumers' desires. Price controls would threaten individual freedom. They would misallocate resources because Washington bureaucrats and politicians had no way of knowing what the right prices were, and in any case it was impossible to implement them fairly or effectively. These shortcomings did not, however, prevent President Nixon from announcing a price-wage freeze on August 15 or, on August 30, Chairman McCracken from defending that policy before the committee that had heard Professor Galbraith.

Although government policies are difficult to predict, most have a straightforward explanation. They are, of course, the outcomes of the political process and reflect the desires of segments of the electorate—although groups seldom get all they want because compromises have to be made with the competing desires of others. Government policies are products of the give-and- take of a democratic society. They are not all bad, and in any case compromise may be inescapable. Our question is: Do economists help or hinder the process?

Adam Smith never argued that laissez-faire would lead to a perfect world. Imperfect knowledge, costs of adjustment, and the reluctance of people to leave their homes and change their jobs allow the perpetuation of what economists call inefficiencies for considerable lengths of time. "Secrets in manufactures" may allow "extraordinary gains... for many years together," Smith wrote, and wages are determined "not by any accurate measure, but by the haggling and bargaining of the market according to that sort of rough equality which, though not exact, is sufficient for carrying on the business of common life."

In spite of the imperfections of the world around us, Smith said: "It is by far the best policy to leave things to their natural course." Government interventions tended to increase rather than reduce inefficiencies by price controls that discouraged food supplies to areas suffering famine, wage ceilings, and restrictions on the movement of labor (employers of agricultural labor dominated Parliament in Smith's time), and the protection of trading monopolies such as the East India Company.

These effects are also familiar to Americans. Most government interventions in the marketplace represent attempts to secure advantages beyond those obtainable by free exchange.

The Interstate Commerce Commission was a means of government enforcement of railway price-fixing agreements. The Federal Reserve was used for the same purpose when legal ceilings on deposit interest rates were introduced in the 1930s. The costs imposed on firms (and their customers) by food and drug regulations discourage the entry of small competitors; and so do the costs of securities issues caused by so-called investor-protection laws. In the area of monetary and fiscal policy, Keynesian counter-cyclical

stabilization policy has in practice served as a rationale for the age-old political inclination toward deficit spending. The tax cuts of 1964 and 1984 were recommended by economists claiming support from opposing demand-side and supply-side theories, but they are better explained by the election cycle. The economy was expanding both times, and the incumbents won by landslides, but one can never be too sure of an election.

All these policies can be explained without reference to economists. We have seen the pliability of chairmen of the Council of Economic Advisors. So why do we employ them?

An obvious and probably the best short answer: for public relations. Publicity is as important to governments as it is to businesses. The best spokespersons are "experts," and it is natural—for the same reason that dentists sell toothpaste and athletes sell shoes —that sellers of government economic programs include economists. The best economists—"recognized experts"—are wanted, and that means published researchers in mainstream competitive theory. If they are young, and have not yet published, they must at least have pledged allegiance to that program, which establishes them as "scientists." The Nobel Prize is awarded for contributions to "economic science," and has gone almost exclusively to mathematical general equilibrium theorists and econometricians.

But it is not all public relations. The advice of economists is sought in most government departments during the policy-making process, and they hold many executive positions. But he who pays the piper calls the tune. Their advisory and executive positions are conditional on satisfactory performance as judged by their political masters. The feasible range of advice is narrow even for independent-minded economists. They will not be listened to, and will soon be dispensed with, if their advice or decisions are not politically acceptable, if they do not supply what is demanded. Who should know this better than economists?

A serious problem for economic advisors is that the real world does not correspond with their mainstream, perfect-knowledge, zero-transactions-cost theory. They are asked to evaluate the probable impacts of alternative policies in a world far removed from their models. It is not surprising that their evaluations conform to their employers' preconceptions. Economists at the United States Department of Agriculture developed sophisticated mathematical/statistical models of hog and corn cycles, which showed that since farmers look only at today's price in planning next year's harvest, and never learn, uncontrolled production would be unstable. The new large public utilities and their regulators were accommodated by economists' discovery of "natural monopoly," a static theory that is still taught in the textbooks and ignores the potential competitive discipline of new rivals attracted by "extraordinary profits."

The greatest divergence between economic theory and economic advice occurs in discussions of financial regulation. Consumer knowledge is perfect in the former and non-existent in the latter.

The language of economic advisors is like that of politicians and lobbyists—and ordinary citizens, for that matter: All favor competition, free markets, etc., except in the case at issue, which is special because it affects me. We have not found much good or bad in economic advice, so far, although if publicity (information) about government programs is as useful as it is for commercial products, we might have to allow it a slight positive value. We should be as forgiving of their hyperbole as we are of the car salesman and of their insincerity as much as others claiming a disinterested interest in our welfare. Shouldn't the following observations from *Wealth of Nations* apply to labor (including that of economists) as well as capital?

> But it is only for the sake of profit that any man employs a capital in the support of industry; and he will always, therefore, endeavour to employ it in the support of that industry of which the produce is likely to be of the greatest value, or to exchange for the greatest quantity either of money or of other goods....
>
> [H]e intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good. It is an affectation, indeed, not very common among merchants, and very few words need be employed in dissuading them from it.

Where economists have the greatest potential for damage is in their idealistic educational efforts—although the interventionist bias of economics textbooks and learned journals makes it difficult to distinguish the desire for influence from a thirst for power. Such a bias is surprising in those whose professional credentials depend on their knowledge of Smithian economics. They are never taught Marx and seldom take courses in socialism or

even the mixed economy. In fact, their policies are based on no system at all unless the multitude of ad hoc special-case departures from their frictionless models can be said to constitute a system. Each real-world situation that comes under their scrutiny reveals inefficiencies, inequities, and other imperfections not present in the theoretical standard and therefore require "some guidance." Although economists have had little influence in policy making, they have been staunch defenders of government programs. For example, most finance and money and banking textbooks treat the banking and financial market regulations introduced in the 1930s as unqualified benefits. In the first edition of *The Economics of Money and Banking,* which became the leading money and banking text, Lester Chandler wrote: "The purpose of the Securities Act of 1933 is to protect buyers against worthless, fraudulent, and misrepresented security issues."

After a general discussion of shady practices without specific examples or recognition of the potential costs, as opposed to the benefits, of regulation, he concluded: "It became evident that only federal legislation, aggressively administered, could cope with the problem." The Securities Act of 1933, "the truth-in-securities act," was similarly necessary, as were the Investment Advisers Act of 1940 (which recognized that bias among advisors required their licensing and regulation), and other securities laws. Furthermore, "Even the most zealous advocates of laissez-faire long ago conceded the right of government to lay down general rules for the chartering and operation of financial institutions....With no minimum capital requirements, no limitation on the number of institutions created, and no restriction on the scope of its operations, our financial system would probably be far different from what it actually is today." Critics of bank regulation had become more extreme than "zealots."

Perhaps the greatest divergence between economic theory and economic advice occurs in discussions of financial regulation. Consumer knowledge is perfect in the former and non-existent in the latter. Because depositors do not know the solvency or liquidity of their banks—and never take the trouble to become informed and always believe the worst (one wonders how they ever became depositors in the first place)—bad news, particularly a bank failure, causes a loss of confidence, a panic, a run, and a general financial collapse. Unless saved by the government.

These conclusions are never based on a careful examination of the causes of American bank failures. They are simply assumed to be the consequences of contagious "runs." In fact, there is no evidence that such an irrational run — that is, a projection of the problems of a failed insolvent bank onto solvent banks — has ever occurred in the United States. Bank failures have overwhelmingly resulted from borrower failures. Most have been small farmers' banks in times of depressed agricultural prices. As a matter of fact, these failures were largely the result of regulation because of the undiversified portfolios forced by laws against branching.

The same story may be told of the separation of investment and commercial banking required by the Glass-Steagall Act of 1933 after the public hysteria over the alleged securities abuses by commercial banks that supposedly caused their failure. In fact, there is no evidence that the failure of any bank during the Great Depression was attributable to its underwriting activities, or that bank stockholders or their customers suffered in any way from those activities. On the contrary, they benefited from their securities departments.

Knowledge and behavior in the real world are somewhere between economists' models and advice, and are probably closer to the first. People are not perfectly informed, but they know a lot and take the trouble to learn about their risks and opportunities. But these theoretical distinctions are irrelevant to public policy because regulations are explained by the give-and-take of economic interests. Securities firms used the New Deal to rid themselves of competition from banks, which were compensated by government-enforced ceilings on deposit costs. Small-town banks retained their local monopolies and received subsidized insurance to offset the risks of unit banking. Some of these restrictions were later thrown off by the public—most notably deposit-rate ceilings—when their costs to depositors began to exceed their benefits to bankers (who had been forced into costly but weak non-price means of competing for deposits).

Professor Chandler was just trying to sell a book by appealing to the tastes of his readers, and probably had no direct effect on legislation. His book's harm, if any, was its reinforcement of the general complacency about the superiority of regulation over free exchange. Harold Demsetz's discussion of this tendency in another area supplies an instructive conclusion.

> The view that now pervades much public policy economics presents the relevant choice between an ideal norm and an existing "imperfect" institutional arrangement. This nirvana approach differs considerably from a comparative institution approach in which the relevant choice is between alternative real institutional arrangements. In practice, those who adopt the nirvana viewpoint seek to discover discrepancies between the ideal and the real and if discrepancies are found, they deduce that the real is inefficient.

Economic Bulletin (ISSN 0424-2769) (USPS 167-360) is published once a month at Great Barrington, Massachusetts, by American Institute for Economic Research, a scientific and educational organization with no stockholders, chartered under Chapter 180 of the General Laws of Massachusetts. Periodical postage paid at Great Barrington, Massachusetts and additional offices. Printed in the United States of America. Sustaining memberships: $59 per year. POSTMASTER: Send address changes to ***Economic Bulletin***, American Institute for Economic Research, Great Barrington, Massachusetts 01230.