

Comment

Go forth and observe:

answer to Peter Radford's [Whither economics? What do we tell the students?](#)

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'Far from being disconnected from the market economy, poor households, including those living on less than one dollar a day, are deeply invested in financial transactions. Because these transactions are mostly informal, thus undocumented, they remain invisible to the one-time visitors and others who look at written records. But if one were to take the trouble of visiting households twice a month over the course of a year, recording the details of all financial transactions, then one would recognize how diligently poor people, using a variety of instruments, manage their portfolios'

Anirudh Krishna in his review of: Daryl Collins, Jonathan Morduch, Stuart Rutherford and Orlanda Ruthven, *Portfolios of the poor. How the world's poor live on \$ 2 a day*. Princeton University Press, Princeton, 2009. *Science* 326 (December 2009) 1634-1635.

Peter Radford asks us, in this journal, what we should tell our students, given the disarray of the science of economics (Radford, 2010). My answer is clear: "find the facts". Fact finding is pivotal to scientific progress. The December 2009 issue of *Science* lists a number of recent scientific breakthroughs. All of these concern the discovery and investigation of 'novel facts'. With this, I mean *empirical* 'novel facts', as well as new ways to observe and measure such data. It is telling, as well as sad, that, in an economics journal, 'empirical' has to be added. But it has. Radford rightly divides the present science of economics into the study of 'economics' and the study of 'economies'. This schism is not just a matter of the inclination, education and focus of different economists (as is stressed in McCloskey, 2002). To an extent, it seems to be embedded in the very fabric of present day theory. In an article in a 'Festschrift' for Paul Samuelson, Hal Varian for instance states that, since its conception in the thirties of the twentieth century, the idea of revealed preference has made significant contributions to economic theory. But after an exhaustive investigation of the many attempts to *measure* 'revealed preference' and at the end of a career largely devoted to such attempts, he tragically exclaims: "We anticipate that in the future, revealed preference analysis will make a significant contribution to *empirical* economics as well (emphasis added, M.K.)" (Varian 2006). The idea of 'revealed preference' somehow seems to defy measurement. Despite the obvious failure of using the idea to fit the facts¹, revealed preference still is one of the staples of microeconomic theory. And 'revealed preference' is no exception. Neurologists like Lamme have, implicitly, evaporated the very ideas of stable and transitive utility functions as well as of rational behaviour (Lamme, 2006; 2009).². This of

¹ Tellingly, the science of marketing, which investigates how and why real people buy real stuff from real companies makes no use at all of 'revealed preference' or the 'homo economicus' and explicitly denounces these concepts: you can't use them to sell nylons. (Kotler e.a., 2006, p. 227; Verhage, 2004, p. 41).

² Different and often competing parts of the brain take different decisions based on incomplete data and different algorithms and that which we call 'rational consciousness' only gets to know about these decisions after they have been made. In the language of the economists: even if all these competing decision centers would be maximizing in a neo-classical way, Arrow's impossibility theorem would prevent the existence of a 'meta' transitive and stable utility function. Again and again it is shown that, when in a supermarket, people make other choices than when they make a shopping list at the kitchen table – *the consumer plans, the shopper decides*.

course goes a long way to explain why textbooks discussing the (always quite vaguely defined) concept of 'utility' have, for many decades, contained little, if any, information on how to measure it – there is nothing to be measured.³ Despite the lack of empirical content and its seemingly a-empirical essence, the model is still around, even in spite of the findings of people like Lamme, though their ideas do seem to be gaining at least some influence at last.

Monetary theory is another example. In the real world, the macro costs of using money are quite high. The costs of the entire banking system, the stock markets, a sizeable part of the insurance industry, the whole IRS and its equivalents outside the USA as well as all accountants and the tens of millions all around the world operating cash registers have, among other costs, to be counted as part of the macro costs of our monetary system. But does anybody know a textbook of economics which even mentions this rather obvious fact, or discusses why we use money, *despite* these high costs? Instead of this, the a-historical and counter to the facts myth 'barter versus monetary exchange' still abounds in economics textbooks (and internet F.A.Q. sites). But just as we did not start to use gasoline to increase the efficiency and speed of horses, so the use of money did not spread because it enhanced the efficiency of non-monetary activities. The use of money spread because a thing called 'a monetary economy' grew next to the non-monetary economy, with new products and techniques. And important aspects of the non-monetary economy still linger on. About half of the stock of capital in modern economies consists of houses – which are of course mainly used by families in their different stages, which are largely organized on the basis of a non-monetary system of division of labor based on age, gender, skills, position in the family and moral values.⁴ But such well known findings and ideas on the history of money are ignored in the textbooks, and scientific articles on the essence of money show an appalling lack of knowledge of the historical record (an overview in Visser, 2009). Again, theory takes prominence over established fact. Sometimes I get the impression that part of theoretical economics is more about science fiction than about the real world: weird aliens hovering about in a strange universe where friction and gravity do not exist. But students do have to learn this science fiction, and are not taught how to measure and investigate the real world.

Of course, economics as a science has, during the last century and especially after about 1920, made great progress in measuring and investigating economic phenomena. Just think of the magnificent system of the National Accounts, which combines hundreds of thousands or even millions of micro-data into a coherent macro economic whole. To me, that's the real 'sound' or 'non-trivial' micro-foundation of macro economics, showing, unlike DSGE models, the results of real choices of real people. Psychologists and neurologists are making great progress in measuring and investigating how choices really are made (therewith unintentionally evaporating the notion of utility and the maximizing individual in the process). Websites with high quality in depth and/or comparative economic information have proliferated (among many, many others: www.cia.gov; www.census.gov ; www.cbs.nl). Also, the GFC has made it clear that, as many data on recent economic phenomena are published much faster than some decades ago, governments can act much swifter to crises (a fast,

³ Surprisingly, the title of the book in Dutch in which Lamme popularizes his idea has to be translated into English as either "There is no such thing as a free choice" or "There is no such thing as a free will". Lamme, 2009.

⁴ One could state this as follows: total production in an economy (monetary as well as non monetary) is equal to: $Y_{total} = f(a_1(K_1, L_1)) + f(a_2(K_2, L_2))$. a_1, K_1, L_1 being technology in the monetary economy and a_2, K_2, L_2 being technology, capital and labor in the non monetary economy. Empirically it seems that $K_1 \approx K_2$ (value) and $L_1 \approx L_2$ (hours) while Y_{total} is a multi-dimensional concept, consisting of money as well as amounts of non-priced goods and services and data on longevity, morbidity and the like.

effective and smart example of effective government intervention was the German 'Schrottpremie' or 'cash for clunkers' system).

So, we do measure the economy and we have become much better and much faster at doing it. Progress is made every day (Elekdag and Lall, 2008). But are our students even aware of this? Do they learn how economic phenomena are measured and do they learn to do this themselves? Do teachers tell their students the importance of knowing the details of definitions? In many sciences, students have to spend, from the first day on, long hours on the tedious process of acquiring the skill to observe, measure and catalogue facts. Textbooks of these sciences bristle with famous discoveries and students often have to acquire detailed knowledge of this kind of information. Not so in economics (a point also made in McCloskey, 2002). Do we teach them how to gather dependable, reliable, representative prices to construct the price index? Do we send them to companies to gain first hand experience with, among other things decisions on investments? Do they have to spend time with the travelling salesmen, this 'nervus vagus' of the modern market economy. I can assure you that all of these activities are very possible – and students love them! I do have to admit that, especially in business schools and the like, there seems to be some progress into this direction. Also, 'behavioral economics departments', which tend to attach much more importance to this, are spreading like wildfire.

But school is not always fun and exciting – and maybe we should, sometimes, make it even more boring. Students of 'old-fashioned' economics still do not have to devise and carry out measurements, to investigate the history of national accounting or of short term economic indicators or to discuss older and newer concepts of core concepts like 'households' or 'consumption' – let alone the development of households (number of people, income, stock of capital, spending, debts, household technology). All this, while such activities are of overriding importance to the work of non-university economists at the OESO or the IMF. Not coincidentally, the websites mentioned above always pay ample attention to details of definitions and methods of measurement, just like all the specialized organizations which assemble, digest raw economic data and publish the statistics which are our 'novel facts'. Our students – and teachers, and this does not only hold for the neo-classical inclined – have to know about this kind of work. Working at organizations like the OESO and the IMF, they will often have to use tons of statistics, and they do need to know about the way these are constructed and assembled. And yes, that makes for quite a boring part of the curriculum. Alas. And it also won't show up on the publication lists of their teachers. Alas.

But teaching our students how to gather and digest raw data gives them the implicit message that there is something to measure, that it's worthwhile to do this and that it is one of the tasks of university trained economists to be involved in the process of gathering data. We do have to think about definitions, about the questions that new companies often are not included in registers used to gather data, about the details of the comparison of price indexes of different countries (this led the European Union to the introduction of the Harmonized Index of Consumer Prices, the HICP – another advance in measurement). There is something better and, in the end, more interesting to do than quarreling about esoteric theories. Students have to study information and discuss definitions and methods as can be found on, among many other sites, <http://www.census.gov/wholesale/> - though I do admit that reading science fiction is more fun.

I do not advocate any kind of simple empiricism. To the contrary. The way variables are defined influences the outcome of the measurements and, therewith, our lives. Indices of

consumer prices play an important role in wage negotiations. The HICP does not include owners' equivalent rent for the price of owner occupied houses, the Dutch (and the German, and the USA) consumer price indices do. If rents rise faster than other prices, the Dutch consumer price index will show a higher rise than the HICP – and there will be more pressure to increase wages than if the HICP is used. And if we do not include environmental damage in GDP, China will in, all probability, surpass the USA as the largest economy of the world towards the end of Obama's second term (PPP-exchange rate). If we do, the current order might last four more years. But taken at face value, this is another reason to teach students how to find the facts – they have to be aware of such problems. And this may channel their, and our, attention away from silly quarrels about outdated concepts and towards real problems – like the costs of living of the elderly, which seem to rise faster than those of the general population (Bureau of Labor Statistics, 2010).

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