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THE ECONOMIST AND THE REAL WORLD

Arnold C. Harberger

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PREFACE

We are pleased to publish this speech by Arnold C. Harberger as the thirteenth in the Center's series of Occasional Papers. This series features broad reflections on development issues by noted scholars and policymakers.

Professor Harberger originally delivered this speech on the occasion of his being awarded the degree of Doctor Honoris Causa by the Pontifical Catholic University of Chile. In it, he expresses his concern over two current trends in modern economics—the overemphasis on esoteric techniques and an unrealistic approach to economic policies that promise something for nothing. He also expresses his thoughts on other issues, including poverty and the problems of formulating and implementing economic policy. In his distinguished career, professor Harberger has made significant contributions to economic theory in areas such as public finance and international trade and has shed much light in the use of economic analysis tools to formulate effective economic policy. He has been advisor to many governments on different aspects of economic policy, and his students from Latin America and elsewhere have served in prominent policy-making and academic positions. In his work, professor Harberger has emphasized the complexity of the relationship between economic policy and economic growth and has stressed the importance of basing economic analysis on observations of the real world. This approach, which he took in editing *World Economic Growth* (ICS Press, 1984), has played an important role in guiding the program of the Center.

Nicolás Ardito-Barletta
General Director
International Center
for Economic Growth

Panama City, Panama
August 1989

ABOUT THE AUTHOR

Arnold C. Harberger is Gustavus F. and Ann M. Swift Distinguished Service Professor at the University of Chicago and professor of economics at the University of California, Los Angeles. He has been a consultant to central banks, finance ministries, and planning agencies in many developing countries and has served in a similar role for the World Bank, International Monetary Fund, regional development banks, and the foreign aid agencies of the United States and Canada. Professor Harberger is a Fellow of the Econometric Society and of the American Academy of Arts and Sciences, and he has recently been elected to membership in the National Academy of Sciences of the United States. His many publications include the books *World Economic Growth*, *Taxation and Welfare*, and *Project Evaluation*.

ARNOLD C. HARBERGER

The Economist and the Real World

The honor you confer on me is a great one, the more so since its previous recipient in the field of economics was none other than my own mentor and friend, Theodore W. Schultz—a man I have admired throughout his exemplary career not just as an economist, but also as a teacher, as an intellectual leader, and as a human being immersed in the realities of his time. In fact, I have often remarked that I viewed T. W. Schultz as a role model for economists. He has exercised his profession with forcefulness and vigor, with a pervading humanity, and with deep insights into human behavior and institutions. Today's honor humbles me for the distinction it automatically carries. It also makes me renew my determination to try to live up to the great example that you yourselves, by your previous choice, have provided.

Remarks on the occasion of being awarded the degree of Doctor Honoris Causa, Pontifical Catholic University of Chile, April 7, 1988.

T. W. Schultz and the Catholic University

Today's occasion also reminds me of T. W. Schultz in another way. A new period in the life of this faculty began in the mid-1950s. At that time Professor Schultz was directing a program on technical assistance to Latin America, in the course of which he made regular visits to this continent. On one such visit, he dined with Albion W. Patterson, then director of what would later be called the USAID mission to Chile. Patterson was greatly impressed by Schultz's grasp of the economic issues facing Latin America, by the clarity of his vision, and by his capacity to bring others, even noneconomists, to see the world in a new light. Indeed, Patterson was so impressed that he organized our exploratory visit to Chile in the first week of July 1955, which led to the university-to-university arrangement that linked the University of Chicago and the Catholic University in the field of economics from 1956 to 1964.

I clearly remember those exploratory talks; at that time there was not a single full-time professor of economics on this faculty, all were part-time. Looking back, I am amazed at the high quality of students the faculty produced under the circumstances—something for which credit must be given to Don Julio Chaná, another great figure in the history of this institution, who was then ably assisted by Don Alberto Neumann.

We immediately diagnosed the situation as untenable for the long run, and we wrote into our contractual arrangement a commitment by the Catholic University to build itself up to at least four full-time professors of economics by the time our first contract terminated in 1961. They more than met this goal—by the end of our second (phase-out) contract in 1964, there were, as I recall, some thirteen full-time professors on the faculty. It was well on its way to being one of Latin America's top centers of economic training and research.

The quality of the faculty today is the result of the effort of a whole generation of economists. They persevered; they surmounted obstacles; they overcame pressures all along the way in building the institution we see today. And by institution I do not mean the beautiful new building on the San Joaquin campus. I mean instead the veritable fortune of human capital it represents. If the crown is the new building, the jewels are the dedicated professors and teachers who are the true embodiment

of the institution. Whether the institution will flourish in the future depends mainly, almost exclusively, on them. Their task is to maintain and enrich the professional quality of the instruction, the depth and relevance of the research. Their challenge is also to preserve and enhance the freedom of the university as a forum where the reigning power is the power of ideas, where the battlefields are the seminar room and the debating platform, where the weapons are those of logic and evidence, and where the ultimate glory is the everlasting pursuit of that elusive goal men call truth.

T. W. Schultz and Policy Economics

As I proceed to the theme of "The Economist and the Real World," I go back once again to the example of T. W. Schultz. When Schultz was studying agricultural economics in the late 1920s, a third of the U.S. labor force was agricultural. Today it is only 3 percent. What was his message at that time? Simply that the natural forces of economic evolution and growth involved a continuing steady migration of people out of agriculture and into the urban economy. Schultz and his colleagues voiced strenuous opposition to farm programs designed to retain the status quo—to keep people on farms artificially by price supports, import quotas, and other protective devices. They favored schemes promoting agricultural research, and improving education in rural areas, thus improving the capacity of rural children to adapt to urban life. Even today the same battles rage, and Schultz and his colleagues are still on the same side. In the meantime many things—both good and bad—have happened. Rural education has been vastly improved in the United States, and tens of millions of people have successfully migrated out of agriculture. Technical advance has abounded, stemming from research in both the private and public sectors. Better techniques have proliferated. Average real wages of agricultural workers have more than tripled. At the same time, wasteful programs have resisted the attack of economists. Schultz's colleague, D. Gale Johnson, estimates that more than $2 billion per year is now being wasted through the absurdly antieconomic sugar program of the United States. More billions in resources are wasted on subsidies that pay farmers to keep land idle.

The political forces that spawn such wasteful programs are not imaginary; they rise from the earth itself, as it were. While they reflect the interests of particular groups, they run counter to the interests of the nation at large. Somebody has to stand for the broader interest, even when only a few dollars come out of each person's pocket simply in order to benefit a politically strong minority. Whom can we expect to do this? Not our lawyers, not our doctors, not our educators, not our sociologists, nor even our political scientists. In my view, as in that of Schultz and a centuries-long tradition of economists starting before the days of Adam Smith, it is the economists who have to bring economic waste and blundering to the attention of the public. It is the economists who can bring economic sense into the public debate about economic issues. As I will repeat later, I am not one who believes that economists should dictate public policy, or that economic considerations should rule supreme. But I am one who believes that economists as a group bear the supreme responsibility of never letting society forget what economic considerations have to tell us. Economists cannot expect, nor should they insist, that their answers be adopted as policy, but they alone have the capacity to bring economic considerations to the fore in public debate.

The role of economists just mentioned—of being the ambassadors of economic ideas and representatives of economic science before the general public—cannot be carried out by those who stay in the ivory tower, or who couch their ideas in language only a few colleagues can understand. Our profession has always dealt with some topics that require an esoteric approach, and has always enjoyed the luxury of a diversity in which different individuals and groups attack the same set of problems from different angles. I do not want to speak against this long tradition—indeed that tradition can be considered an integral part of the process of scientific advance.

But if the economists are to carry out their responsibility to society, they must as a group maintain communication with the public at large. In my view, the average economist should be able to communicate effectively and simply with the average citizen. This is an art which Schultz has represented well, throughout his long career. More than that, such communication used to be more characteristic of the bulk of economists than it is today.

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The Virus of Supertechnicism

In my opinion, the economics profession in the United States and many other places has gone too far in the direction of what I call supertechnicism. Students come out of graduate schools in full command of the latest and most esoteric techniques, but less prepared to diagnose real-world situations, and less prepared to enter a fruitful dialogue with the average citizen than were the students of ten, fifteen, or twenty years ago.

A leading professional executive of the World Bank has, for example, told me that he asks each interviewee to suggest what advice he would give to a finance minister who is in the midst of a trade liberalization program. The minister is beset with complaints from the industries whose trade barriers are being lowered, and he asks his economist, how can I respond? Who is it that benefits from this program? Can I be sure that the benefits outweigh the costs? Twenty years ago, almost any university-trained candidate entering the employ of the World Bank would be able to answer these questions. Today, my executive friend tells me, hardly any of them can.

The reason, I am afraid, is that today's economic training focuses too much on what is novel, what is advanced, and what is in some sense at the frontier of economic research. It neglects what is fundamental, what is basic, and what is at the core of the discipline of economics as a *useful* theory for understanding the world around us. This is probably not the place for me to elaborate on these matters, but let me emphasize that many others share my concerns about the direction the economics profession has taken, the way our students are being trained, and the way our journal articles are selected. It is still possible for a student today to receive the sort of training that students more-or-less routinely got in the 1960s and early 1970s. But it no longer happens routinely. Students have to seek out the right professors, have to be careful in designing a program, perhaps have to insist on imposing a criterion of relevance for thesis work. Otherwise they may be caught up in the fad of modern supertechnicism.

In making these observations on current trends in the economics profession, I am not just communicating my own subjective impressions. I have conversed with dozens, maybe even a hundred or more senior economists who are equally troubled. But perhaps more convinc-

ing is the recent article by David Colander and Arjo Klamer entitled "The Making of an Economist."[1] It reported on a survey of 212 graduate students at six leading universities: Chicago, Columbia, Harvard, MIT, Stanford, and Yale.

According to this study, students are motivated to come to graduate school because they have a strong interest in policy. Fully 53 percent express a desire to engage in policy formation; only 17 percent consider such a desire unimportant. But when asked to calibrate the determinants of success, 65 percent of them cited "being good at problem solving," and 57 percent cited "excellence in mathematics" as being very important. By contrast only 3 percent thought "having a thorough knowledge of the economy" was very important, only 10 percent thought "having a broad knowledge of the economics literature" was very important, and only 16 percent thought "being interested in and good at empirical research" was very important.

According to the authors,

> most [graduate students] entered economics because they hoped it would shed light on policy. . . . [But], to make it through the first two years of graduate school, [they] have to focus on technique. Thus, [they end up] well-trained in problem solving, [for which] little real world knowledge of institutions is needed. . . .
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> Students come into graduate school wanting economics to be relevant. . . . But they grudgingly come around; they perceive the incentives of the system. They are concerned that formal modeling is important to success, [even though they] are not convinced that the formal models provide deep insight into or . . . solid understanding of the economic institutions being modeled. Believing this, they want to be trained in what the profession values.
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> The likely reason for students' transformation into technique-oriented individuals is that most of them aspire to academic jobs. They know that tenure depends on publication in the right journals. They logically choose a source of study that is most likely to lead to their goal of succeeding in that intermediate goal. Knowing a technique that can be applied to ten areas can lead to ten articles; knowing a specific area well might lead to one or two articles. Thus, students see little incentive to know the literature in an area or to have institutional knowledge of a particular area. This emphasis does not reflect their lack of concern about policy; it reflects the perceived incentives in the system. Novelty in approach, not slogging through

> enormous amounts of data or becoming an expert in the literature, is important.[2]

In my view, this trend toward supertechnicism represents a deviation from the main track of the economics profession. I believe Colander and Klamer are right. The new techniques are not being valued because they have proven themselves vis-à-vis older, simpler, and I would say, more robust methods. They are instead valued because they are on the frontier of the profession, and that is where academic reputations are made.

The recruiters at the World Bank, at finance ministries, central banks, and budget and planning offices around the world tend to share the views I am expressing here. They want to see a flood of younger people more in the style of T. W. Schultz and D. Gale Johnson, of Harry Johnson and Max Corden, of William Vickrey and Martin Feldstein, of Milton Friedman and Franco Modigliani, of Michael Boskin and Charles McLure. All of these people respect economic theory; indeed, they use it day by day as they observe and interpret the world. They gravitate to relatively simple, robust, and *useful* theories, which they then employ to structure their thoughts. While much of their work uses quantitative data, they realize that a complete quantitative accounting of each detailed category of goods and services is forever beyond our reach. They realize we only know the dollar value of imports of computer equipment, and cannot break that value down into its component parts of price and quantity. But that does not mean they must abandon the concept of a demand curve for imports of computer equipment, in which its unobservable quantity is a function of its unobservable price. They use such a concept of demand when they consider the effects of taxes or tariffs, of changes in the organization of the industry, and of technical advances that reduce the costs of production. On this latter point, they may realize the futility of ever trying to fit supply curves for many types of goods, because the supply curve shifts so dramatically (downward and outward) year by year as technical advance occurs. But the fact that the curve is not stable through time does not keep it from being an extremely useful tool for analyzing the effects of government policies, for identifying disequilibria, and for recognizing the nature of the adjustments needed to restore equilibrium.

I am happy to say that the best institutions of economics training in Latin America—of which this is surely one—have not fallen prey to the temptations of modern supertechnicism. Their economics still, as far as I can tell, has the characteristics of simplicity, robustness, applicability, and relevance that I prize so highly. It is only eight years since the first Latin American regional meeting of the Econometric Society was held in Buenos Aires in July of 1980. Yet in this short span of time the Latin American meetings have developed a worldwide fame for their different flavor. The studies presented at the Latin American meetings are less esoteric, and much more real-world oriented than those of other regions. They deal more often with actual problems, with real diagnoses, with suggested solutions that just might conceivably be implemented. Some economists from other regions have remarked how refreshing it is to come to the Latin American meetings and see good economics put to use

So this and other leading faculties of economics in Latin America have a lot to be proud of, and have a tradition to preserve and defend. In all the world this is the region that has best defended itself against the modern virus of supertechnicism in economics. Let us hope that the antibodies are firmly in command, and maybe that a genuine immunity has been established.

The Virus of Demagogy

At the other end of the spectrum from supertechnicism is another group of viruses, which I classify under the label of demagogy. Demagogy is insidious because it pretends to talk about the real world, while it in fact only conjures up a dream world. Demagogy is dangerous because the solutions it offers do not solve existing problems, and the policies it promotes promise benefits but generate losses.

I should note that demagogy is not a technical term in the economics literature. It is my own label for a whole political approach to economic problems. Perhaps the easiest way for you to get the feel of what I mean by demagogy is to realize that it usually carries the connotation of getting something for nothing, or at the very least of getting huge benefit at very small cost. In action, its promises are never realized.

Latin America has probably had more than its fair share of exposure to the viruses of demagogy. While the best faculties of economics have managed to keep from being infected, the great bulk of university-level economics teaching in the area is suffused with it. One can find it in Mexico, Guatemala, Ecuador, Venezuela, Brazil, and many other countries. One has seen its reflection in policies in Chile, under Allende; in Argentina, under Peronism, exaggeratedly so with Mrs. Peron; in Nicaragua recently; and in Bolivia in the early 1980s. Other eruptions, perhaps lesser ones, have occurred in Jamaica in the 1970s; in Panama, particularly after 1977; and in Uruguay, semichronically between 1950 and the early 1970s.

Demagogy is related to good economic policy in much the same way that get-rich-quick schemes are related to sound investment strategies. Both promise big gains and deliver very little—most commonly, big losses. Both are a trap for the misinformed and the gullible. Both play capriciously on people's hopes and dreams.

Demagogy in Camouflage: Multiplier Effects

In economics, the messages of demagogy are often camouflaged under technical-sounding verbiage. The investment multiplier is one example. There is a genuine economic model in which additional "autonomous" expenditures generate multiplier effects. This model came closest to fitting reality during the Great Depression, when there was massive unemployment of both labor and capital resources. The model has no applicability in an economy where added expenditure leads only to inflation, where new credits to some activities mainly displace real spending by others. In short, most Latin American economies in recent decades do not fit the model that generates old-fashioned Keynesian multiplier effects.

A more modern way of expressing the beneficence of certain types of investment would build on the positive "externalities" that might be attributed to such investments. Such external effects are an integral part of the best traditions of economic analysis, and it is not at all demagogic to be concerned with them. But one must realize that external effects can be negative as well as positive. Investing in an aluminum plant will

cause the demand for electric energy to increase. If electricity rates are high enough, this could increase profits of the electricity enterprise and tax revenues of the government. These will normally be positive external effects of the aluminum project. But it is also possible that electricity rates are below marginal cost in an economic sense; in this case the external effect would be negative. Also, when capital is raised for the aluminum project, much of it will normally come at the expense of other types of investments, which upon reaching fruition would have generated a stream of taxes to the government. When other investments are displaced, the opportunity cost to society is the before-tax yield those investments would have produced.

On the whole we have little reason to presume that investments "as such" systematically produce large positive externalities. The major task is to see to it that the investments undertaken are productive for the economy and society. For this we have the concept of the marginal productivity of investments of different types—of their social or economic rates of return. In modern parlance the difference between the social rate of return and the private rate (received by investors or equity holders in the project) is the net external effect.

So today, when someone talks of the large multiplier effects of an investment I ask, do you mean it produces an economic rate of return of 20 or 30 percent per year? If so, how is that rate of return composed? Our experience with investment projects suggests that on the whole a real social or economic rate of return of 10 percent per year is quite a respectable target. Fifteen percent is excellent but rare, and 20 percent a magnificent but still rarer achievement.

Think of it this way. If the capital borrowed by Latin America's major debtor countries had all been invested at an average real rate of return of 10 percent, the debt crisis would probably have turned into a simple credit squeeze. If the capital had been invested at an average real rate of return of 20 percent, creditors would probably not even have imposed a credit squeeze. In any event, the productivity of the investments would have provided an ample cushion to help countries surmount both the credit problems and the fall in terms of trade that in fact precipitated the debt crisis. Thus one can say that below the surface of the debt crisis lie portfolios with low and negative returns. These were mainly the result of private sector actions in some countries, such as

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