The Profit Doctrine

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Economists of the Neoliberal Era

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1
Prophets and Profits

> As an economist, I often find myself defending "bad guys"—companies outsourcing American jobs, gas stations gouging consumers with high prices, Wal-Mart undercutting small retailers with low prices, Mexican immigrants sneaking into our country, the Chinese fixing their exchange rate, American companies opening sweat shops abroad, foreign companies dumping cheap goods onto our markets, and pharmaceutical companies profiting off other people's sickness and misfortune. Sometimes I feel like a defense attorney for economic criminals.
>
> Unlike real defense attorneys, however, I get clients that are mostly innocent. The study of economics provides a cogent defense for these alleged evil doers.
>
> Greg Mankiw (2006)

> Despite the enormity of recent events, the principles of economics are largely unchanged. Students still need to learn about the gains from trade, supply and demand, the efficiency properties of market outcomes, and so on. These topics will remain the bread-and-butter of introductory courses.
>
> Greg Mankiw (2009)

From 2003 to 2005, Gregory Mankiw was the chairman of the Council of Economic Advisers for President George W. Bush. In 2006, he became an economic adviser to Mitt Romney, a role he maintained during Romney's 2012 presidential bid. He is a professor of economics at Harvard and was paid a $1.4m advance to write his best-selling textbook *Principles of Economics*. Economic giant Paul Samuelson once claimed, "Let those who will, write the nation's laws if I can write its textbooks" (quoted in Chandra, 2009). Despite student protests at the narrowness of Mankiw's teaching—in 2011, students walked out of his principles course in protest over his "limited view of economics"

(Concerned Students of Economics 10, 2011)—it is this version of the discipline that has been largely taught in classrooms around the United States. As we will demonstrate throughout this book, Mankiw's unshakeable belief in the efficiency of the market system reflected the dominant trend in the field of economics after the late 1970s.[1]

A standard list of economic goals and priorities would include stable growth, price stability, full employment, and the efficient allocation of resources. Some might even add to this list an environmentally sustainable economy and a reasonably equitable distribution of wealth and income. But the evidence suggests that the post-1970s period in the United States can be characterized as one of instability and inequality relative to the "Golden Age" that preceded it. After the 2008 collapse, critics inside and outside economics accused those dominating the profession for the last three decades of behaving like an "ostrich with its head in the sand," suffering from "groupthink," and promoting "Zombie" economics. While there is some truth to each of these claims, we believe they all miss the central charge.

We will argue that the economists of this era who rose to prominence (like Mankiw) did so not because of their contributions to the standard list of economic goals, but primarily because of their contribution to corporate profits and the wealth of the business class. An efficient, healthy economy shared by all was never a likely outcome of the policies advocated by those who had the power to assert their own interests. And those possessing that power got their way with the help of the economics profession. This period in American history, including the post-2008 years, has been an unqualified success for the American business class. While economics is ostensibly guided by commitments to scientific rigor and objectivity, this boon to business was the predictable result of the specific policy recommendations of those that came to dominate the profession.

How Do "Bad" Economic Ideas Develop?

> The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than

1 The term "economics" in this book means the academic and professional fields of economics, not trends in the actual economy.

> is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite 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. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas … soon or late, it is ideas, not vested interests, which are dangerous for good or evil.
>
> John Maynard Keynes (1936, p. 383)

Keynes's eloquent account of the importance of economic ideas has been widely used by economists across the ideological spectrum to explain the influence that the profession wields. He suggests that it is the "gradual encroachment of ideas" that influences policy. Keynes also seems to be suggesting that "wrong" or even "evil" ideas of an "academic scribbler" can come to dominate the profession and influence "madmen in authority." Indeed, after the economics profession appeared to fail so miserably during the economic crisis that started in 2008, critics from inside and outside the discipline queued up to point out how wrong (or even evil) economics had become.

If outsiders think the economics profession is a homogeneous discipline where consensus is easily achieved and genuine debate an infrequent visitor, there has been strong criticism of the profession from within, especially since the 2008 economic meltdown. Jeffrey Sachs has been a professor at Columbia and Harvard. He is a special adviser to the UN on its Millennium Development Goals. He has been very critical of recent trends in economics: "What I know about our training, since the early 1980s, the way we train people to think has left them, in mainstream economics and, I would say in mainstream politics, has left them almost unable anymore to distinguish the surface from the underlying reality" (Sachs, 2008). People who would view themselves as slightly further on the fringes of mainstream economics have been even more critical (for a more complete look at economists' opinions on their colleagues' work, see Box 1.1). An important theme of this book is that these internal criticisms were seldom heard, and even more rarely paid attention to, between the late 1970s and the 2008 crisis. Further, there were important limitations to the criticisms

of those economists, like Paul Krugman and Joseph Stiglitz, who did manage to make their objections heard.

Academic observers from outside the field of economics have been even more scathing. Akeel Bilgrami, a philosophy professor at Columbia University claimed that

> … economics is perhaps about the worst offender among disciplines in inuring itself in alternative frameworks of thought and analysis. In fact, I would venture to say that I have never come across a discipline which combines as much extraordinary sophistication and high-powered intelligence with as much drivel. (Bilgrami, 2008)

In the wake of the 2008 economic collapse, even the popular media vilified the profession. Headlines in the *New York Times* argued that

Box 1.1 Economists on economics

The 2008 crisis has resulted in some serious soul-searching within economics. Much of the self-criticism revolved around the very narrow nature of what it means to study economics after 1980.

Perry Mehrling, a professor of economics at New York's Columbia University says his graduate students are growing increasingly frustrated by the tendency to "define the discipline by its tools instead of its subject matter … they find little relationship between the mathematical models in class and the world outside the door" (quoted in Basen, 2011).

Robert J. Shiller, an economist at Yale, claimed that the reason the profession failed to foresee the financial collapse was "groupthink": "Wander too far and you find yourself on the fringe. The pattern is self-replicating. Graduate students who stray too far from the dominant theory and methods seriously reduce their chances of getting an academic job" (quoted in Cohen, 2009).

Willem Buiter, a London School of Economics professor and a former member of the Bank of England monetary policy committee was especially scathing: "The typical graduate macroeconomics and monetary economics training received at Anglo-American universities during the past 30 years or so may have set back by decades serious investigations of aggregate economic behavior and economic policy-relevant understanding. It was a privately and socially costly waste of time and other resources. Most mainstream macroeconomic theoretical innovations since the 1970s … have turned out to be self-referential, inward-looking distractions at best. Research tended to be motivated

academic economists were not sufficiently repentant for their role in creating the economic crash, with headlines like "Ivory Tower Unswayed by Crashing Economy," and "How Did Economists Get It So Wrong?" Other publications were in a more punitive mood. The *Financial Times* wanted to "Sweep Economists Off Their Throne," and *The Atlantic* opted for the corporal "Will Economists Escape a Whipping?" Canada's national newspaper, the *Globe and Mail* weighed in with "Economics Has Met the Enemy, and it is Economics." The fact that it is almost impossible to imagine another area of academics being the subject of such irate headlines underscores both the level of genuine anger at the failings of the profession, but also the fact that Keynes was right in claiming that it had so much influence.

The focus of all these critics is that those dominating the profession won the war of ideas to the detriment of society. How could ideas and

by the internal logic, intellectual sunk capital and aesthetic puzzles of established research programs, rather than by a powerful desire to understand how the economy works—let alone how the economy works during times of stress and financial instability. So the economics profession was caught unprepared when the crisis struck" (Buiter, 2009).

James K. Galbraith, an economist at the Lyndon B. Johnson School of Public Affairs at the University of Texas, and long-time critic of orthodox, mainstream economics, was not optimistic about these criticisms leading to any real change in the discipline: "I don't detect any change at all." Academic economists are "like an ostrich with its head in the sand." "It's business as usual," he said "I'm not conscious that there is a fundamental re-examination going on in journals" (quoted in Cohen, 2009).

The most systematic and, perhaps, damning indictment of the state of modern economics can be found in Australian economist James Quiggan's book, *Zombie Economics* (2010). Like Galbraith, he is pessimistic that the flaws in economics that were revealed by the 2008 crisis will lead to any real change in the discipline: "Economists who based their analysis on these ideas contributed to the mistakes that caused the crisis, failed to predict it or even recognize it when it was happening, and had nothing useful to offer as a policy response.

Three years later, however, the … reanimation process has taken place in the realm of ideas. Theories, factual claims, and policy proposals that seemed dead and buried in the wake of the crisis are now clawing their way through the soft earth, ready to wreak havoc once again" (Quiggan, 2010a).

policies that proved to be such an abject failure come to dominate the economic landscape? Surely, some "academic scribbler" influencing "Madmen in authority" is not an acceptable explanation of the evolution of ideas or policy. Keynes mystified the origin of these ideas and, more importantly, trivialized the means by which they rise to the top. His implication that there is an evolutionary and progressive character to the development of ideas obscures the existing power structure in society. Marx's reflection on an earlier era is a better place to begin if one is looking for a conceptual framework to understand how ideas take hold in society. Marx argued that once the economic system of capitalism became dominant in the nineteenth century, economic debate was

> … no longer a question, [of] whether this theorem or that was true, but whether it was useful to capital or harmful, expedient or inexpedient, politically dangerous or not. In place of disinterested inquirers, there were hired prize fighters; in place of genuine scientific research, the bad conscience and the evil intent of apologetic. (Marx, 1873, p. 25)

This is not to suggest that Marx's "prize fighters" of intellectual ideas are being dishonest with themselves or the public. Rather, their ideas, in which they no doubt genuinely believe, are promoted, popularized and enacted into policy by those who stand to benefit from them.

Unlike Keynes, who insists that the contest for intellectual dominance is a contest of ideas, Marx argues that it is a contest of power. Economic ideas, and the policies that arise from them, have profoundly different impacts on different groups in society. It is, therefore, in any group's interest to promote those ideas from which it will benefit, while discrediting those that are harmful. The question then becomes, what is the capacity for different groups to promote certain ideas and dismiss others? This depends, most obviously, on the financial, political and institutional resources that they can bring to bear but also on their coherence as a group and their ability to act in concert.

As Marx also suggests, ideas are not formed, disseminated and popularized in a context-free intellectual vacuum. Instead, the ideas that come forward, the extent to which they are believed, and whether

they will be adopted as policy are influenced by the social and economic contexts in which they emerge. This could be seen in the fallout from the 2008 crisis. After the economic collapse, there was much more opportunity for critics of the prevailing economic wisdom than was the case prior to the crisis. The ideas of the critics had not changed. Economists like Shiller and Galbraith had been railing against some of the more conservative of the dominant economic ideas, and the policies that stemmed from them, for years without being given a great deal of credence until the crisis. Yet, the lack of real change within economics departments, or in public policy, also demonstrates that it is not only economic conditions that influence ideas. As Quiggan suggested, economic policy that was thoroughly discredited in the eyes of many by the economic crisis still appears to rule the day. This demonstrates that it is not simply economic conditions, broadly speaking, that influence economic ideas, but the way in which those economic conditions affect the material interests of those groups in society that have the capacity to influence the intellectual climate.

The economics profession has a lot to answer for. After the late 1970s, the ideas of influential economists have justified policies that have made the world more prone to economic crisis, remarkably less equal, more polluted and less safe than it might be. We seek to explain why a particular type of economist became so influential, especially from the late 1970s, and demonstrate the damage that their policies have wrought.

Since the 1970s, a dominant group of famous economists have swayed the direction of the discipline, and the policy that it influences, with easily identified distributional consequences. Starting with Milton Friedman, we trace the intellectual history of a common core of economic assumptions and beliefs about using the autonomous individual as the centerpiece for economic analysis, a commitment to formalized modeling, faith in market forces and the failure to recognize power relationships in society. We trace the rise of this dominant trend in the discipline by examining the works of its most famous adherents to demonstrate the limits of the mainstream economists' models and show how implementation of these ideas created the economic context for many of the economic difficulties that we face today. While these economists have helped create an economic policy environment that has proved catastrophic for many, it has also proved remarkably

beneficial for the privileged minority, which partly explains why their ideas were greeted with such enthusiasm.

The Book in Brief

Chapter 2 examines how certain ideas came to dominate the discipline itself and the broader policy debate in society. Why do some ideas become accepted, institutionalized and popularized while others are ignored? We argue that economic knowledge is not a Darwinian process where superior ideas overcome their inferior predecessors. Rather, the ideas that dominated the discipline were shaped by a correlated combination of commitments to idealized techniques, methodological individualism and the market. Further, the adoption of certain economic ideas over others has been more a result of the imperatives of the economic environment of the time, and the institutional clout mustered by those who benefit from economic policy, than a battle of academic ideas taking place in a context-free vacuum of abstract intellectual debate. As a result, for over three decades, income, status and Nobel prizes have been the reward for those who created and justified economic policy that has had debilitating effects on the majority of citizens while benefitting a privileged minority.

Chapter 3 provides a concise review of the current economic state of affairs in the United States. This chapter lays out the economic trends that are the result of enacting the economic ideas documented in the rest of the book. The last 35 years have featured stagnating incomes for most Americans alongside large income gains for the rich, creating growing inequality. For the privilege of modest income gains, US families are working longer hours and are subject to worrying environmental conditions. Finally, what limited successes there were in the post-1980 economy were based on the inevitably shaky foundation of household debt, which came crashing down in the 2008 crisis.

Chapter 4 starts our individual case studies with Milton Friedman (Nobel Prize 1976), the godfather of the so-called "conservative counter-revolution" in economics. His writing followed two streams. One was the academic work, sometimes with Edmund Phelps (Nobel Prize 2006). His natural-rate-of-unemployment hypothesis, monetary theory, and views on fiscal policy all contained the message that government should not interfere with the macroeconomy.

The second was his more popular work railing against government regulation and defending the free market. We argue that once you translate the algebra and jargon, Friedman's ideas served the interests of American business at the expense of the rest of society. As with the other economists in this book, we will examine the distributional consequences of Friedman's ideas.

Chapter 5 discusses the works of Gary Becker, James Buchanan, Sam Peltzman, George Stigler and Gordon Tullock, five economists who provided a novel intellectual justification for Friedman's fear of government intervention in the economy. George Stigler (Nobel Prize 1982) is best known for developing the Economic Theory of Regulation, also known as "capture," in which interest groups and other political participants will use the regulatory and coercive powers of government to shape laws and regulations in a way that is beneficial to them, rather than for whom those laws were designed to help.

Becker won the Nobel Prize (1992) for "having extended the domain of microeconomic analysis to a wide range of human behavior and interaction, including nonmarket behavior." Former Treasury Secretary and current Harvard University President Lawrence Summers, claimed it "was the most overdue prize they've ever given." Becker is most famous for applying the assumptions of the rational, maximizing individual to problems that were, prior to Becker, considered outside the realm of economics, like crime, the family, and discrimination. Relevant here is his analysis of interest groups lobbying for government favors.

James Buchanan (Nobel Prize 1986) and Gordon Tullock expanded on this in what became known as "Public Choice" interest group theory, which argues that government intervention leads to waste in the economy. Public choice created the intellectual justification for the elimination of regulations by arguing that the government solution will inevitably be worse than the market failure it was designed to solve. By ignoring corporate economic and political power, public choice introduces a misleading bias into the analysis of how public policies are determined and the appropriate solution to capture.

Robert Lucas (Nobel Prize 1995), Neil Wallace, Thomas Sargent (Nobel Prize 2011), Finn Kydland (Nobel Prize 2004) and Edward Prescott (Nobel Prize 2004) are the subject of Chapter 6. Taken together, these economists advanced a macroeconomic theory that, at

its heart, contained two ideas that became very influential in economic policy. The first is that Keynesian fiscal policy was ineffective given the inherent efficiency of markets. The second is that the economy performs best when it is most "flexible." Essentially, this means that the price mechanism is able to fluctuate as freely as possible, which is accomplished in practice by eliminating labor market impediments to downward wage movements, such as minimum wages, favorable union rules, and unemployment benefits. These theories cannot explain the prolonged periods of economic downturn. Critics have ridiculed the interpretation of the Great Depression offered by these economists. Franco Modigliani mocked these economic ideas for implying that, "What happened to the United States in the 1930s was a severe attack of contagious laziness!" (Modigliani, 1977, p. 6). Paul Krugman contemptuously described their explanation of the Depression as the "Great Vacation" (Krugman, 2009e).

Chapter 7 looks at the connection between economics and financial crises. According to the World Bank, there have been 117 systemic banking crises worldwide since the late 1970s (Caprio, 2003). These recurrent crises occurred during a period in which the financial sector became a much larger component of economic activity and there was a decline in regulatory oversight. The ideas of three economists contributed substantially to these trends. Robert C. Merton and Myron S. Scholes (Nobel Prize 1997), or the "Newton of modern finance," developed the formula for opening up the options and derivatives markets. Eugene Fama (Nobel Prize 2013) is famous for the Efficient Market Hypothesis (EMH), which stated that assets are accurately priced and financial bubbles practically, if not entirely, impossible. According to James Crotty, the ideas of these authors led to the light regulatory approach of what he termed the New Financial Architecture (NFA), but they are "based on patently unrealistic assumptions and … no convincing empirical support. Thus, the 'scientific' foundation of the NFA is shockingly weak and its celebratory narrative is a fairy tale" (Crotty, 2009, p. 564). Deregulation of the financial sector and the creation of exotic financial instruments created a very profitable policy environment for the financial sector. It was also directly responsible for the 2008 crisis.

Lawrence Summers and Alan Greenspan are the subjects of Chapter 8. Summers and Greenspan have not garnered economic fame