Mitchell's Musings 1-14-2013: To Be Perfectly Honest

Daniel J.B. Mitchell

Economists sometimes define their field as the science of choice. Why do people, firms, etc., make the choices they do? Of course, there is the old joke that economics is the science of choice and sociology is the science of why you don't have a choice. One can get into grand philosophy about freewill going down this path. The brain, after all, ultimately is a kind of biological machine. And in recent years, at least some economists have been taken up with behavioral/psychological research which often shows that decisions are made that depart from classical economic notions of rationality.

The popular *Freakonomics* books, radio program, and blog sometimes explain real world phenomena in terms of classical rationality. But there is also recognition of notions of non-rational behavior. However, there is a type of detachment and aloofness in social science that focuses attention on what other people do, not what researchers do.

I was struck recently by an excerpt from the *Freakonomics* radio show in which Steven Levitt, co-author of the books, makes an observation about biases in business. The particular show dealt largely with confirmation bias, i.e., the idea that people start with an opinion and then look for evidence that supports the opinion and reject contrary evidence. But a related area discussed was confessing ignorance.

Levitt comments that there is a temptation for individuals to answer questions even though the respondent actually doesn't know the answer, i.e., there is an aversion to admit ignorance. He even admits that *he* sometimes answers questions about which he doesn't really know the answer. But Levitt then goes on to say that in his consulting with business, he finds that there is great resistance to testing of alternatives. As a result, he says, the main thing MBAs learn is how to fake knowledge. When he (Levitt) suggests randomized testing of business alternatives, the suggestion is rejected since it would suggest that company executives who are supposed to know the answer really don't know. As a result, Levitt says, businesses don't learn anything. Academics, in contrast, start out with an acknowledgment that they don't know and then spend years neutrally researching the true answer.

I have posted this brief excerpt from the program at http://www.youtube.com/watch?v=vsJFGDoJYm0.

Particularly in fields of social science, including economics, I think it would be hard to establish that there is always a neutral starting point for academic researchers. There are respected economists, for example, who are routinely described as liberal or conservative. So even using the same data sets, they tend to come to different (predictable) conclusions.

To take a recent example, a National Bureau of Economic Research (NBER) working paper recently appeared on the subject of "Okun's law." <http://www.nber.org/papers/w18668.pdf> It provided various statistical tests which indicated that the law had held through the Great Recession, i.e., that the Great Recession – while deeper than most – did not involve a wholesale break in economic relationships. Okun's law, named after the late Brookings Institution economist Arthur Okun, refers to an empirical regularity rather than a logical deduction. Basically, it involves how much of a real GDP advance is needed to produce a given drop in the unemployment rate. The usual rule of them is that shoving up the real GDP by an extra 1% cuts the unemployment rate by something like half a percentage point.

Note that real GDP and unemployment – while linked – involve a variety of employer decisions. A GDP positive shock creates more product demand and hence more labor demand by employers. But labor productivity can vary so some of the added demand can be dissipated by added productivity growth. And adding more labor can involve adding hours to the existing workforce (not hiring) or adding more workers. To the extent that any additional workers come from the pool of the unemployed, the unemployment rate will decline. But some additional workers come from outside the labor force, i.e., they are drawn in by the availability of more job opportunities and were not previously officially unemployed. You can think of the connection between real GDP and the unemployment rate as involving a set of gears which can slip. Okun suggested, however, that despite potential slippage, there was in the end a relative constancy in the real GDP/unemployment rate relationship.

A finding that the Great Recession, while deep, did not fundamentally change economic relationships such as Okun's Law has policy implications. It suggests that the traditional remedy for recession – demand stimulus – is as appropriate now as it was in the past. It suggests that the alternative idea – that somehow things changed at around the time of the Great Recession - so that traditional remedies are not appropriate – is incorrect. (The alternatives are typically stories that there was a structural mismatch that arose in the workforce between the kinds of skills needed by employers and the skills possessed by workers so that unemployment is high due to mismatch, not inadequate demand.)

If you look at the NBER paper on Okun's Law cited above, you will find that the authors view themselves as refuting other empirical studies suggesting that the Law broke down recently. That is, other researchers looking at the same real GDP and unemployment rate find that there has been a change. It is likely that those with liberal views favoring stimulus will see virtue in the new study and will be skeptical of the others. For conservatives, who generally don't like government intervention in the economy, the rival studies will seem more credible.

Personally, I find it unlikely that some technological shift happened to occur in 2008 coincident with, but unrelated to, the Great Recession. So the idea of there being no change in Okun's Law seems quite plausible. But obviously, there are those with alternative viewpoints. Maybe the academic world is not quite as different from the business world as Levitt suggested.

Arthur Okun