

**Opinions****The value and limits of economic models****By Steven Pearlstein** November 13 at 3:17 PM

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**ECONOMICS RULES****The Rights and Wrongs of the Dismal Science**

By Dani Rodrik

Norton. 253 pp. \$27.95

The alleged failings of economics are now widely understood, except perhaps by economists themselves. You hear that economics is ideology masquerading as hard science. That it has become overly theoretical and mathematical, based on false or oversimplified assumptions about the ways real people behave. That it systematically misunderstands the past and fails to anticipate the future. That it celebrates selfishness and greed and values only efficiency, ignoring fairness, social cohesion and our sense of what it is to be human.

In his latest book, "Economics Rules," Dani Rodrik tries to bridge the gap between his discipline and its skeptics, laying out in an accessible and compelling way the strength and foibles of economics. Although he is respectful of his colleagues and their work, he pulls no punches in exposing the profession's intellectual blind spots, arrogance and pretensions. His book should be required reading for all economics majors and graduate students.

As an economist, Rodrik is no slouch. A Harvard professor with a PhD from Princeton, he is best known for his work on the economics of developing countries, including two popular books that take a critical view of globalization. He recently finished a two-year stint at the Institute for Advanced Study, the prestigious research center in Princeton whose most famous alumnus is Albert Einstein. His work has been supported by the Carnegie, Ford and Rockefeller foundations.

Rodrik begins the book by explaining and defending economic models, the building blocks of economic understanding. There are very simple models, like David Ricardo's famous one about a world where there are only two countries (England and Portugal) and only two goods (wool and wine), which he used to demonstrate that both countries are made better off by specializing in the one good in which they have a "comparative advantage" and trading for the other. And then there are those big, complex computer models, built on hundreds of mathematical equations, which try to capture the interactions of an entire modern economy. Those are the models used to make economic forecasts or predict the effect of a tax cut or an interest-rate increase on employment or prices.

It is easy to mock the unrealistic assumptions that underlie all such economic models. Anyone can see that there are more than two goods and two countries, as in the case of Ricardo's model, but from it comes a powerful insight about how specialization and trade make everyone better off than if countries try to do everything themselves. And while everyone knows that people are not always rational, that market competition is not always perfect, and that market prices often fail to capture all the social costs and benefits associated with a transaction, those and other simplifying assumptions are often necessary to reduce the complexity of economic interaction to a manageable intellectual construct. Just as a scientist in a laboratory manipulates the environment to see what happens to a cell or a piece of rock under certain conditions, Rodrik explains, an economist uses models to test hypotheses and insulate, isolate and identify economic cause and effect.

"Models are never true; but there is truth in models," he writes. "We can understand the world only by simplifying it." The problem, he says, comes when, having gained a particular insight into the way the economy works, economists forget about all the simplifying assumptions they made and begin to believe that their model actually describes reality. What start out as narrow insights morph into broad generalizations or universal truths (trade is always good, taxes are always bad). Or as Rodrik describes it, economists begin to mistake "a model for *the* model, relevant and applicable under all conditions."

Rodrik cites the example of deregulation and privatization, which generally produce a stronger economy when undertaken by an advanced economy. But as the recent experience of Russia demonstrates, introducing those policies into a country that does not have a strong foundation of the rule of law can result in a kleptocracy run by corrupt and politically connected oligarchs.

Similarly, there are economic models showing that allowing capital to flow freely across borders could help developing countries without lots of domestic savings make crucial investments in infrastructure and education. But as it turns out, in developing countries that lack effective banking systems and stock markets, free-flowing global capital can also result in speculative bubbles, debt-fueled consumption and overvalued currency that leaves them worse off. Think Thailand and Indonesia in the 1990s, or more recently Brazil.

Industrial policy has proved disastrous when practiced in South America and has shown mixed results in Europe and India. But in Japan, South Korea and China, the skillful use of protective tariffs, currency manipulation, and government ownership and subsidies has produced economic miracles.

What economists forget, Rodrik says — or even worse, what they never are taught — is that the answer to most important questions is "It depends." What's right for one country at one time may not be right for another country or another time. Context matters. And because context matters, he argues that too much of the focus in economics has been on developing all-encompassing models and grand theories that can be applied to every context, and too little on expanding the inventory of more narrowly focused models and developing the art of knowing which ones to use. As the philosopher Isaiah Berlin might have put it, Rodrik thinks economics could use more practical "foxes" who know lots of little things and fewer ideological "hedgehogs" who know only one big thing.

While Rodrik no doubt set out to offer an evenhanded view of modern economics, in the end he winds up delivering a fairly devastating critique. "The discipline hobbles from one set of preferred models to another, driven less by evidence than by

fads and ideology,” he writes. He despairs that his profession has become one that values “smarts over judgment,” has disdain for other disciplines and is content to produce mathematically elegant research papers that few outside the guild will ever use or understand. The standard economics course offered to undergraduates, he rightly complains, winds up presenting nothing more than “a paean to markets” rather than a “richer paradigm of human behavior.”

Rodrik’s plea is for economics to be practiced with a bit more humility both by those who extol free markets and those who would tame them. Economics, he argues, is less a hard science capable of producing provable truths than a set of intuitions disciplined by logic and data and grounded in experience and common sense.

It was John Maynard Keynes, arguably the greatest economist of his generation, who once quipped, “If economists could manage to get themselves thought of as humble, competent people on a level with dentists, that would be splendid.”

Decades later, Keynes’s friend and intellectual rival, Friedrich Hayek, used the occasion of his Nobel lecture to deliver a similar plea for humility: “The curious task of economics is to demonstrate to men how little they really know about what they imagine they can design.”

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Steven Pearlstein is a business and economics columnist who writes about local, national and international topics.

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