

Economics – Purposes and Directions Post-Crisis

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What does it mean to be an economist? What is economics about? What do economists agree on? It is interesting that a discipline which appears to be powerful and important should need to ask such questions. Yet it clearly does. Most professions have Charters and organisations which set standards. They require continuing professional development. Economics does not. At the conference which is the basis of this book, no member of the audience of economists was prepared to agree that even 50% of the contents of the basic textbook were true!

Perhaps this is the reason that economists (I am not going to use the term profession any more) have found it difficult to respond effectively to the challenge of the financial crisis. When the Queen, opening a new building for the London School of Economics, asked her famous question about why economists didn't see this coming, one answer, from LSE economists, suggested it was because there were always external shocks and that models would not capture these. Another answer, from a more eclectic group of which I was part, suggested that economists had neglected the lessons of history, and overplayed the possibility of prediction. A subsequent seminar at the LSE with speakers from both groups was able to agree that economic history, and the history of economic thought were under taught and undervalued.

Both of these subjects would definitely bring a different tone and much less certainty to the subject than it presently has. Humility about how far economists actually affect the economy might well result, and a wider range of interests be attracted to the subject.

But to be able to agree that history matters does not answer the question of what economics is about. In this note I want to address the purpose of economics, the purpose of economists, and the relationship of economics with other disciplines.

These reflections are based on my own experience both in academic life and in policy making. Both in macroeconomics and in competition and planning policy areas there is quite a gap between economic theory, practice and reality. These gaps continue to drive my interest in doing economics differently. From being a member of Chancellor Clarke's '7 Wise Men', to giving evidence as an expert witness, to working as the Chief Economist to the Mayor and the Greater London Assembly for eight years, to making the case for infrastructure projects, it has always been important for me to think about how economics works in practice.

The purpose of economics

Economics has been described as the study of resource allocation – the relationship between ends and scarce means¹. Much of standard microeconomics deals with these issues and the

¹ Robbins, *An Essay on the Nature and Significance of Economic Science*, London, Macmillan, 1932

identification of optimal conditions for optimal allocation. Much progress has been made in considering how to create such conditions when taking into account human failings such as limited information, inadequately defined rules of the game and so on.

These approaches have become highly influential in technical research and in government. Unfortunately, much of this does not connect with the purposes that non-economists think economics is for. In business, economics is for dealing with regulators – few businesses employ economists directly to understand their markets or to analyse their decisions. If economists are employed, it is to look at external events and to prepare forecasts. It is the macro economy which the outside world thinks economics is about. And here there is still only limited progress beyond time series curve fitting.

If economics is about understanding how economies evolve, there is indeed little to agree on. Our understanding of growth and innovation are limited². How institutions affect growth and performance is contested, indeed there is little on economic dynamics and processes of adjustment. Hypotheses, theories and empirical testing all need a lot more work. So if economics has made progress in micro matters, this is not the main function that outsiders want us to address.

Moreover, even in microeconomics the areas of activity that our models cover is far from complete. Economic analysis deals best with markets where it is reasonable to assume that agents are independent and similarly informed, and where products are readily available and with fixed qualities. As the world has become more connected and products more variable, these assumptions become less and less relevant. Network and fashion effects can produce very different results from a standard market analysis, with heuristics, rules of thumb and winner take all outcomes³. The description of the rational agent in a world with choice overload might be very different from the description of such an agent in a world with limited choice and ability to collect all relevant information⁴. To be complete, economics needs to deal with all possibilities.

Years ago, I conducted a study whose aim was to measure marginal and average cost curves to assess whether a product was being dumped⁵. The managers of the factories I visited found these concepts to be bizarre. All the relationships were full of discontinuities and managerial trade-offs. It could not even be ‘as if’. The main difference between plants was between the quality of their management and the shop floor relationships. Forcing costs into the pre-defined models was like forcing my feet into high heels – painful and likely to result in an accident.

I conclude therefore that different people are likely to believe different things about the purpose of economics, and even in the context of a narrow definition which focuses on the allocation of

² See for example, Antonelli, C. (2003). *The Economics of Innovation, New Technologies, and Structural Change*. Routledge

³ Two classic references are Schelling, J.C. (1973), ‘Hockey helmets, concealed weapons, and daylight saving: a study of binary choices with externalities’, *Journal of Conflict Resolution*, 17, 381-428 and Watts, D.J. (2002), ‘A simple model of global cascades on random networks’, *Proceedings of the National Academy USA* 99, 5766-71

⁴ For example, R.A. Bentley, M. O’Brien, and P. Ormerod (2011a), ‘Quality versus mere popularity: a conceptual map for understanding human behaviour’, *Mind and Society*, 10, 181-191

⁵ It was for NEDO and looked at TV production

resources, we still have only scratched the surface. In terms of a wider definition which covers the evolution of the economy, growth, dynamics and innovation, we are still further away.

The purpose of economists

What are economists for? A cynic might think their purpose is to think up rules. Indeed many economists in public policy circles certainly do this, in competition cases, in regulated industries. They work on the basis that they must try to make the industry in question as much like a perfect market as possible. Many appear not to have heard of the fundamental theorem of second best established over 50 years ago by Lipsey and Lancaster⁶ – making one industry ‘perfect’ might make the system less so.

Still there is plenty of employment in categorising the industry, defining its degree of competition and modelling what it might look like. And plenty of scope for disagreement, which adds to the employment. The concepts in use are those which define the equilibrium output of an industry when there is profit maximisation. Of course, this leaves out the possibility that equilibrium might not be useful in a changing industry, and that maximisation is pretty impossible too.

It could be that we need people to ‘think like an economist’. I define this as considering incentives, balancing costs and benefits, asking about market failures. This is certainly how the distinction feels in public policy. Perhaps it should also be about wanting to look at the data. Economic data did not exist before there were economists. Adam Smith relied on case studies and descriptions. No Standard Industrial Classification, no price indices, no output statistics. Much of the work of economic historians is trying to patch together the data that they need to do economics as it is done today.

However, it is quite surprising how little economists know about the data they use and how much they take for granted. I have heard economists complain that market data – for example of the number of telephone calls made – is too soft compared to data on employment levels. Yet different data sources on employment in London differ by as much as 200,000 people. Economic data gets revised, is estimated on sample bases, and tries to measure the hard to measure. Market data is clear, never revised, and measures what it says on the tin. The problem is to understand it. Economists think they understand economic data because they have been taught a concept. Whether the statistic measures it is a whole other story, and one that needs a lot more attention. Thinking like an economist should include knowing the nuts and bolts of the numbers.

The purpose of an economist might be to understand how the economy works. I have to say after forty years of trying, I still find huge puzzles here. What is the most effective balance between tradeables and non-tradeables? How do we define a ‘local’ economy? When does turning non-marketed activity into marketed activity undermine civil society? What is the right way to compensate those affected by the destruction part of creative destruction? How is risk managed and what can economists say about this?

⁶ R.G. Lipsey & Kelvin Lancaster (1956-1957). "The General Theory of Second Best". *The Review of Economic Studies*, 24(1), pp. 11–32

There are 1500 economists in government service. The habits of thought that an economist learns can indeed be very useful – looking at costs as well as benefits is an obvious one. The skills of number crunching, of the use of logic and rationality can be useful. But some ways of economist thinking can be less helpful. Believing that the economist's world view is perfect, that maximising rational behaviour is possible, that the data are correct are all weaknesses that need to be overcome.

Can economics learn from other disciplines?

Economists are often accused of having physics envy, of wanting to be too scientific, too maths oriented. Indeed, the standard neo-classical model can be aligned to the standard Newtonian physical model, where there are no uncertainties and the laws have predictable consequences.

However, the scientific method by which hypotheses are tested against data, must be replicated, and retested before being accepted, is a good starting point for any form of enquiry. Of course we know that experiment is hard in social science. So is it in medicine, but the double blind trial has still been invented and tested in medicine to ensure that treatments do work.

A rigorous approach to the testing of hypotheses and an open mind are good pre-cursors to creating an established discipline. Anthropology is an example of a discipline which at the outset was troubled by evidence collection which appeared to find what it was looking for, and which had a fair share of scandals. Over time, professionalization and evidence standardisation has made significant improvements in the reliability of its results. Psychology too has gathered a body of confirmed evidence and supported hypotheses which have resulted in the discipline making inroads into economics.

Economics has seen itself as the most scientific of the social sciences. Nonetheless some of its key hypotheses about agent behaviour have been undermined by experiment about actual decision making. It is time to take a good look at how to extend the coverage of the subject into the nature of rationality, how agents are connected and influence each other, the processes of economic growth and evolution.

Of course there are circumstances in which the standard model of independent market participants, able on average to build a good model of the market, in a rational way, will be a sensible approach. But there are many circumstances when these conditions will not hold. It was noteworthy that innovation, growth, and disruption got little coverage at the conference. What is the model for considering large scale investment which will change connectivity between markets for example? What about technical innovation which disrupts markets? These are the sorts of changes which have been a distinguishing feature of capitalism and which have made possible the standard of living, health and longevity we now enjoy. We didn't discuss these and we must.

Businesses are all about processes and how to make better decisions or indeed any decisions. They are likely to have consequences in the real world, which in turn have consequences for other businesses. An understanding of this and how behaviours and motivation might matter for outcomes is an important area which will not be captured by equilibrium analysis.

Also, if most ordinary people think economics is about forecasting, then analysis of the limits of predictability is also crucial, as well as putting this over to the wider public.

Students need to be taught about the history and limitations of the subject and the exciting challenges that await them in a discipline which has good problems to get its teeth into.

Economics continues to have good problems, and it has some good skills. But it still lacks a set of good theories and quite often lacks good data as well.