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Why do economists persist in using false theories?

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It is easy to establish that many of the core theories used by Economists are false. For example, there is overwhelming empirical evidence against the theory of utility maximization; for a survey of this evidence, see Zaman and Karacuka (2011). Similarly, Romer (2016) documents how leading monetary economists persist in believing that monetary policy does not affect the real economy, despite very strong empirical evidence to the contrary. This failure of economic theory became obvious to all when economists failed to foresee the Global Financial Crisis (GFC) of 2007. Worse, leading economists confidently predicted continued prosperity, and dismissed warnings of trouble in financial markets After the crisis, many leading economists and practitioners realized that there were fundamental flaws in the structure of mainstream economic theories – for a collection of quotes, see "Quotes Critical of Economics".

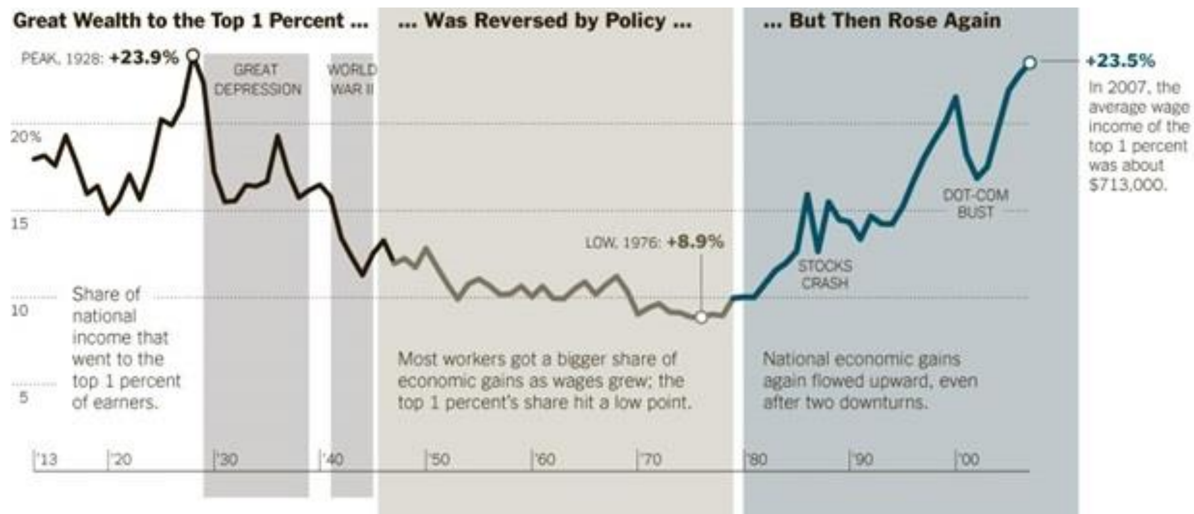
The question we wish to address is deeper than a one-time failure of economic theory. The same models which failed spectacularly in the GFC continue to be used after the crisis. The same models of consumer behavior overwhelmingly refuted by behavioral economists continue to be exposited in microeconomics textbooks, and taught to unsuspecting undergraduates around the globe. Central Banks around the globe continue to make monetary policy decisions on the basis of models known to be false. In a paper with the revealing title "Monetary Policy Without A Working Theory of Inflation", Daniel Tarullo, former head of the Federal Reserve, writes that " We do not, at present, have a theory of inflation dynamics that works sufficiently well to be of use for the business of real-time monetary policy-making". Around the world, Central Banks continue to raise interest rates to fight inflation, while the data overwhelmingly contradicts this causal link – see "Do High Interest Rates Reduce Inflation? A Test of Monetary Faith". So we can repeat the question of the title: Why do economists continue to use theories, even though they are well aware that empirical evidence is in strong conflict with these theories?

To answer this deeper question, we must dig deeper into the nature of economic theory itself. What is the function of economic theory, if it is not to learn the truth about how the economic system works? Once we explore economic theories within the historical contexts in which they arose, the answer becomes blindingly clear: economic theories serve to protect the interests of those in power. We provide a three examples of this below; for more, see ET1%: Blindfolds Created by Economics.

The Marginal Product of Capital: All economics textbooks argue that the returns to labor and capital (wages and interest) are determined by the technology, encapsulated in the production function, and the operation of competitive markets. None of them mention that this is a concealed moral argument to counter Marx's claim that Capitalists exploit labor. Since the returns to capital and labor are determined by the workings of the market mechanism in a symmetric way, with exactly the same mathematical form, we can conclude that both parties receive just compensation for their input to production. Both capital and labor are paid in proportion to their contribution to the productive process. Once we realize that a moral argument is being made, it becomes possible to counter this on several different grounds. Chapter 8 of Hill and Myatt's *Anti-Textbook of Microeconomics* provides a thorough discussion. One

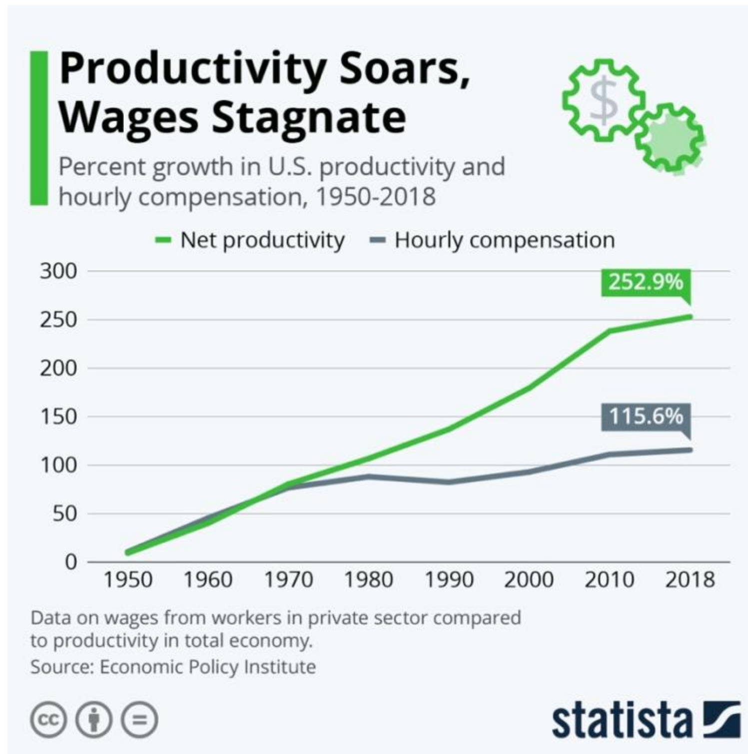
line of argument comes from the strong empirical evidence that most firms set prices, which shows that markets are not competitive. If the capitalists are able to set prices for their goods, then they can also set wages to be exploitative. A second line of argument comes from the mathematics. Production functions where the two marginal products (to capital and labor) exceed the total product, are easy to find. In such cases, it is technically impossible to pay the marginal product to both factors. Why do textbooks never mention such cases, and confine discussion to a simple special case where the two marginal products exactly equal the total product? A third line of argument comes directly from moral philosophy. Laborers labor to earn their wage. The capitalist "owns" capital to earn his reward – does ownership justify payment in the same way as working? One must look beyond all of these details to the bigger picture: A moral argument justifying payments to capitalists, and countering Marx's charge of exploitation, is being made in mathematical disguise.

The Keynesian Revolution and the Monetarist Counter-Revolution: The intimate connection between economic theory and political power is clearly illustrated by the rise and fall of Keynesian Economics in the 20th Century. Confidence generated by theories glorifying the workings of a market economy led leading economists to predict permanent prosperity, just prior to the Great Depression of 1929. After the crash, Keynes set out to resolve the most glaring contradiction between economic theory and reality. While economic theory maintains that free markets automatically eliminates unemployment, the Great Depression created high unemployment which persisted for more than a decade. Keynesian theory recognized this failing of free markets, and placed responsibility for creating full employment on the government. Application of Keynesian theory led to a period of unprecedented prosperity in Europe and USA following the 2nd World War. However, there was a snake in the Garden of Eden: the wealth share of the top 1% declined precipitously between 1930 and 1980:



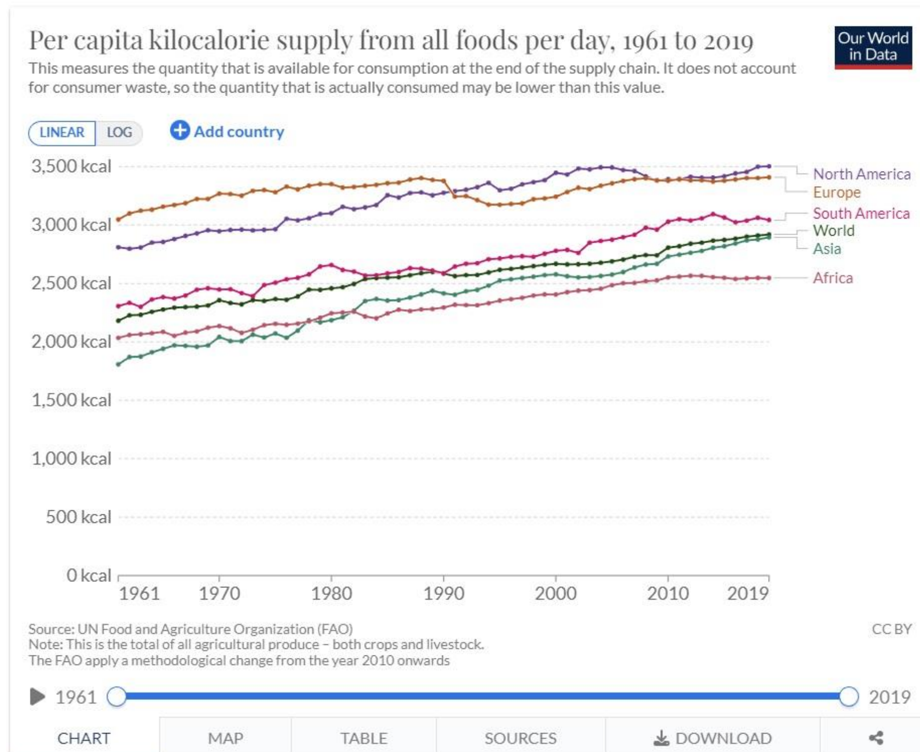
The top 1% fought back by a well-thought out multi-dimensional plan to reverse this decline in their wealth shares; details of this planning are available from Naomi Klein's Shock Doctrine, and Alkire and Ritchie Winning Ideas: Lessons from Free Market Economics. A central element of this plan, implemented in the Reagan-Thatcher era, was the rejection of Keynesian economics and a return to the same pre-Keynesian ideas that had been proven wrong by the Great Depression of 1929. Modern textbooks of labor theory continue to teach that free markets eliminate unemployment, blithely ignoring the massive amounts of empirical evidence against this proposition. Chicago school economists argued that government interventions to create full employment bring about short term increases in employment, which are reversed in the long run. Furthermore, such interventions inflict great costs upon

the economy in the form of high inflation. Central Banks responded by dropping the goal of reducing unemployment, and shifting policy focus to fighting inflation only. The result was a long period of economic stagnation, with high unemployment, which weakened power of labor force and enabled capitalist exploitation, reflected in the rapid rise of the wealth share of the top 1%. Another graph which shows that the productivity increased a lot, but the wealthy captured the lion's share of these gains, while the labor share remained nearly constant, is given below:



This clearly demonstrates why economics textbooks stick to the theory that free markets create full employment, when they obviously do not (see: 70 years of failure by economists to understand the labor market). Allowing unemployment to exist, and preventing the government from intervening to eliminate it, permits capitalists to exploit labor to the hilt, appropriating all gains from increasing productivity, and denying labor any share of the increasing profits.

The Scarecrow of Scarcity: As detailed in my paper on The Normative Foundations of Scarcity, the foundations of economics were shifted from an approach focusing on material welfare, to an approach based on scarcity. When we ask "Why?" we find the same answer: the concept of scarcity is designed to conceal the wealth of the rich and protect it against the claims of the poor. This is a continuation of a strategy adopted by Malthus, who argued, purely from his imagination and without any data, that poverty was due to the high fertility rate of the poor, and giving them food would only increase this rate of growth and be counterproductive. The proponents of scarcity argue that the reason that there are over a billion people living below the poverty line on the planet is because of the scarcity of resources to feed them. However the data on food per capita contradicts this view:



The data shows that in all continents, including Africa, the per capita kilocalories supplied by food has been increasing, and is above minimal requirements. So poverty does not exist because there is not enough food for all, it is because planetary resources are concentrated in the hands of a few rich people. As Gandhi observed: "There is enough for everyone's need, but not enough for everyone's greed". The obvious solution to the problem of poverty lies in the redistribution of wealth. But, since this would harm the interests of the wealthy, this line of thinking is actively discouraged. "Nobel Laureate" Lucas states that:

> "Of the tendencies that are *harmful* to sound economics, the *most* seductive, and in my opinion the *most* poisonous, is to focus on questions of *distribution*. The potential for improving the lives of poor people by finding different ways of distributing current production is nothing compared to the apparently limitless potential of increasing production."

While many different lines of research have converged on the truth that elimination of poverty requires redistribution of wealth concentrated in the hands of a tiny minority, economists stubbornly refuse to acknowledge this, and insist that we must create more growth and acquire more wealth in order to be able to feed the poor.

Concluding Remarks: Richard Feynman argued that the defining characteristic of scientific theories is that they are rejected and revised when they conflict with experimental evidence: "It doesn't matter how beautiful your **theory** is, it doesn't matter how smart you are. If it doesn't agree with **experiment**, it's **wrong**". These three examples above, as well as a host of others not discussed, show that the defining characteristic of textbook economic theory is that it remains the same regardless of how much empirical evidence accumulates against it. A closer examination of progress in economic theory shows clearly that the core has remained the same, while the evolution and progress has been in the complex defense mechanism devised to protect these core theories against mountains of accumulating conflicts with empirical realities. Regarding these tendencies, Romer writes that the economists' "*dismissal of*

fact goes so far beyond post-modern irony that it deserves its own label. I suggest "post-real." While it is impossible to understand the evolution of economic theory as a progressive increase in understanding the complex economic reality, it is easy to understand all resistance to change when it is viewed as an ideology designed to protect the interests of the wealthy and powerful.

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