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Economics and reality

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ABSTRACT

This paper is a non-technical and somewhat philosophical essay, that seeks to investigate the relationship between economics and reality. More precisely, it asks how reality in the form of empirical evidence does or does not influence economic thinking and theory. In particular, which role do calibration, statistical inference, and structural change play? What is the current state of affairs, what are the successes and failures, what are the challenges? I shall tackle these questions moving from general to specific. For the general perspective, I examine the following four points of view. First, economics is a science. Second, economics is an art. Third, economics is a competition. Forth, economics is politics. I then examine four specific cases for illustration and debate. First, is there a Phillips curve? Second, are prices sticky? Third, does contractionary monetary policy lead to a contraction in output? Forth, what causes business cycles? The general points as well as the specific cases each have their own implication for the central question at hand. Armed with this list of implications, I shall then attempt to draw a summary conclusion and provide an overall answer.

> "As regards the scope of political economy, no question is more important, or in a way more difficult, than its true relation to practical problems. Does it treat of the actual or of the ideal? Is it a positive science concerned exclusively with the investigation of uniformities, or is it an art having for its object the determination of practical rules of action?" (Keynes, 1890, Chapter 2).

1. Introduction

The title of this paper is reminiscent of Sims (1980) to catch the reader's eye. This is an intentional act of marketing and surely not fair to the reader. His paper is a path-breaking contribution to our science, whereas the paper at hand is a somewhat loosely argued piece of philosophy.[1] Furthermore, neither have I made the fundamental contributions nor do I have the deep wisdom that would entitle me either to that flagrant act of self-promotion or this grand-standing sermon. Indeed, anything that I may say correctly, I have learned from the giants in the field—and everything that I shall say incorrectly should not be said

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[1] It therefore may be more reminiscent of Lawson (1997), though I sharply disagree with his rejection of formal, mathematical models to address the social reality of economics and several other conclusions. For more discussion of Lawson, see Fullbrook (2008).

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in the first place. Voicing deep thoughts about economics should better be left to others! I can do no more than pretend. But here I am. Thus, without further apologies, let me proceed anyhow.

This paper seeks to investigate the relationship between economics and reality. More precisely, it asks how reality in the form of empirical evidence does or does not influence economic thinking and theory. In particular, which role do calibration, statistical inference, and structural change play? What is the current state of affairs, what are the successes and failures, what are the challenges?

I shall tackle these questions moving from general to specific. For the general perspective, I examine the following points of view.

1. Economics is a science.
2. Economics is an art.
3. Economics is a competition.
4. Economics is politics.

I then examine specific cases for illustration and debate.

1. Is there a Phillips curve?
2. Are prices sticky?
3. Does contractionary monetary policy lead to a contraction in output?
4. What causes business cycles?

The general points as well as the specific cases each have their own implication for the central question at hand. Armed with this list of implications, I shall then attempt to draw a summary conclusion and provide an overall answer.

2. What is economics

"Economics is what economists do".[2] Perhaps. But they approach it in four different ways.

2.1. Economics is a science

Economics is a science. As such, it concerns itself with the description and explanation of economic phenomena. "Positive economics is in principle independent of any particular ethical position or normative judgments" (Friedman, 1953). It describes "what is", as opposed to normative economics, which deals with "what ought to be" (Keynes, 1890).

Positive economics can be used to derive normative implications, though. Economics seeks to find allocations which make humans as happy as possible, taking preferences as given, i.e., taking as given the individual comparison of circumstances as to how happy it will make them. Seeking to improve on the human character, i.e. changing her or his preferences, or dictating ones own preferences as valid for someone else, is typically not only outside the scope of economics, but is generally frowned upon by economist as an approach to crafting economic policy. Indeed, this conflict is often at the heart of public debates, in which economists take one of the sides. The positive economic theorist often seeks to solve for the Pareto optima in her or his model: if one therefore buys into the premises of what makes people happy, then these Pareto optima are indeed the set of normatively best solutions possible.

Economics as a science deduces empirical predictions from theories and induces theory from empirical observations. Both approaches are of importance and mutually complement each other. Smith (1776) deduced deep insights and predictions from the first principles of economic self-interest. So did Menger (1871), the founding father of the so-called "Austrian School of economics" and developer of the concept of marginal utility. Induction in economics could perhaps be associated originally with the "Historical School", led by Gustav von Schmoller (1875), and positing that one cannot trust theories not derived from historical experiences or empirical evidence. Schmoller furthermore argued that there cannot be universally valid economic laws, that cultural specificity is central, that structural breaks are ubiquitous.

This "Methodenstreit der Nationalökonomie", this dispute between Menger and Schmoller finds its echo in the modern debates between the proponents of a theory-led deductive approach and the proponents of an empirically grounded inductive approach, all the way to the extreme positions. There are those which reject empirical or econometric techniques altogether, at the one end. At the other end, there are those who reject structural modeling and argue that only natural experiments are valid sources of information. Both sides tend to argue for their perspective with vigor. There, economics is not different from any other science. And as in any other science, both perspectives contribute to its progress in the end. These debates are fruitful and crucial, when viewed from that angle.

I therefore reach a first, tentative conclusion on the relationship between economics and reality, and the specific question of whether empirical evidence does or does not influence economic thinking and theory. The answer is: Reality guides economics. Empirical evidence influences and should influence economics, as in any scientific discipline—but there is not a sin-

[2] This phrase has been attributed to Jacob Viner, see Backhouse et al. (1997).