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Encouraging More Reality in Economics

By LOUIS UCHITELLE

CHICAGO, Jan. 5 — The annual meeting of the American Economic Association, which opened here on Friday, is usually a pretty esoteric affair.

But this year it could resonate much more broadly as the departing president of the organization, which represents most of the nation's academic economists, tries to push prevailing economic theory further away from the free market approach that has generally held sway for the last four decades.

The protagonist in this drama is George A. Akerlof, a Nobel laureate, who is using the same platform that the late Milton Friedman adopted in 1968. As president of the A.E.A. back then, Friedman laid out new theoretical justifications for a market system that he argued performs most favorably for nearly everyone when the government avoids tinkering with its operation.

The hundreds of economists who listened that day to Mr. Friedman's memorable speech did not immediately embrace his ideas. Keynesian economics, with a big role for government, still held sway.

But over time the Friedman approach took hold, eventually having profound effects on politics and government policy far beyond the ivory tower. This was partly because of Mr. Friedman's insistent, larger-than-life personality, and partly because Keynesian economics failed to adequately explain and respond to the simultaneous outbreak of higher inflation and rising unemployment that emerged in the 1970s.

Mr. Akerlof's style, in contrast, is more diffident and modest. But he has already contributed significantly to a revamping of the economic theory that Mr. Friedman championed. Now, at 66, he is hoping to spread that debate by taking on some of the profession's most sacred cows.

And he is doing so at the moment when income inequality, more concentrated wealth and upheavals from expanded globalization are straining faith in a relatively unfettered market system.

"I am trying to effect a return to sensible economics," Mr. Akerlof said in an interview. "And what is sensible economics? It is very pragmatic. You think about problems in the world and you ask: can government do something about that? At the same time, you maintain your skepticism that government is often inefficient."

This challenge is not from some outsider in economics. Mr. Akerlof — educated at Yale and the Massachusetts Institute of Technology, and currently a professor at the University

of California, Berkeley — is at the heart of the academic establishment. His wife, Janet Yellen, a top economist in the Clinton administration, is president of the Federal Reserve Bank of San Francisco. Their son, Robert, is a Ph.D. candidate in economics at Harvard.

The stakes are considerable. Keynesians, for example, argued that the government could use changes in taxes and spending to help push the economy to full employment without running the risk of excessive inflation. Friedman, by contrast, described a “natural rate” of unemployment below which the nation could not go without causing wages and prices to spiral upward.

In the text of his speech to be delivered on Saturday afternoon, Mr. Akerlof argues that the Friedman approach is based on false assumptions about human behavior.

For example, he says, people don't automatically insist on raises that keep their pay on par with inflation. They often are happy with smaller raises, considering them a compliment from the boss for valued work.

That makes pressure for higher pay less inflationary than the Friedman approach would assume.

A result, Mr. Akerlof says, is misleading theory and misguided policy.

Mr. Akerlof is facing considerable criticism for his view that standard economics leaves out too much actual human motivation. What Mr. Akerlof sees as missing content, Mark Gertler, a New York University economist, describes as “frictions” that distort accurate theory.

“What Akerlof is doing is stepping out of line,” said Mr. Gertler, who did research with Ben S. Bernanke before Mr. Bernanke became chairman of the Federal Reserve. “A lot of people are correctly taking rational behavior as a baseline and are adding frictions, such as constraints on borrowing, that can lead to temporarily inefficient markets.”

More than most economists, Mr. Akerlof goes far afield to gather information that he considers to be played down or ignored in ways that leave mainstream economics divorced from real life.

In his speech, he encourages others to follow his lead, rejecting the focus on what he calls “parsimonious modeling” inspired by Friedman. Everyday experience and observation must be returned to a prominent place in the profession, he argues.

“The early Keynesians got a great deal of the workings of the economic system right in ways that are now denied,” Mr. Akerlof said in a study newly posted on the Internet that closely tracks the text of his speech. “They based their models, as Keynes put it, on ‘our knowledge of human nature and from the detailed facts of experience.’ ”

A lot of what Mr. Akerlof advocates in his speech is already under way, with Mr. Akerlof himself a major contributor. He shared a Nobel in economics in 2001 for his work on imperfect information, concluding, for example, that economic outcomes are altered when a used-car salesman knows more about the condition of a vehicle he is selling than the buyer. It was an imbalance that helped to produce state “lemon laws” that protect buyers.

He was an early participant in behavioral economics, another assault on the rational, fully-informed behavior that Mr. Friedman counted on to make markets work efficiently without regulation or intervention.

People often do not behave rationally, the behaviorists found in their experiments. Most do not bother to sign up for a voluntary 401(k) plan, for example, but do not pull out of such a plan if an employer signs them up automatically.

Now Mr. Akerlof is taking a big step on his own. His speech is based on more than a year of research, much of it done with Rachel Kranton, a University of Maryland economist. They are trying to incorporate into theory, as Keynes once did, the great variety of “norms” that determine human behavior.

What Mr. Akerlof is trying to do, with Ms. Kranton’s help, is to reflect the variety of motivations that come from the sense people have of “what they are and how they should behave,” as Ms. Kranton put it.

Among the examples they cite:

A teacher in good standing among the parents of her students puts the preservation of that reputation ahead of attempts to maximize her pay.

A change in income will permanently alter a worker’s spending, a view that challenges the more common belief that spending matches a worker’s lifetime income and savings, evening out over time.

Workers resist wage cuts even when unemployment is rising, despite standard theory that they will accept less pay to save their jobs.

The variations in norms and behavior are numerous and Mr. Akerlof, in his speech, calls on economists to incorporate this diversity into standard economic theory.

“If there is a difference between real behavior and behavior derived from abstract preferences, New Classical economics has no way to pick up those preferences,” Mr. Akerlof asserts. “A macroeconomics that incorporates observations regarding how people think they should behave combines the best of the two approaches.”