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## REVIEWS

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### Policy Entrepreneurs vs the Professors

*Paul Krugman, Peddling Prosperity: Economic Sense and Nonsense in the Age of Diminished Expectations, Norton, New York, 1994*

*Reviewed by Michael James*

The dust-jacket of *Peddling Prosperity* tells us that in 1991 Paul Krugman was awarded the John Bates Clark Medal, a prize that the American Economic Association gives every two years to 'the best American economist under the age of forty'. Much in the book shows why Krugman won the prize. His limpid and ironical prose helps him make some difficult economic ideas not just comprehensible to the layman but engaging as well. His critique of strategic trade policy is outstanding. Yet Krugman is unable in the end to offer any solution to the problem he identifies, because he leaves unresolved the central dilemma that arises from it.

The problem is that since 1973, when the postwar 'magic' of America's economy suddenly disappeared and productivity growth dropped from nearly 3 per cent annually to less than 1 per cent, the White House has twice been captured by 'policy entrepreneurs' peddling bogus quick fixes for restoring the magic. In the 1970s the Republicans bought the ideas of the 'supply-siders', a bunch of spivs who seized control of the editorial page of *The Wall Street Journal* and softened up the country for the Reaganomics of the 1980s. Then in the 1980s and early 1990s the Democrats were persuaded by some similarly unqualified publicists that America was becoming 'de-industrialised' by international competition, but could counter this trend by government intervention to promote 'strategic' industries of high 'added value'. But the Clinton administration's current reliance on the ideas of strategic traders like Robert Reich, Ira Magaziner, and Lester Thurow will prove as futile as the Reagan administration's faith in supply-siders like Robert Bartley, Arthur Laffer and Paul Craig Roberts.

Krugman contrasts the policy entrepreneurs to the 'professors' (the academic economists). The entrepreneurs derived their ideas from certain professors, but in order to sell them they had to strip them of their caveats and qualifications, and in the process they grossly exaggerated the potential of economic policy to achieve its official goals. They got as far as they did because they were meeting a demand for simple ideas from politicians eager to restore the American dream. Of course it would be better if the professors were more influential in their own right. But Krugman thinks they are at a disadvantage because, although they can offer useful macroeconomic advice and show that import protection and price controls don't

work, 'they don't know how to make a poor country rich, or bring back the magic of economic growth when it seems to have gone away' (p.9).

Krugman makes short work of the supply-siders. He shows that their two main claims — that tax cuts would either generate enough additional tax revenue to close the budget deficit or produce enough additional private saving to finance it easily, and that a drop in the value of the US dollar would inevitably result in domestic inflation — were decisively refuted and discredited by the experience of the 1980s. His later chapters on the strategic traders are more immediately relevant because their ideas are still current in Washington and elsewhere. Although Krugman himself is one of the 'professors' whose ideas the strategic traders have caricatured, he can fairly point out that he always opposed strategic trade *practice*. He argues cogently that the idea of 'international competitiveness' is really just another version of the mercantilist fallacy, based on a mistaken belief that nations compete in the way that corporations do. In reality, a country's prosperity depends not on its trading performance as such but on its level of productivity. And since America's economy consists mainly of services, a given increase in productivity is worth more if it occurs in service industries than in manufacturing industries. Discussing the push to promote high-tech, high value-added manufacturing sectors, Krugman shows that in 1988 workers in the cigarette and petrol-refining industries added several times more value than those in the aircraft and electronics industries, where the value added was only the average for all manufacturing.

But *Peddling Prosperity* is more than a demolition job on two sets of policy entrepreneurs: it also engages in the macroeconomic debate among the professors over the last 20 years. A strong sub-theme of the book is that the attack on Keynesian economics by 'conservative' professors in the 1970s failed, and that Keynes was in effect rehabilitated in the 1980s (though too quietly for anyone outside academia to notice). In the 1970s Milton Friedman and Robert Lucas argued that recessions happened because workers and firms mistook general falls in demand for falls in the demand for their specific labour or products; Keynesian macroeconomic policies tended only to add to the confusion, thus delaying recovery. Against this, Krugman insists that the 1980s and early 1990s showed that recessions can linger even when everyone is fully aware of what's happening — thus paving the way for the return of Keynes. He himself espouses the 'New Keynesian' argument that untreated recessions can persist because price rigidity reflects behaviour that is sensible, if not perfectly rational in a textbook sense.

Krugman thinks that the good things of the 1980s happened despite Reaganomics, and the bad things mainly because of it. The Fed, in Keynesian mode, is given the credit for the recoveries of 1982 and 1992, and for the low inflation throughout the 1980s. Reaganomics is awarded some of the blame for the sluggish productivity growth of the period, and much of the blame for the growing income inequalities, which, according to Krugman, involved actual falls in the income of the poor. (On the other hand, Krugman thinks that the big budget deficits of the period were not as harmful as widely supposed.) The recent revival of America's productivity growth is noted but not attributed to anyone's policies.

Margaret Thatcher also comes in for a pasting, but here Krugman is less sure-footed. The privatisation of Britain's monopoly utilities has involved mistakes, but to write it off as 'disastrous' (p.172) seems careless in view of the worldwide imitation of the process. The attack on Britain's monetarist experiment of 1981-86 is sounder. But even here Krugman overlooks the fact that, although unemployment was very high throughout, economic growth resumed in late 1981 some months after a savagely *deflationary* budget was brought down, in the teeth of a recession, so as to ensure that the budget deficit continued to shrink. Thatcher was surely right to back her own judgment and to ignore the 364 professors who signed the notorious post-budget letter in the *Times* foretelling imminent ruin.

Nor does Krugman acknowledge that Britain's unemployment rate has been kept higher than otherwise by *microeconomic* factors like trade union power, inflexible housing markets, and unemployment traps. But then, microeconomic factors play only a small role in the book in general. For example, in summarising a range of explanations for sluggish productivity growth, Krugman ignores the highly relevant work of Mancur Olson, who argues in *The Rise and Decline of Nations* (1982) that economic growth tends to slow under conditions of political stability as 'distributional coalitions' form to take advantage of rent-seeking opportunities, an activity that displaces productive effort. The truth is that we know more about how to restore growth to a sluggish economy than Krugman wants to admit. The current high growth rates in New Zealand and Thailand, for example, must be more than a matter of luck.

Yet New Keynesian theory need not rule out technical and institutional changes and microeconomic policies that increase the scope and incentives for prices to adjust promptly to changing circumstances. This point brings us to the unresolved dilemma at the heart of Krugman's analysis. Krugman wants governments to have the discretion necessary to implement Keynesian macroeconomic policies. Yet governments exercising such discretion are vulnerable to capture by policy entrepreneurs. It is Krugman's failure to confront the dilemma that renders his final section, on 'The Role of the Economist', such a let-down. After recognising that good ideas will 'often lose to convenient nonsense', he concludes by noting feebly that 'In the long run we are all dead, but one must have faith that good ideas live on' (p.292). But if policy were more rule-governed, the scope for 'convenient nonsense' would shrink, while the loss of macroeconomic discretion could be balanced by a greater effort to make markets work well.

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