The Empress's New Clothes: The Identity Crisis of Economics

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Economics is in crisis. After decades of dogmatic teaching and analysis, focusing on narrow mainstream models and excluding alternative thinking from its ivory towers, the purported queen of the social sciences is naked. Most economists have failed to foresee the financial crisis, while some helped bring it about. The paper follows the emergence and evolution of the discipline over time, from its political and moral roots towards a discipline modeled on physics. It examines some recent swings of the pendulum back towards political economy, and considers the way forward.

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Economics is in crisis. After decades of dogmatic teaching and analysis, focusing on narrow mainstream models and excluding alternative thinking from its ivory towers, the purported queen of the social sciences is naked. Most economists have failed to foresee the financial crisis (as admitted for example in a letter from the British Academy to Queen Elizabeth II), since they were busy studying narrow technical questions and "frequently lost sight of the bigger picture"[1]. Some economists were actually involved in causing the meltdown. Robert Merton and Myron Scholes, the 1997 Nobel Prize winners in economics, were on the board of directors of Long-Term Capital Management which operated based on their asset-pricing model. After LTCM's collapse in 2000, they created Platinum Grove Asset Management, which also failed in 2008. Perhaps the best expression of the disconnect between the economics profession and the real-world was given by Randall Bartlett, who – while investigating the curious lack of any serious discussion of the concept of power in economics – wrote: "Economists are an inbred race and seem to recognize things only when they come from within the tribe, expressed in the local dialect, paying homage to the special deities"[2].

Why is this a concern for economists and, more importantly, for the public at large? John Maynard Keynes put it succinctly during the height of the Great Depression:

> The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back[3].

A recent manifestation of the destructive power of misguided economic theories is the recent turn to austerity in the United States and in Europe. In spite of persistent high unemployment and weak growth, politicians in both areas are focused more on reducing deficits than on boosting employment and growth. As Paul Krugman wrote in his New York Times column, "when people in D.C. talk about deficits and debt, by and large they have no idea what they're talking about — and the people who talk the most understand the least"[4]. Krugman criticizes 'debt-worriers' (in the U.S. and Europe alike) for confusing the national economy with a case of a family that has borrowed too much. Unlike families, however, governments do not have to pay their debts; rather they need only ensure that the tax base (which depends on the economy) grows faster than the debt. Additionally, much of a country's debt is to itself (notwithstanding foreign deficits), whereas households or families owe money to others. More than 250 years earlier, Jean Jacques Rousseau had already emphasized the falsehood of the analogy between a nation and a family: "Even if there were as close an analogy as many authors maintain between the State and the family, it would not follow that the rules of conduct proper for one of these societies would be also proper for the other. They differ too much in extent to be regulated in the same manner"[5].

[1] British Academy, *Letter to her Majesty the Queen* (London, 22 July 2009). URL: http://media.ft.com/cms/3e3b6ca8-7a08-11de-b86f-00144feabdc0.pdf

[2] Randall Bartlett, *Economics and Power* (Cambridge University Press, 1989), 18.

[3] John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (Harcourt, 1991).

[4] Paul Krugman, *Nobody Understands Debt*, New York Times, January 1, 2012.

[5] Jean Jacques Rousseau, *A Discourse on Political Economy* (London: Dent and Sons, 1920), 249.

In order to understand what is happening to economics today, we need to look back into history and see how the discipline has emerged and changed over time. In his classic books about the history of economics, which he referred to as 'The Worldly Philosophy', Robert Heilbroner traced the evolution of the discipline throughout the ages. Among other early sources, Heilbroner mentioned the important distinction made by Aristotle between œconomia and chrematistiké. The former has to do with "'housekeeping' or the maintenance of a well-run state" while the latter involves "the sheer making of money for its own sake"[6]. Unlike modern economists, Aristotle (as well as the Bible, Thomas Aquinas and others) did not (pretend to) avoid moral judgments or values. He clearly considered œconomia to be natural, "necessary and honorable", while deploring chrematistics as unnatural and morally objectionable[7].

Economics became much more focused on production and then exchange with the advent of the Commercial and Industrial revolutions. The Physiocrats, followed by the classical political economists, examined the respective roles and rewards of land, labor and capital, all the while keeping in clear sight the position and political insertion of each class. Even Adam Smith, erroneously worshipped today as the patron saint of *laissez-faire*, was concerned with the moral and social aspects of economics, as is clear from his book *The Theory of Moral Sentiments* which preceded *The Wealth of Nations* by 17 years.

The current conundrum is not the first time that economics and economists were held in low esteem. William Stanley Jevons, one of the fathers of neoclassical economics, lamented the status of the profession in 1870:

> There is no one who occupies a less enviable position than the Political Economist. Cultivating the frontier regions between certain knowledge and conjecture, his efforts and advice are scorned and rejected on all hands. If he arrives at a sure law of human nature, and points out the evils which arise from its neglect, he is fallen upon by the large classes of people who think their own common-sense sufficient; he is charged with being too abstract in his speculations; with overlooking the windings of the human heart; with undervaluing the affections. However humane his motives, he is lucky if he escape being set down on all sides as a heartless misanthrope[8].

Jevons, together with Leon Walras and Carl Menger, helped bring about Marginalist Revolution which steered economics away from its political and moral roots towards a discipline modeled on physics. Ironically, today one may complain that economics suffers from exactly the same problems – being too abstract, ignoring human morality and psychology, and being heartless.

What we know as Economics today was called Political Economy for most of history. In his book *The Invisible Handcuffs of Capitalism* (in a chapter titled "How Economics Marginalized Workers"), Michael Perelman traces the first usage of the term 'economics' to a book title by Julian M. Sturtevant[9], as well as to Henry Dunning Macleod, who in 1887 defined economics as "a science which treats of the laws which govern relations of exchangeable quantities"[10]. This usage was adopted by Marshall, who – while naming his famous book *Principles of Economics* – still used it interchangeably with Political Economy: "Political Economy or Economics is a study of mankind in the ordinary business of life; it examines that part of individual and social action which is most closely connected with the attainment and with the use of the material requisites of well-being"[11].

Beyond a change of name, the discipline had been transformed from one rooted in ethics, politics and philosophy, to an abstract and highly formalized pseudo-science that is often at odds with (or at a considerable distance from) the real world. Even Charles Babbage, himself a mathematician who invented the world's first mechanical computer, complained about this problem in economics:

[6] Robert Heilbroner, *Teachings from the Worldly Philosophy* (New York, Norton and Company, 1997), 7.

[7] Ibid, 8.

[8] William Stanley Jevons, "Opening Address as President of Section F (Economic Science and Statistic) of the British Association for the Advancement of Science", *Methods of Social Reform and Other Papers* (London: Macmillan and Co., 1883), 195.

[9] Michael Perelman, *The Invisible Handcuffs of Capitalism: How Market Tyranny Stifles the Economy by Stunting Workers* (Monthly Press Review, 2011), 75.

[10] Henry Dunning Macleod, *On the Modern Science of Economics* (London: John Heywood, 1887), 111.

[11] Alfred Marshall, *Principles of Economics: An Introductory Volume*, 8th edition (London: Macmillan & Co., 1920),

> Political economists have been reproached with too small a use of facts, and too large an employment of theory. If the facts are wanting, let it be remembered that the closet-philosopher is unfortunately too little acquainted with the admirable arrangements of the factory…[n]or let it be feared that erroneous deductions may be made from such recorded facts; the errors which arise from the absence of facts are far more numerous and more durable than those which result from unsound reasoning respecting true data[12].

The pendulum swung partially back with John Maynard Keynes. As Joan Robinson noted in her book *Economic Philosophy*:

> Keynes brought back the moral problem that laissez-faire theory had abolished. It is true that in Cambridge we had never been taught that economics should be wertfrei or that the positive and the normative can be sharply divided. We knew that the search was for fruit as well as light. But the anodyne of laissez-faire had worked pretty thoroughly even in Cambridge…[However,]…by making it impossible to believe any longer in automatic reconciliation of conflicting interests into a harmonious whole, the General Theory brought out into the open the problem of choice and judgment that the neo-classicals had managed to smother. The ideology to end ideologies broke down. Economics once more became Political Economy[13].

Another recent swing of the pendulum away from abstraction and towards real-world analysis can be seen in behavioral economics. One of its main proponents (despite his training at the University of Chicago, traditionally the stronghold of neoclassical theory), Richard Thaler, explained the difference between mainstream and behavioral economics thus: "Traditional economics is based on imaginary creatures sometimes referred to as 'Homo economicus'…Real people have trouble balancing their checkbooks, much less calculating how much they need to save for retirement; they sometimes binge on food, drink or high-definition televisions… Behavioral economics is the study of Humans in markets"[14].

Economics is clearly at a crossroads. After surveying the history of economic thought in his classic book *The Worldly Philosophers*, Robert Heilbroner closes with a chapter titled "The End of the Worldly Philosophy?" As Heilbroner makes clear, the word 'end' means both termination and purpose. In attempting to define the purpose of economics, Heilbroner says: "[a]t its core, economics is an explanation system whose purpose is to enlighten us as to the workings, and therefore to the problems and prospects, of that complex social entity we call the economy"[15].

Resuscitating economics out of its current coma would entail keeping this historical background in mind. The discipline needs to be repositioned solidly within the social sciences, as an equal – or, at most, *primus inter pares* - rather than an empress. There needs to be a wide understanding that *any* economy is embedded in society, and that *every* economy is political. Rather than seeking to discover immutable laws (as in physics and the other natural sciences), we need to constantly remind ourselves that the term *homo economicus* – normally used to conjure the notion of rationality - also implies the centrality of *humans* in the economy. We must liberate economics from the economists and return it to the citizens of the world.

[12] Charles Babbage, *On the Economy of Machinery and Manufactures* (1835; New York: Augustus M. Kelly, 1971), 156.

[13] Joan Robinson, *Economic Philosophy* (Chicago: Aldine Publishing Co., 1962), 74-76.

[14] Richard Thaler, "Mortgages Made Simpler", *New York Times*, July 5, 2009.

[15] Robert Heilbroner, *The Worldly Philosophers* (New York: Simon and Schuster, 1999), 311.