

# Naked Economics: Undressing the Dismal Science

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## INTRODUCTION

The scene is strikingly familiar. At a large American university, a graduate student stands at the front of a grand lecture hall drawing graphs and equations on a chalkboard. He may speak proficient English; he may not. The material is dry and mathematical. Come exam time, students may be asked to derive a demand curve or differentiate a total cost function. This is Economics 101.

Students are rarely asked, as they might be, why basic economics made the collapse of the Soviet Union inevitable (allocating resources without a price system is overwhelmingly difficult in the long run), what economic benefit smokers provide for nonsmokers (they die earlier, leaving more Social Security and pension benefits for the rest of us), or why mandating more generous maternity leave benefits may actually be detrimental to women (employers may discriminate against young women when hiring).

Some students will stick with the discipline long enough to appreciate “the big picture.” The vast majority will not. Indeed, most bright, intellectually curious

college students suffer through Econ 101, are happy to pass, and then wave goodbye to the subject forever. Economics is filed away with calculus and chemistry—rigorous subjects that required a lot of memorization and have little to do with anything that will come later in life. And, of course, a lot of bright students avoid the course in the first place. This is a shame on two levels.

First, many intellectually curious people are missing a subject that is provocative, powerful, and highly relevant to almost every aspect of our lives. Economics offers insight into policy problems ranging from organ donation to affirmative action. The discipline is intuitive at times and delightfully counterintuitive at others. It is peppered with great thinkers. Some, such as Adam Smith and Milton Friedman, have captured mainstream attention. But others, such as Gary Becker and George Akerlof, have not gotten the recognition outside of academe that they deserve. Too many people who would gladly curl up with a book on the Civil War or a biography of Samuel Johnson have been scared away from a subject that should be accessible and fascinating.

Second, many of our brightest citizens are economically illiterate. The media

are full of references to the powerful Ben Bernanke, who has played a crucial role in the U.S. government response to the global financial crisis. But how many people can explain what exactly he does? Even many of our political leaders could use a dose of Econ 101. Just about every political debate includes an assertion by one or more candidate that outsourcing and globalization are “stealing” American jobs, leaving us poorer and more likely to be unemployed. International trade, like any kind of market-based competition, does create some losers. But the notion that it makes us collectively worse off is wrong. In fact, those kinds of statements are the economic equivalent of warning that the U.S. Navy is at risk of sailing over the edge of the world. In my lifetime, the guy who made the most colorful assertion along these lines was Ross Perot, a quirky third party candidate in 1992 (when Bill Clinton and George H. W. Bush were running as the mainstream candidates); Perot argued emphatically during the presidential debates that the North American Free Trade Agreement would lead to a “giant sucking sound” as jobs left the United States for Mexico. The phrase was memorable; the economics were wrong. It didn’t happen.

The Perot campaign was, as he might have put it, “a dog that didn’t hunt.” But that does not mean that those world leaders who do get themselves elected have a solid grasp of basic economics. The French government in 2000 undertook a program to tackle chronic double-digit unemployment with a policy that was the economic equivalent of fool’s gold. The Socialist-led government lowered the maximum workweek from thirty-nine hours to thirty-five hours; the supposed logic was that if all people with jobs work fewer hours, then there will be work left over for the unemployed to do. The policy did have a certain intuitive appeal; then again, so does using leeches to suck toxins out of the body. Sadly, neither leeches nor a shorter workweek will cause anything but harm in the long run.

The French policy was based on the fallacy that there are a fixed number of jobs in the economy, which must therefore be rationed. It’s utter nonsense. The American economy has created millions of new Internet-related jobs over the last three decades—jobs that not only didn’t exist in 1980, but that no one could have even imagined—all without the government trying to divvy up work hours.

In 2008, the French government under Nicolas Sarkozy passed legislation

allowing companies and workers to negotiate away the thirty-five-hour workweek, in large part because the policy did nothing to fix the unemployment problem. No sane economist ever thought it would—which doesn't necessarily mean that politicians (and the people who elect them) were willing to listen to that advice.

Which is not to say that America doesn't have its own economic issues to deal with. Antiglobalization protesters first took to the streets in Seattle in 1999, smashing windows and overturning cars to protest a meeting of the World Trade Organization. Were the protesters right? Will globalization and burgeoning world trade ruin the environment, exploit workers in the developing world, and put a McDonald's on every corner? Or was *New York Times* columnist Thomas Friedman closer to the mark when he called the protesters "a Noah's ark of flat-earth advocates, protectionist trade unions and yuppies looking for their 1960's fix"?<sup>1</sup>

During the 2008 presidential primaries, Barack Obama criticized the North American Free Trade Agreement, which was negotiated during the presidency of fellow Democrat Bill Clinton. Were Obama's comments good economics, or just good politics (since he happened to be running against Bill Clinton's wife)? After Chapter 12, you can decide.

I offer only one promise in this book: There will be no graphs, no charts, and no equations. These tools have their place in economics. Indeed, mathematics can offer a simple, even elegant way of representing the world—not unlike telling someone that it is seventy-two degrees outside rather than having to describe how warm or cool it feels. But at bottom, the most important ideas in economics are intuitive. They derive their power from bringing logic and rigor to bear on everyday problems. Consider a thought exercise proposed by Glenn Loury, a theoretical economist at Boston University: Suppose that ten job applicants are vying for a single position. Nine of the job candidates are white and one is black. The hiring company has an affirmative action policy stipulating that when minority and nonminority candidates are of equal merit, the minority candidate will be hired.

Further suppose that there are two top candidates; one is white, the other is black. True to policy, the firm hires the black candidate. Loury (who is black) makes this subtle but simple point: Only one of the white candidates has suffered from affirmative action; the other eight wouldn't have gotten the job anyway. *Yet all*

*nine white candidates go away angry, feeling that they have been discriminated against.* Loury is not necessarily a foe of affirmative action. He merely adds nuance to a discussion that usually has none. Affirmative action can harm the very race relations that it seeks to heal.

Or consider the periodic campaign to mandate that insurance companies cover the cost of two nights in the hospital for women who have delivered babies, rather than just one. President Bill Clinton found this issue sufficiently important that he vowed in his 1998 State of the Union address to end “drive-by deliveries.” But there is a cost to such a plan that should be made explicit. An extra night in the hospital is not medically necessary in most cases, but it is expensive, which is why new parents don’t pay for it themselves and insurance companies don’t want to pay for it either. If insurance companies are forced to offer this benefit (or any other new benefit mandated by law), then they will recover their extra costs by raising premiums. And when premiums go up, some people on the margin will no longer be able to afford any health insurance at all. So the real policy question is: Are we willing to pass a law that will make many women more comfortable if it means that a much smaller number of men and women will lose coverage for basic care?

The tradeoff underlying that seemingly narrow question has enormous resonance as America debates health care reform. The more generous a health care system is in the benefits it guarantees, the more it is going to cost. That’s true regardless of whether the government is operating the system or not. In fact, the most important question related to health care reform often gets far too little attention: Given the proliferation of fabulously expensive medical technology, some of which produces great results and some of which doesn’t, how do we design a system that says “yes” to procedures that justify their cost and “no” to those that don’t?

Is economics one big advertisement for the Republican Party? Not exactly. Even Milton Friedman, a Nobel laureate in economics and the most articulate spokesman for free markets, would concede that unfettered markets can lead to deeply flawed outcomes. Consider the American lust for the automobile. The problem is not that we like cars; the problem is that we don’t have to pay the full cost of driving them. Yes, we buy the car and then pay for maintenance, insurance, and gasoline. But we don’t have to pay for some of the other significant costs of our

driving: the emissions we leave behind, the congestion we cause, the wear and tear on public roads, the danger we pose to drivers in smaller cars. The effect is a bit like a night on the town with Dad's credit card: We do a lot of things that we wouldn't do if we had to pay the whole bill. We drive huge cars, we avoid public transportation, we move to far-flung suburbs and then commute long distances.

Individuals don't get the bill for this behavior, but society does—in the form of air pollution, global warming, and urban sprawl. The best way to deal with this growing problem is not the stuff that laissez-faire conservatives usually talk about. It is higher taxes on gasoline and cars. Only with those kinds of measures, as we shall explore in Chapter 3, will the cost of climbing behind the wheel of a car (or a hulking SUV) reflect the real social cost of that activity. Similarly, larger subsidies for public transportation would properly reward those commuters who spare the rest of us by not getting into their cars.

Meanwhile, economists have done some of the most substantive work on social issues like discrimination. Have the world's symphony orchestras historically discriminated against women? Harvard economist Claudia Goldin and Princeton economist Cecilia Rouse came up with a novel way of finding out. In the 1950s, American orchestras began to use "blind" auditions, meaning that the aspiring orchestra member would perform behind screens. Judges did not know the identity or gender of the musician trying out. Did women do better under this blind system than they did when judges knew their gender? Yes, decidedly so. Once the auditions became anonymous, women were roughly 50 percent more likely to make it past the first round and several times more likely to make the final cut.<sup>2</sup>

Economics presents us with a powerful, and not necessarily complex, set of analytical tools that can be used to look back and explain why events unfolded the way they did; to look around and make sense of the world; and to look forward so that we can anticipate the effects of major policy changes. Economics is like gravity: Ignore it and you will be in for some rude surprises.

The demise of the investment bank Lehman Brothers, which declared bankruptcy on September 15, 2008, ushered in "the financial crisis," which deserves its frequent description as the worst economic downturn since the Great Depression.

How did it happen? How did so many consumers, who are supposed to have a rational understanding of their own well-being, end up crushed by a housing “bubble”? Who were the knuckleheads who loaned them all that money? Why did Wall Street create things like “CDOs” and credit-default swaps, and why did they prove so devastating to the financial system?

Chapter 2 makes the case that most of the reckless behavior that led to the financial crisis was predictable, given the incentives built into the system. Why did mortgage brokers originate so many reckless loans? *Because it wasn't their money!* They were paid on commission by the banks that made the loans. More mortgages meant more commissions, and bigger mortgages meant bigger commissions.

So why were the banks willing to put so much of their own capital at risk (particularly given the incentives of the mortgage brokers who were bringing them customers)? Because banks typically “sell” most of their mortgage loans, meaning that they get a lump sum of cash now from some third-party investor who gets the stream of future mortgage payments in return. (You may now recognize this situation as an adult version of “hot potato” it doesn't matter how bad a loan is as long as you can pass it on to someone else before the borrower defaults.)

Okay, then who would buy these loans? That's what Chapter 2 explains. I'll give you one clue now: Wall Street gets involved and it doesn't end well.

Having written all that, I must admit that there is some soul searching going on in the economics profession. As obvious as the financial crisis seems after the fact, few economists saw it coming (with some notable exceptions). Virtually none anticipated how severe it might be. In the fall of 2005, several prominent economists wrote in a prestigious journal, “As of the end of 2004, our analysis reveals little evidence of a housing bubble.”<sup>2</sup>

Wrong. Actually the article was worse than wrong, because it was written explicitly to refute the signs of a bubble that had become obvious to many laypeople—which is kind of like the fire department showing up at a house with smoke wafting from the roof and declaring, “No, that's not a fire,” only to have flames start leaping from the attic twenty minutes later. There was a bubble. And it can be explained best by incorporating psychology into economics, namely the tendency of individuals to believe that whatever is happening now is what's most likely to happen

in the future.

Economics is evolving, like every discipline. One of the most interesting and productive areas of inquiry is the field of behavioral economics, which explores how individuals make decisions—sometimes in ways that aren't as rational as economists have traditionally theorized. We humans underestimate some risks (obesity) and overestimate others (flying); we let emotion cloud our judgment; we overreact to both good news and bad news (rising home prices and then falling home prices).

Most of this was obvious to Shakespeare, but it's relatively new to mainstream economics. As *New York Times* columnist David Brooks noted, "Economic behavior can be accurately predicted through elegant models. This view explains a lot, but not the current financial crisis—how so many people could be so stupid, incompetent and self-destructive all at once. The crisis has delivered a blow to classical economics and taken a body of psychological work that was at the edge of public policy thought and brought it to front and center."<sup>4</sup>

Of course, most of the old ideas are still pretty darn important. Federal Reserve chairman Ben Bernanke was a scholar of the Great Depression before leaving academe, a fact that has had implications far beyond the Ivory Tower. Chapter 10 will make the case that Bernanke's creative and aggressive interventions at the Federal Reserve, many of which were inspired by what went wrong in the 1930s, prevented a bad situation from getting much, much worse.

This book walks through some of the most powerful concepts in economics while simplifying the building blocks or skipping them entirely. Each chapter covers subjects that could be made into an entire book. Indeed, there are minor points in every chapter that have launched and sustained entire academic careers. I have glossed over or skipped much of the technical structure that forms the backbone of the discipline. And that is exactly the point: One need not know where to place a load-bearing wall in order to appreciate the genius of Frank Lloyd Wright. This book is not economics for dummies; it is economics for smart people who never studied economics (or have only a vague recollection of doing so). Most of the great ideas in economics are intuitive when the dressings of complexity are peeled away. *That is naked economics.*

Economics should not be accessible only to the experts. The ideas are too important and too interesting. Indeed, naked economics can even be fun.







