Letter from America —

Bankrupt!

In this Letter from America, Angus Deaton captures the contrasting reactions to the present crisis amongst US economists.

Mayhem aside, it's a privilege to live through a classical slump, rather than to read about it in a textbook. It feels like attending the premiere of a Shakespeare play, or meeting a dinosaur. The experience certainly helps understand the political and economic environment within which Keynesian policies must operate. As an undergraduate, my Cambridge teachers explained how the great depression need never have happened, if only the poor, unenlightened policy makers had understood Keynesian economics, just as diabetics need never have died if they had only known about insulin. As in too much of the economics we were taught, politics was neglected, and in the US, the politics has certainly come back to bite. The Republican party is unanimously anti-Keynesian and robustly challenges stimulus policies with talk of printing money, inflation, generational theft, and of the USSA —the first 'S' stands for socialist — and sinister purpose was even read into the visit to Washington of Britain's *socialist* prime minister.

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This talk would not have been unfamiliar 80 years ago. Many politicians and much of the media take it as obvious that the stock-market is the measure of social welfare, and the fall in the market in the early days of the administration marks its policies as having failed. In spite of spreading stock market ownership, opinion polls show that most Americans do not share these views. The majority of American economists — including many who have advised and worked with Republican administrations — have not argued against stimulus spending in and of itself. Yet there has been no unanimity. Robert Barro of Harvard, writing about what he calls 'Voodoo multipliers', sounds a common theme, that current events 'do not invalidate everything we have learned about macroeconomics since 1936', for example that the multiplier is zero so that presumably people are saving—not because their wealth has fallen—but so that their great grandchildren will have enough to repay the loans for Obama's stimulus. Instead, he recommends that the elimination of the corporate income tax (which income is that?) as a 'brilliant' way to address the crisis. Ed Prescott of Arizona State notes that it is not true that all economists agree on the effectiveness of a fiscal stimulus though 'If you go down to the third-tier schools, yes, but they are not the people advancing the science.' The (libertarian) Cato Institute found 200 economists to sign a full-page advertisement stating that government expenditure has not stimulated economies in the past, and will not do so now. Prominently absent from the signatories are professors of economics at 'third-tier schools' such as Harvard, MIT, and Princeton, perhaps because so many of their faculty are in Washington, helping to construct the stimulus. It is not clear how many of the 200 signers actually endorse Ricardian equivalence or DSGE models, and many may simply be sceptical of large government programs under current American political conditions. Yet many economists do not appear to recognise that such programs might act differently in a slump than at full employment, nor would they learn such a thing in many modern graduate courses in macroeconomics.

In December, I attended a meeting to celebrate 30 years of research on economic development at the World Bank, followed quickly by the American Economic Association (AEA) meetings in San Francisco. At both, there was a feeling of crisis. At the Bank, it was clear that the model of development through concessionary lending is broken, and that the research agenda that supports those loans, and is financed out of them, is bankrupt both financially and intellectually. The atmosphere was dreary, the gloom unrelieved. The AEA meetings were not engineered to talk about crises in financial markets or in the profession, if only because the program was set nine months ahead. Yet much was arranged at the last minute, and instead of gloom and depression, there was a sense of invigoration, of a task to be done, and of the talent to deal with it. Over and again people happily argued that, at last, macroeconomics would change and that labour economics would have to be rewritten, with behavioural approaches the most promising candidates for a way forward. Something that is not often commented upon is that three-quarters of new PhDs in economics from American departments are now awarded to non-Americans, compared with about a quarter thirty years ago. The faculty of my own department is more than two-thirds foreign-born, with representatives from 21 different countries and five continents. These people grew up in political and intellectual environments that have not been well represented in American economics for much of its recent history, and perhaps the only parallel for their influence for change is the influx from Europe in the 1930s.

The stock-market is shaping the profession in another way. Most of the first-tier schools in the US—though not Arizona State — are private institutions whose operating budgets are shaped by their endowments typically according to a spending rule in the form of a fixed percentage with upper and lower limits, beyond which adjustments in spending are mandated. The dynamic programmers, who have derived optimal intertemporal spending rules for many kinds of agents, do not seem to have solved the corresponding rule for a private university, whose endowment is random and illiquid (but partly under its own control through fund-raising,) whose spending is hard to change in the short run, whose means-tested aid policies commit them to large spending increases at times of economic contraction, and whose fees are subject to intense political scrutiny. Indeed, the lack of a well-argued spending rule has caused embarrassment for universities in recent years as congressional scrutiny has sought justification for policies that seemed intended to create enormous endowments while simultaneously raising tuition fees (and faculty salaries) faster than the rate of inflation. Senator Charles Grassley has proposed that universities with more than $500 million be required to spend five percent of their endowments, a rule that currently governs charitable foundations. Universities have fought this legislation, but administrators have been pressured to spend more, which has made things much worse now, further exacerbated by some universities having been unable to resist the creative investment strategies of the last decade. Princeton, which has been relatively conservative in such matters, recently borrowed a billion dollars to support its operating budget; Harvard, which was less conservative (and larger), borrowed $2.5 billion in December. One economist quipped that the 'ivory tower' should be renamed the 'ivory towering inferno'. Many state universities are doing even worse, as state governments fight to stave off ruin. Arizona State, for example, has eliminated 500 jobs and will require all staff to take 10 to 15 days unpaid leave next year.

With their universities in flames, and their pension funds in ashes, academic economists are facing a new and less pleasant reality. Economists will no longer be able to hire as many new PhDs as they find intellectually interesting, but this may not matter, because no one — outside some of the state schools like Berkeley or Wisconsin, which have defined-benefit pension schemes — will be willing to retire as long as he or she can be wheeled into the classroom. There is a new advantage to European, central-government funded universities, at least in the Keynesian countries. As alternative opportunities dry up, we can expect working conditions to become harsher, at least relative to the current low teaching, high pay, and frequent absence equilibrium. In this world of increased personal insecurity, perhaps it may seem that voluntary leisure is a more accurate description of our own circumstances — at least up until now — than of those who are losing their jobs in the current maelstrom. It may even be possible, in another echo of the 1930s, that the science can be advanced in new and different directions.

Note: The discussions at the World Bank can be found in *Development economics through the decades: a critical look at thirty years of the World Development Report*, by Shahid Yusuf. Webcasts of several of the discussions of the crisis at the AEA meetings are available to members at http://www.aeaweb.org/webcasts/assa2009.php