

# Elaborating on Rationality

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## Three Influences

There are three primary sources of inspiration for GEM Project. First, and foremost, is the extraordinary body of work by the first-generation Internal-Labor-Market (ILM) theorists, notably including Clark Kerr, John Dunlop, Richard Lester, Lloyd Reynolds, Frederick Harbison, Charles Myers, and Arthur Ross, who dominated mainstream American labor economics during the middle 20<sup>th</sup> century. Kerr identified the school's objective: to use their neoclassical training to study "real-world" labor behavior, a good deal of which occurs inside large firms. They pioneered the analysis of workplaces restricted by asymmetric information.

Early ILM scholars modeled objectives informed by close observation of employee preferences, relevant constraints rooted in modern technology, and management-constructed mechanisms of exchange. They emphasized the central role of reference standards in rational behavior and were close to providing an early solution to debilitating labor-related deficiencies characteristic of market-centric economics. They uncovered the facts but ultimately failed to construct a consistent theory of workplace behavior and were increasingly pushed outside the neoclassical mainstream. For me, Harbison's graduate labor seminar at Princeton was seminal and provided bedrock analysis for a lifetime of research and application of macroeconomics.

Second is Robert Solow, my colleague at MIT and co-founder of the original efficiency wage theory. That variant sought to microfound meaningful wage rigidity by modeling optimizing exchange inside firms restricted by costly, asymmetric workplace information, confronting the need for an economic theory of employee behavior that goes beyond the convenient totems of perfect supervision and the dominating desire to shirk on the job. Solow has long been the profession's biggest, most insistent voice that modern theorists must not ignore the keystone role of MWR in their analysis of macro instability. He has, as a result, been the most robust guardian of the trust between macroeconomists and stabilization policymakers carefully cultivated by Early Keynesians and badly damaged by market-centric New Keynesian thinking.

The third influence results from a powerful presence who, from another perspective, has been equally insistent that macroeconomics be practiced the right way. Robert Lucas has long insisted that modeling must be rooted in rational exchange organized around continuous general equilibrium. I resisted his message for too long, and the GEM Project is greatly indebted to the commanding force with which he made his case, despite the inherent limitations of working within the market-centric mainstream framework.

Moreover, to his credit, his more mature work appears to recognize many of those limitations. From Lucas (2001, p.5): "The construction of theoretical models is our way to bring order to the way we think about the world, but the process necessarily involves ignoring some evidence or alternative theories—setting them aside. That can be hard to do—facts are facts—and sometimes my unconscious mind carries out the abstraction for me: I simply fail to see some of the data or some alternative theory. This failing can be costly and embarrassing to me, but I don't think it has any effect on the advance of knowledge. Others will see the blind spot ... [and] keep what is good and correct what is not."

## Rational Behavior

Last week's post was hard on Lucas. It drew attention to the irony of his headline contribution to macro theory, the rational-expectations Phillips curve, being inconsistent with rational behavior. I argued that its inherent irrationality was the reason why his Phillips interpretation is incompatible with crucial macro evidence. The GEM Project's rational-arrangement Phillips curve is consistent both with rationality and with the relevant evidence. It is clearly the superior reduced-form model of short-term nominal wage determination.

But the GEM correction does not imply the Lucas's larger point, the centrality of rational behavior in useful macro theory, is also wrong. It is not, leading to an important point. Many macroeconomists, who would be expected to approve of the Early Keynesian revival produced by the GEM Project, are turned off by its maintenance of the rigor provided by rational behavior. One of today's best-known economists, whom I admire, illustrates the criticism. From Paul Krugman's 2009 *New York Times Magazine* essay, *How Did Economists Get It So Wrong*: "As I see it, the economics profession, as a group, mistook beauty, clad in impressive-looking mathematics, for truth.... Unfortunately, this sanitized vision of the economy led most economists to ignore all

the things that can go wrong. They turned a blind eye to limitations of human rationality that often lead to bubbles and busts; to the problems of institutions that run amok; to the imperfections of markets - especially financial markets - that can cause the economy's operating system to undergo sudden, unpredictable crashes; and to the dangers created when regulators don't believe in regulation."

I mostly sympathize with Krugman, especially his criticism of the mainstream macro model and the related over-emphasis on mathematics. (Next week elaborates on the mathematics problem.) But this antipathy to rational-behavior modeling is way off-base.

Had Krugman explained the mainstream failure to be useful in the Great Recession as resulting from the near universal, intuitively erroneous assumption that all interesting exchange occurs in the marketplace, his passionate analysis of the problems of consensus macro thinking would have also been insightful. However, his scatter-gun elaboration of mainstream ills, divining an important causal role in the 2008-09 extreme instability to limitations of human rationality is both shallow and misleading.

The GEM Project uses, and vigorously defends, the economic methodology of optimizing, price-mediated exchange organized by continuous general decision-rule equilibrium. The most powerful argument supporting rationality to motivate behavior is thinking through the alternatives. Irrationality, the replacement that comes most quickly to mind, is not a viable option. Other virtues of the rational-behavior theory include its clarity and persuasive power, as well as the capacity to systematically interpret evidence, to distinguish among competing theories, and to explain and anticipate important economic phenomena. The approach unsurprisingly enjoys special status in the support of government, business, and investor decision-making.

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