Why Economics Textbooks Should, but Don't, and Won't, Change

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Laurie Tarshis, one of the first Keynesian economists, recounts how his principles professor handled the Great Depression. (Colander and Landreth 1996) Tarshis was in class on Black Friday when the U.S. stock market crashed, beginning the Great Depression. The professor walked into class and announced that the events of that day were probably the most significant events of the century. Then he went into his standard lecture based on the text. He never mentioned the Depression again.

I have recounted this story many times in explaining why I did not expect the financial crisis of 2008 to have a significant effect on the economics profession, on how macroeconomics is done, or on the textbook presentation of economics. Unfortunately, I was correct. Economics has not changed in any fundamental way since the financial crisis, and shows little likelihood of change. In response to the crisis, there have been some slight adjustments to the scientific model, and to the texts; DSGE representative agent models have been tweaked; and the ad hoc tweaked DSGE model can be made to fit just about any data series, as a number of macro economists at Federal Reserve banks are demonstrating.

Similarly, there are now some discussions in the texts of macro prudential policy, zero lower bounds, structural stagnation issues, (although much of that discussion goes under the incorrect name, secular stagnation), quantitative easing, and even some mention of Minsky moments. But, in both the science and the texts, the underlying macro model of a stable economic system exhibiting composite aggregate rationality remains. So, in terms of fundamentals, macroeconomic theory, and economics teaching of macro, has not changed, even though, to most economists here at this conference, and to an impartial outside observer, that lack of change is indefensible.

Most mainstream economists see the situation differently. They do not see this lack of change in the fundamental model as a problem; they see it as reflecting the soundness of the current model; they argue that critics want the impossible—a model that will predict crises. Yes, they argue, the mainstream didn't predict the timing of the crisis, but that was not a problem with the fundamental science of macroeconomics. Instead it was an engineering or management problem. Ben Bernanke (2010) puts it as follows: "The recent financial crisis was more a failure of economic engineering and economic management than of what I have called economic science." Because they see it as an engineering problem, the crisis did not lead to any significant change in the practice of macroeconomics, nor in the economic textbooks. The economy may have had a crisis, but the economics profession did not.

This justification of the mainstream models is not satisfying to critics such as myself. Critics were never objecting to the macro model because of its failure to predict the timing of the crisis. As I have discussed elsewhere (Colander, 2011) the problem was that the pre-crisis DSGE representative agent macro models were not *even capable of allowing* for an endogenous crisis. It had to be added as an ad hoc addition. The basic macro scientific macro model is one of a stable economy where crises come from outside exogenous shocks. But the financial crisis, and the suppressed recession that followed it, was not precipitated by outside shocks; there was no exogenous event that kicked it off. It developed endogenously; government's attempts to deal with the endogenous problems may have been the precipitating cause, but the underlying cause was in the fundamentals of the economy. For critics, because underlying fundamentals have not changed, the likelihood of future crises is high. So, for critics, the fundamental macro model that we teach should be one of an economy as a complex evolving system capable of endogenous crisis. It should not be a model of as a mechanistic, stable system. You don't see discussions of that in the texts, so, in macro theory, mainstream economics has failed society.

Inequality

A second area where mainstream economics has failed society is in its treatment of income distribution and the growing wealth and income inequality.[1] The mainstream economics profession has provided little guidance in explaining why income inequality is increasing, and in providing options about what can be done about it. This failure accounts for the unwarranted acclaim given to Thomas Piketty's book (Colander, 2014b). In mainstream textbooks income distribution is presented as being determined by abstract "marginal productivity" market forces that are largely beyond the control of government policy. Here again, the problem is that economists fundamental model is not of the economy as a complex evolving system, but is of a deterministic system in which technology determines income distribution. In this mainstream model, if income distribution is not to our liking, we need to design policies to *re*distribute income. Unfortunately those policies are politically and administratively almost impossible to institute, so we are left in a policy bind.

It doesn't have to be that way. In the "evolving complex system" view if we have inequality we don't like, it is because institutions have evolved in a way that does not achieve the distribution we want, and the way to change that distribution is to change the institutions. [2] Mainstream models don't even touch on that possibility.

John Stuart Mill (1848) recognized the problem with marginal productivity theory long ago, as he split distribution theory from production theory. In doing so Mill deviated from Ricardo and argued that technological forces alone do not determine the distribution of wealth and income; in Mill's theory, income and wealth distribution are co-determined by technology, cultural, and social forces that become entwined with the legal and institutional structure of the economy. In Mill's model of the economy, marginal productivities do not follow from

[1] This argument is developed more fully in Colander (2014a)

[2] It isn't only mainstream economists who get this wrong. It is also critical economists such as Thomas Piketty (2014), whose discussion of income redistribution policy focuses on progressive taxation and wealth taxation, not on getting institutions right so we don't need redistribution. He, like mainstream theory, assumes that income distribution is determined by technology, and is the starting point of policy. That is a losing strategy because of the takeaway principle: *It is much harder to take something away from someone than not give it in the first place.* The take away principle has significant implications for any pro-equality distribution agenda. It explains why it is so hard to change the income distribution through progressive taxation, even when, in principle, the majority of the population favors more equality. A progressive taxation redistribution policy undermines the pro-equality sensibility of people because it frames the issue as if you are taking something away from people. People want equality, but they don't want anything taken away from someone to achieve it. Thus, to achieve fairness, equality can be much more easily achieved if the pro-equality policy is embedded in institutions.

technology. Instead they follow from a much more complex process that is a necessary part of the model.

In Mill's approach marginal productivities do not exist independently of cultural and social forces that create the laws. Thus, a rich person's marginal productivity is determined by the legal and property rights structure combined with technology, not by technology alone. Different property rights embedded in institutions and culture lead to different income distributions.

Mill's theory provides a different, approach to achieving a pro-equality income distribution agenda in which policy is designed not to redistribute income, but instead to create a more equal distribution or income and wealth within the institutional structure, thereby requiring far less redistribution to achieve the same pro-equality result. [3]

Mill's approach to thinking about marginal productivity and distribution theory and policy and going far beyond marginal productivity theory was followed by Alfred Marshall, who, in his *Principles of Economics* (Marshall, 1896) specifically noted that marginal productivity theory is not a complete theory of income distribution; but is simply a part of the story. The problem for Marshall was that developing a full theory was beyond the analytic technology of the day, so he, like Mill, emphasized that it was necessary to go beyond economic theory in thinking about economic policy and distribution theory. For Mill and Marshall, economic theory only provided half-truths and the connection between theory and policy had to go far beyond any existing models or theory.

Economists in the 1930s did not follow the Mill/Marshall "half-truths" path in which economic policy followed not from formal economic models, but from reasoned judgment that used those models but integrated their results with a broader, more expansive world view. Economics went wrong, and that wrong was built into the texts.

To fix it we need a much more careful discussion of property rights in the texts, and how they can be changed, and for ideas of how changing property rights can be built into policy. We should consider property rights that have more limited duration. We should consider how regulatory rules could allow for narrower specialists, so that the rents created are spread more widely and more competition is created. We should consider how more open certifications could

[3] Mill's belief that marginal productivities could be changed through policy played an important role for Mill in rejecting Marx's critique of liberal policy, and calls for revolution. Mill writes:

> The laws of property have never yet conformed to the principles on which the justification of private property rests. They have made property of things which never ought to be property, and absolute property where only a qualified property ought to exist. They have not held the balance fairly between human beings, but have heaped impediments upon some, to give advantage to others; they have purposely fostered inequalities, and prevented all from starting fair in the race. That all should indeed start on perfectly equal terms is inconsistent with any law of private property: but if as much pains as has been taken to aggravate the inequality of chances arising from the natural working of the principle, had been taken to temper that inequality by every means not subversive of the principle itself; if the tendency of legislation had been to favour the diffusion, instead of the concentration of wealth—to encourage the subdivision of the large masses, instead of striving to keep them together; the principle of individual property would have been found to have no necessary connexion with the physical and social evils which almost all Socialist writers assume to be inseparable from it. (Mill, 1848, p. 209)

affect income distribution. We should consider how to encourage norms that emphasize individual's social, not materialistic, proclivities. We should consider how society could advocate and support a stronger tradition of social responsibility of the rich, so that achieving social goals becomes a favored luxury good of the rich. We should consider how institutions could have been designed to encourage social benefit, rather than private benefit, and how entrepreneurship can be directed toward social, not private profit goals. We should consider how the materialism embedded in the GDP goals could be countered by replacing GDP with other measures of social success such as Sen's Capabilities Index. There are many more.

Explaining the Lack of Crisis in the Economics Profession

We see little of that consideration happening on either the macro front or the income distribution front. Many heterodox economists and other critics of economics see this lack of reaction by the economics profession as unexplainable. I don't, for the same reason that I see the economist's current macro model, and their current income distribution model as unacceptable. Both are based on an assumption of what might be called a systemic composite rationality of the system. Critics ask: "Wouldn't any rational person see the problem with the existing macro models?" The answer is, yes a rational person would, but what happens in the economics profession does not reflect what a single composite rational person would do or think. The economics profession, like the economy, is best thought of as an evolving complex system. By that I mean that it is composed of hundreds of thousands of economists each trying to survive and get ahead in the existing institutional structure.

Just as there should be no expectation that the economy will exhibit the representative agent rationality that the mainstream macro model assumes, there should be no expectation of that economics profession will exhibit composite rationality in what it studies or what it does. The institutional structure determines the composite reaction, which can be quite irrational, just as the macro economy and income distribution process can be quite irrational.

Systemic aggregate rationality depends on the norms and institutions that have developed to guide interactions among the individuals in the system. Each individual economist operating in his or her institutional structure may be reacting fully rational. But the summation of component rational can be total chaos unless the institutions somehow prevent it. The macroeconomic question is not—why does the macro economy sometimes have crisis. It should be: why does it exhibit as much stability as it does.

The same holds for the economics profession. If the economics profession were compositely rational, because of the enormous uncertainty about what is the correct model, it would have a pluralistic approach, with multiple research programs and a wide variety of models which deal seriously with the uncertainty, complexity, and non-linearities that make crises a normal state of complex systems. Stability is achieved in these models by developing norms and a jerry-rigged set of institutional constraints that limit individual rationality, but in doing so hold the system together.

For the economics profession, the institutions are not right, and faced with a poor prediction, a crisis caused by poor advice, or a failure to provide useful policy advice, in our existing institutions there are few incentives for economist within the economics profession to change their actions in response to changes in the real world events, at least in any short run period. An important reason why is that the economics profession is dominated by academics whose pay is not market determined. In a market, in which economists were paid by their contribution in either successful prediction or in understanding, you would see change—money would stop flowing to economists and they would change what they do.[4]

The large majority of the economics profession does not operate in a market environment. The largest component of the profession operates in a non-market environment in which revenue flows are not directly related to predictions or to providing useful policy advice. Revenue flows to economists reflect institutional arrangements. Academics researchers are judged by publications in peer reviewed journals, which means that they write primarily for other economists—their peers. More and more central bank economists are similarly judged. Economist's success in publishing is what they focus on. This institutional structure makes the economics profession a closed system in which the relationship of its research to the outside world events is of secondary importance. What matters to economist's advancement is how other economists in this closed system react to their work.

These arguments are well understood by heterodox economists and by many mainstream economists as well.[5] But there is no incentive for anyone to change them, which leaves the profession in its current state, reinforcing the status quo.

Economists who are primarily teachers operate in a similar non-market environment. Their pay depends on how well they fit within the system, not how much light he or she sheds on a subject. The least effort approach is for professors to simply teach what is in the texts. Wanting to teach something different is difficult. It involves enormous work since most principles teachers are not experts in the material, and most students are more concerned with the certification aspect of education than the learning aspect. Thus, the large majority of teachers see their role as teaching what is in the textbooks. The reliance on textbooks for guidance in what is taught creates circularity, because textbooks are market driven. A textbook is a reflection of what the market wants, not what the author thinks is the truth. Textbook authors, of which I am one, are similarly caught up in the system. Publishers rely on focus groups to tell them what should be in the texts. Publishers recruit authors by telling them that they want something different, but then they use reviewers of existing users who are not experts in the field to determine what book they will publish. Why, because that is the book that will sell. The system becomes self-reinforcing.[6]

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[4] That actually happened in the 1980s when many firms closed down their economics shops. For profit businesses kept some economists and macroeconomic models, not so much for prediction, but to give presentations to clients, to give general advice, and to translate down how aggregate changes will filter down to firm specific changes. Business economists are quite different than academic economists.

[5] Alan Kirman tells of a newly tenured professor at a top school who wrote Alan telling him that Alan was right, and that the macro theory to which he was contributing was far from what would make sense to study. He said that he had thought that after he received tenure, that he would change his research, but when that time came he found himself too much into the existing research; he would lose too much human capital if he changed.

[6] As I discuss in Colander, (2012) changing the system is quite difficult and in deciding what should be taught, one has to consider who the teachers are. There are many dimensions of economics, and what should be taught is most advantageously decided on the local level.

I present this overview of the decision making process not as a condemnation, but as an explanation for why I do not see the economics profession in crisis, and why I did not expect it to change because of the financial crisis. For the economics profession, the crisis was not a crisis; the crisis was a boon to the existing system. The larger the crisis, the more students want to hear what economics has to say; more sign up for economics, and more revenue flows into economics reinforcing the existing institutional structure. This leads the profession to respond to pressures to change: Why change what they are doing? We are doing quite well thank, you.

Concluding Comment

So what does one do? I wish I had a good answer. My answer has been to spend some of my rents from my principles text on changing the system, pushing the limits of what is presented to encourage evolutionary change, always pushing the 15% limit that publishers allow in mainstream texts. I similarly push the limits on research, developing arguments that make sense to me and encouraging discussion. I don’t expect to bring about immediate change, but I do see my work as making change slightly more likely. By describing the textbook process to others with an inside view, I encourage others to , and create an environment in which, with the stars aligned just right, change is more likely. Once one starts thinking of the economy as a complex evolving system, one starts thinking about economic policy differently.[7] Current models lead us to think of economic policy narrowly. Thinking of the economy as a complex evolving systems leads to policy being thought of in a much broader context.

Economic policy doesn’t involve controlling the economy; a complex evolving system is beyond control. Economic policy involves positively influencing institutions so that they bring about more desirable results. That policy goes far beyond narrow economic focus, and requires one to take into account feedbacks on norms, and culture. The models we have in macro, and the models we teach in principles of economics have little to say about this broader concept of economic policy In terms of macro, it means rethinking the goal of macro policy—and the materialistic fetish that is built into GDP.

In terms of income distribution it means it is time to stop thinking about redistribution policy and to focus more on distribution policy. But if we focus policy on a pro-equality distribution policy agenda—a policy that includes a norms policy, a cultural policy, and a pro-equality property rights policy that is designed to achieve as much equality as possible. Our society is an affluent materialistic society, where the materialistic focus of individuals is encouraged by policy. Given existing institutions, tastes, and culture, there is little hope to achieve a pro-equality redistribution agenda. However if we rid ourselves of our society’s current materialistic fetish, movement toward equality can be achieved in a way that would be supported by a large majority of the population on both the right and the left.

[7] This argument is spelled out more fully in Colander and Kupers (2014).

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