What's Left of Cambridge Economics?

Although mainstream economics has moved past the market fundamentalism of the 1970s and 1980s, it has yet to establish a new theoretical footing. One reason is that well-meaning reformers in the field continue to embrace the same false premises that they should be seeking to overturn.

James K. Galbraith

Project Syndicate, Jan 14, 2022

AUSTIN – Diane Coyle, an economist and professor of public policy at the University of Cambridge, has set a daunting task for herself: to provide a reasoned critique of the economics discipline from an insider's perspective, while defending mainstream economics from the harsh – and mounting – criticism leveled by outsiders.

In *Cogs and Monsters*, Coyle seeks to advance an engaged, policy-relevant vision of economics drawn from the work of leading academics in the field. The implication is that the pieces are there and need only to be assembled. "For economics itself," she tells us, "the agenda is clear": "We need to build on the work that already exists to incorporate as standard externalities, non-linearities, tipping points, and self-fulfilling (or self-averting) dynamics. We need to revive and rethink welfare economics. ... We need a modern approach to the public provision and regulation of information goods, applying the rich literature on asymmetric information. ... And we need to put the social, not the individual, at the heart of the study of economics ..." Dismissing macroeconomists as "forecasters" (harsh, but not completely wrong), Coyle would prefer to dwell on the applied microeconomics that preoccupies most academic economists nowadays. This dodge allows her to quote John Maynard Keynes on numerous side issues without having to account for the fact that he himself repudiated micro theory. Having shunted Keynes onto an intellectual siding, Coyle argues that it is microeconomists who have advanced the field beyond the simple doctrines of 40 years back; it is they who are now on the cusp of making economics into something useful.

The Micro Perspective

One can understand and even sympathize with Coyle's project. The real world has overtaken Friedrich von Hayek and his lead disciple, former British Prime Minister Margaret Thatcher. Today's profound inequalities are becoming politically unacceptable. Financial crises are endemic, and now climate change is upon us, too. The free-market, deregulate-and-privatize verities of Coyle's professional youth have lost appeal.

But as Coyle points out, the discipline is still exceptionally disciplined. Academic success demands publication in one of only five "top" journals, all of which are tightly controlled by acolytes of the mainstream orthodoxy. For most economists today, the only practical way to get ahead is to build on (and therefore accept) that orthodoxy.

Deference, even sycophancy, is required. Thus, Coyle herself recites from the catechism: "What markets do brilliantly, nevertheless, is coordinate the use of resources in a process of discovery and challenge. The information signaled by the prices set by demand and supply is a wonderful coordinating device."

To be sure, the modern applied microeconomics that Coyle celebrates is scattered and diverse, often without the crisp self-assurance of free-market legionaries from decades past. It makes room for those who question the axioms of "rational" economic calculation, showing by experiment that real people's decision-making bears little resemblance to textbook predictions.

The new microeconomists point to problems such as pervasive "asymmetric information" – a favorite theme of the very progressive neoclassical economist Joseph E. Stiglitz. Others emphasize common flaws and sources of friction in markets – sticky wages, sticky prices, monopoly power – while still others focus on social costs and the provision of public goods. And yet all these "departures" still hew to the orthodoxy that treats perfectly informed, fully rational, price-adjusting buyers and sellers in perfectly competitive markets as the ideal type. It doesn't seem to matter that the ideal type doesn't exist anywhere in practice and never has. The presumed purpose of economic policy is to iron out all the flaws so that the world will behave "as if" it conformed to the ideal. A characteristic manifestation of this belief structure is the fashionable idea of "new antitrust," which prescribes breaking up companies like Facebook, Google, and Amazon in order to ensure price competition in those industries. Another example is advocacy of carbon pricing as a mechanism to slow global warming. And even more pernicious is the case for "flexible labor markets" as a cure for joblessness. On this last point, Coyle writes that "both the Greek and Italian economies are widely thought to be hamstrung by an accumulation of regulations at the expense of competition, innovation and economic growth." (Note the passive voice: "are widely thought.") Mainstream economists may indeed think such things; but they are wrong. The Greek labor market was wholly deregulated a decade ago by IMF fiat. What disappeared was not unemployment but formal work and the middle class. Moreover, there is ample evidence that what is really good for jobs is union-driven wage solidarity, as practiced over the years in Scandinavia, Austria, and at times in Ireland. This fact has eluded mainstream economics and will continue to do so, because articles advancing such insights cannot get published in the "top five" journals.

Prices Are Not the Key to Everything

Coyle subscribes to the grand illusion that price adjustment is the economy's prime mover. But as the Cambridge Keynesian economist Nicholas Kaldor noted in his slim 1985 book, *Economics without Equilibrium*, "the intuitive belief that prices are the key to everything" is simply wrong. The foundation on which Coyle places modern mainstream economics is a myth. As Kaldor put it: "... the important conclusion is that the signal that causes an economic 'agent' to do something different – produce more or produce less, or switch his manufacturing facilities from some varieties to others – is *always* a quantity signal, not a price signal. ... In the actual adjustment of supply and demand, prices play only a very subordinate role, *if any*." (Emphasis added.)

When I attended the University of Cambridge in 1974-75, I read Keynes, met Piero Sraffa, listened to Joan Robinson, and studied with Kaldor, Luigi Pasinetti, Richard Goodwin, Ajit Singh, Wynne Godley, Robin Marris, and Adrian Wood. Back then, it was understood at Cambridge that markets do nothing like what Coyle claims they do. Just as Einstein had erased Euclid's axiom of parallels, Keynes's *General Theory* had long since obliterated the supply curves for labor and saving, thereby eliminating the supposed markets for labor and capital.

It followed that the *prices* of production were set by *costs* (mostly labor costs and interest rates), while *quantities* were determined by effective *demand*. Markets were not treated as if they were magical. It was obvious that most resources and components did not move under the influence of an invisible hand. Rather, they moved according to contracts between companies on terms set by negotiation, as had been the case for more than a hundred years. Technology was managed by organizations – mostly by large corporations – in what was sometimes called "the new industrial state." But the Cambridge school of economics that understood these things has died out. It was targeted in the great intellectual purge of the Thatcher era, and it was pried from its footholds in North America by early-stage McCarthyism, Reaganism, the MIT self-proclaimed Keynesians, and the Chicago School. Only a few scattered survivors remain today. But while the economics discipline has changed, the real world is still as it was. It is not the never-never land described by Milton Friedman, Robert Lucas, or Hayek, nor could it ever have been. Coyle recapitulates Kaldor on two key points: the importance of product differentiation and what economists call "increasing returns." But she describes the seemingly unmanageable complexity posed by "dozens of mobile phone packages, and [choices to] eat vegan or gluten-free in high street fast-food outlets" as proof, along neoclassical lines, of the impossibility of socialism. (A trip to China might have disabused her of this view.) In real life, as Kaldor noted, large organizations plan for diversity by maintaining inventories of *inputs*, not of finished goods, so that they can respond to changes in the demanded *quantities* of different items: "Even the manufacturer of standard articles is likely to sell numerous varieties of the same commodity (think of shoes, cameras, detective novels, refrigerators and cookers) all of which make use of much the same materials but are of a somewhat different design. ... In all these cases the possession of a large 'input stock' puts the manufacturer in a far more favorable position to satisfy his customers than possession of output stocks." It is not such a hard problem. Companies, not markets, overcome the challenge of product diversity all the time. One need only abandon the notion that anything substantial depends on price signals. The question is why something that Kaldor emphasized back in the 1980s is not appreciated by an economist at the same university 40 years later.

The Return of Increasing Returns

"Economics," Coyle correctly argues, "needs to have at its heart increasing returns and the kind of dynamics they imply. The characteristics of a knowledge economy are distinctive." But this "vibrant area of research … is not yet the mainstream benchmark, and still less so in the lecture hall or the corridors of power." As it happens, here is Kaldor on the same topic: "The progress of knowledge ... is very often the result gained from experience – learning by doing. And as the great American economist, Allyn Young, emphasized in his famous paper 'Increasing Returns and Economic Progress,' published shortly before his early death in the winter of 1928-1929 – *a paper which for reasons that are not clear to me did not have the influence in his native country that it so clearly deserved* – once we allow for increasing returns the laws of economics take on quite a different appearance." (Emphasis added.)

Young saw almost a century ago, and Kaldor emphasized 40 years back, that increasing returns generate *cumulative causation*: the advancing gains of leaders over laggards produce increasingly extreme inequalities and disequilibrium.

Having reinvented these ideas, Coyle's treatment of increasing returns in the digital age is the most perceptive part of *Cogs and Monsters.* She also is admirably aware of the problem of "data bias," especially the prevalence of *a priori* category schemes in surveys that implicitly determine what economists choose to study, even though they are not necessarily material to the processes that need to be understood. (This particular problem has preoccupied me for decades, underlying my work on the measurement of inequality and much else.) Ultimately, these issues lead us right back not only to Keynes but also to his "circus" of peers such as Kaldor, Sraffa, and Robinson. These earlier Cambridge economists did not develop "forecasting models," and macro-policy prescriptions were, for them, a sideline. They and their successors (above all Pasinetti, who continues to publish in his 90s), practiced a unified theoretical economics that encompassed money, banking, production, employment and unemployment, market power, international trade, industrial corporations, and technological change. Coyle's belief in a distinctive applied microeconomics based on markets and price signals is an artifact of the "neoclassical synthesis" constructed in post-war Cambridge. It was here – in Cambridge, *Massachusetts* – that MIT and Harvard economists bifurcated the discipline, reduced Keynes's thinking to formulas, and set the stage for the Chicago cult of rational "microfoundations." In view of increasing returns and data bias – trends that have been accelerated by artificial intelligence in the digital age – Coyle concludes that "economics needs to change." She is surely right about that. But it is impossible for economics to advance as long as it remains anchored to the mainstream bedrock on which Coyle's own training was based. Cumulative intellectual causation, theoretical evolution, and the development of ideas suited to new conditions will continue to be blocked. Keynes, Kaldor, and their Cambridge colleagues understood this perfectly. Yet, despite the brilliance of their intellectual firmament, only Keynes merits a quotation in Coyle's book. Kaldor gets a footnote on an irrelevant point, and the rest are not mentioned at all. Cambridge has forgotten Cambridge, and it is poorer for it.

- **Diane Coyle, *Cogs and Monsters: What Economics Is, and What It Should Be*, Princeton University Press, 2021.**
  Nicholas Kaldor, *Economics without Equilibrium*, Routledge, 1985.