A Response to Waknis

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We thank Parag Waknis for his comment. If nothing else, it succeeds – albeit unintentionally – in providing a fine illustration of the problems with contemporary economics that our article described.

In our article, we suggested that the methodology that has dominated economics for the last generation leaves economists unequipped to make arguments for active macroeconomic policy. Since agents know the true parameters of the distribution of future outcomes and inter-temporally optimise at all points based on that, the link between current income and current expenditure, and the consequent centrality of aggregate demand are broken. The result of this approach is that recessions and periods of high unemployment are simply assumed to be the result of optimising choices on the part of agents. Waknis does not challenge the accuracy of this description of current economic practice; he just does not see anything wrong with it.

Sleight of Hand

Waknis employs a common rhetorical sleight of hand, conflating the undisputed importance of expectations and profit-seeking behaviour, with one specific approach to them. Economists have always been interested in how people make choices, and analysis of aggregates has always incorporated stories about the individual behaviour underlying them. What is new to the modern consensus is the idea that the only legitimate way to handle expectations is to assume that all economic actors know the true probability distribution of all possible future events. When people like Waknis say that we must think about expectations, what they really mean is that we must *not* think about what happens when expectations are distorted or differ between actors, or about the concrete process through which expectations are formed.

However much this approach monopolises the textbooks, it is not useful for describing real world booms, cycles and crises, as Waknis himself inadvertently demonstrates. In the paragraph immediately following his lecture urging "faith in people's ability to make choices", he announces that investors in Europe made consistently wrong choices about the riskiness of public debt! Waknis may be right that southern European public debt was systematically mispriced, but it is logically incompatible with the models economists use to think about government budgets, which assume that financial market participants know the true expected values of government spending and taxing across all future time.

Turning to questions of policy, it appears that Waknis does not understand what a multiplier is. He notes a range of multiplier estimates around one, and takes this to mean that increased public borrowing crowds out an equal quantity of private spending. But as anyone who has sat through an undergraduate macroeconomics course should know, what the multiplier measures is the ratio of the change in total output to the change in government output. So with a multiplier of one, there is *no* crowding out; government spending increases real output dollar for dollar. Under today's conditions, most empirical economists prefer estimates at the high end of Waknis' range; the chief economist of the International Monetary Fund recently suggested a typical value "substantially greater than one" (Blanchard and Leigh 2013). But even lower values still mean that higher government spending will raise output and reduce unemployment. Waknis thinks he is bringing these estimates up as arguments for austerity, but he is really offering testimony for the other side. His confusion on this elementary point suggests a harsher judgment on the state of economics than anything in our original article.

Waknis' inability to grasp the role of aggregate demand is striking, but sadly not unusual. It leads naturally to the claim that high unemployment, especially in Europe, is due to overgenerous benefits to those out of work. There is an immense empirical literature on this claim, which finds the evidence for it somewhere between weak and non-existent (Howell et al 2007). Indeed, the countries with the highest and most comprehensive unemployment benefits (Norway and Denmark) have substantially lower unemployment than the US (OECD 2013). The argument also fails the test of common sense. Today, unemployment in the European Union (EU) is about five points higher than in the US. But as recently as the fall of 2009, US and EU unemployment rates were identical. Surely the European welfare state is not a fresh creation of the past four years? More fundamentally, if the rise in unemployment is due to declining "incentives to work", it follows that newly unemployed prefer their current state of leisure to the jobs they had before. Waknis ends his letter with a call for continued research. One useful contribution he might make is interviewing unemployed workers, and asking them how they are enjoying the vacations they have chosen. We expect he will find the answers most stimulating.

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