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Chicago Economics on Trial

Nobel-winning economist Robert Lucas on the high cost of the welfare state, why he voted for Barack Obama, and how Milton Friedman changed his life.

By HOLMAN W. JENKINS, JR.

Let's face it, the "Chicago School" of economics—the one with all the Nobel Prizes, the one associated with Milton Friedman, the one known for its trust of markets and skepticism about government—has taken a drubbing in certain quarters since the subprime crisis.

Sure, the critique depends on misinterpreting what the word "efficient" means, as in the "efficient markets hypothesis." Never mind. The Chicago school ought to be roaring back today on another of its great contributions, "rational expectations," which does so much to illuminate why government policy is failing to stimulate the economy back to life.

Robert E. Lucas Jr., 74, didn't invent the idea or coin the term, but he did more than anyone to explore its ramifications for our model of the economy. Rational expectations is the idea that people look ahead and use their smarts to try to anticipate conditions in the future.

Duh, you say? When Mr. Lucas finally won the Nobel Prize in 1995, it was the economics profession that said duh. By then, nobody figured more prominently on the short list for the profession's ultimate honor. As Harvard economist Greg Mankiw later put it in the New York Times, "In academic circles, the most influential macroeconomist of the last quarter of the 20th century was Robert Lucas, of the University of Chicago."

Mr. Lucas is visiting NYU for a few days in early September to teach a mini-course, so I dash over to pick his brain. He obligingly tilts his computer screen toward me. Two things are on his mind and they're connected. One is the failure of the European and Japanese economies, after their brisk growth in the early postwar years, to catch up with the U.S. in per capita gross domestic product. The GDP gap, which once seemed destined to close, mysteriously stopped narrowing after about 1970.

The other issue on his mind is our own stumbling recovery from the 2008 recession.

For the best explanation of what happened in Europe and Japan, he points to research by fellow Nobelist Ed Prescott. In Europe, governments typically commandeer 50% of GDP. The burden to pay for all this largess falls on workers in the form of high marginal tax rates, and in particular on married women who might otherwise think of going to work as second earners in their households. "The welfare state is so expensive, it just breaks the link between work effort and what you get out of it, your living standard," says Mr. Lucas. "And it's really hurting them."


Terry Shoffner

Turning to the U.S., he says, "A healthy economy that falls into recession has higher than average growth for a while and gets back to the old trend line. We haven't done that. I have plenty of suspicions but little evidence. I think people are concerned about high tax rates, about trying to stick business corporations with the failure of ObamaCare, which is going to emerge, the fact that it's not going to add up. But none of this has happened yet. You can't look at evidence. The taxes haven't really been raised yet."

By now, the Krugmanites are having aneurysms. Our stunted recovery, they insist, is due to government's failure to borrow and spend enough to soak up idle capacity as households and businesses "deleverage." In a Keynesian world, when government gooses demand with a burst of deficit spending, the stick figures are supposed to get busy. Businesses are supposed to hire more and invest more. Consumers are supposed to consume more.

But what if the stick figures don't respond as the model prescribes? What if businesses react to what they see as a temporary and artificial burst in demand by working their existing workers and equipment harder—or by raising prices? What if businesses and consumers respond to a public-sector borrowing binge by becoming fearful about the financial stability of government itself? What if they run out and join the tea party—the tea party being a real-world manifestation of consumers and employers not behaving in the presence of stimulus the way the Keynesian model says they should?

Mr. Lucas and colleagues in the early 1960s were not trying to undermine the conventional prescriptions when they began to think about how the public might respond—possibly in inconvenient ways—to signals about government intentions. As he recalls it, they were just trying to make the models work. "You have somebody making a decision between the present and the future. You get a college degree and it's going to pay off in higher earnings later. You make an investment and it's going to pay off later. Ok, you can't do that without this guy taking a position on what kind of future he's going to be living in."

'If you're going to write down a mathematical model, you have to address that issue. Where are you supposed to get these expectations? If you just make them up, then you can get any result you want."

The solution, which seems obvious, is to assume that people use the information at hand to judge how tomorrow might be similar or different from today. But let's be precise, not falling into the gap between "word processor people" and "spreadsheet people," as Mr. Lucas puts it. Nothing is *assumed*: Data are interrogated to see how changes in tax rates and other variables actually influence decisions to work, save and invest.

Mr. Lucas is quick to credit the late John Muth, who would later become a colleague for a while at Carnegie Mellon, with inventing "rational expectations." He also cites Milton Friedman, with whom Mr. Lucas took a first-year graduate course.

"He was just an incredibly inspiring teacher. He really was a life-changing experience." Friedman, he recalls, was a skeptic of the Phillips curve—the Keynesian idea that when businesses see prices rising, they assume demand for their products is rising and hire more workers—even if the real reason for higher prices is inflation.

"Milton brought this [Phillips curve] up in class and said it's gotta be wrong. But he wasn't clear on why he thought it was wrong." In his paper for Friedman's class, Mr. Lucas remembers reaching for a very rudimentary notion of expectations to try to explain why the curve could not operate as predicted.

Growing up in the Seattle area, Mr. Lucas recalls a road trip he took as a youngster that terminated in Chicago, a city with two baseball teams! Chicago, in his mind, became "the big city," a gateway to a wider world. That, and a scholarship, is how he would end up spending most of his career at the University of Chicago.

We are sitting in an inauspicious guest office at NYU. A late summer sprinkle dampens the city. Mr. Lucas describes his parents as intelligent, reading people, neither of whom finished college—he suspects the Great Depression had something to do with it. "They got into left-wing politics in the '30s, not really to do anything about it, but to talk about. That was our background—me and my siblings—relative to our neighbors and relatives, who were all Republicans." In a community not noted for its diversity, his parents were especially committed to civil rights, his mother giving talks on the subject.

I ask about a report that he voted for Barack Obama in 2008, supposedly only the second time he had voted for a Democrat for president. "Yeah, I did. My parents are dead for a long time, but my sister says, 'You have to vote for Obama, for what it would have meant for Mom and Dad.' I felt that too. It's a huge thing. This [history of racism] has been the worst blot on this country. All of a sudden this charming, intelligent guy just blows it away. It was great."

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A complementary consideration was John McCain's inability to say anything cogent about the financial crisis then engulfing the nation. "He didn't have a clue about the economy. I just assumed the guy [Obama] could do it. I thought he was going to be more Clinton-like in his economics and politics. I was caught by surprise by how far left the guy is and how much he's hung onto it and, I would say, at considerable cost to his own standing."

Refreshing, even bracing, is Mr. Lucas's skepticism about the "deleveraging" story as the sum of all our economic woes. "If people start building a lot of high-rises in Chicago or any place and nobody is buying the units, obviously you're going to shut down the construction industry for a while. If you've overbuilt something, that's not the problem, that's the solution in a way. It's too bad but it's not a make-or-break issue, the housing bubble."

Instead, the shock came because complex mortgage-related securities minted by Wall Street and "certified as safe" by rating agencies had become "part of the effective liquidity supply of the system," he says. "All of a sudden, a whole bunch of this stuff turns out to be crap. It is the financial aspect that was instrumental in the meltdown of '08. I don't think housing alone, if it weren't for these tranches and the role they played in the liquidity system," would have been a debilitating blow to the economy.

Mr. Lucas believes Ben Bernanke acted properly to prop up the system. He doesn't even find fault with Mr. Obama's first stimulus plan. "If you think Bernanke did a great job tossing out a trillion dollars, why is it a bad idea for the executive to toss out a trillion dollars? It's not an inappropriate thing in a recession to push money out there and trying to keep spending from falling too much, and we did that."

But that was then. In the U.S. at least, the liquidity problems that manifested themselves in 2008 have long since been addressed. To repeat the exercise now with temporary tax and spending gimmicks is to produce the opposite of the desired effect in consumers and business owners, who by now are back to taking a longer view. Says Mr. Lucas: "The president keeps focusing on transitory things. He grudgingly says, 'OK, we'll keep the Bush tax cuts on for a couple years.' That's just the wrong thing to say. What I care about is what's the tax rate going to be when my project begins to bear fruit?"

Mr. Lucas pulls up a bit when I ask him what specific advice he'd give President Obama (this is before Mr. Obama's two back-to-back speeches, one promising temporary tax cuts and the other permanent tax hikes, which mysteriously fail to levitate the economy). Unlike many of his colleagues, Mr. Lucas has not spent stints in

Washington advising politicians, or on Wall Street cashing in on his Nobel laureate reputation. "No, that doesn't interest me at all," he says. "Now I've taken a salary cut. I don't go to faculty meetings. I don't teach undergraduates. I just write papers. It's great. I feel lucky about this."

Still, an answer comes. Mr. Lucas launches into a brisk dissertation on the work of colleagues—Martin Feldstein, Michael Boskin, others—whom he credits with disabusing him and fellow economists of a youthful assumption that taxes have little effect on the overall amount of capital in society. A lesson for Mr. Obama might be: If you want to stimulate growth in investment, productivity and income, cut taxes on capital.

Alas, don't look for this idea to feature in the next Obama speech on the economy, due any minute now.

Mr. Jenkins writes the Journal's Business World column.