

OTHER THINGS EQUAL

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Schelling's Five Truths of Economics

A while ago I was at a conference in Sweden, in a splendid hotel far up the lakes from Stockholm, during a warm summer like an Ingmar Bergman movie. A number of American economists I admire were at the conference, the economic historians Douglass North and Bob Fogel, for example, and Tom Schelling. As an undergraduate in the early 1960s I had *not* taken Schelling's pioneering course in game theory. Students are like that, tasteless, because they are ignorant. The list of courses from great economists that I ignorantly spurned is long and embarrassing: Galbraith's course on industrial structure, Leontief's course in graduate price theory, Kuznet's course in national income statistics, Haberler's course in international trade, Solow's course up the street at MIT in anything at all. It's why I am not *laissez faire* in matters of curriculum. By definition and by empirical test the student/consumers are too ignorant to select optimally.

Anyway, I was acquainted with Schelling but had never been his student. So I had not heard his amazing proposition about economics and accounting.

At the Swedish conference he told the story of a visit to Yale in the 1950s of Peter Bauer, already then a distinguished economist whose opinions were to be believed. Bauer asserted mysteriously that an economist knew only five things — this is, really, truly knew, as against what one might be willing to publish in the *American Economic Review* or think vaguely plausible when the moon was new. Schelling, a nervous assistant professor at the time, did not get around to asking Bauer which five things he was thinking of, so had to reconstruct them himself.

Schelling figured out that what economists really, truly know, and non-economists do not, are matters of accounting. (1) The national accounts add up, national product equalling national income. (2) The balance of foreign payments adds up, too. (3) The money supply is "created" by a system of banks in which each holds as a reserve only a fraction of the money deposited with it (this one was discovered by Chester Phillips of the University of Iowa in the 1920s). The fourth and fifth of the Truths consist of a couple of demographic truths of accounting, which might be illustrated with the growth of the unmarried population be exactly two when a husband and wife get a divorce.

These are the few things an economist would be willing to stand before God and declare to the True. Learning to think like an economist, Schelling argues, consists in good part of learning to speak such bits of accounting logic. As Adam Smith said in the first sentence of *An Enquiry into the Nature and Causes of the Wealth of Nations*, where he announced the Truth that national income equals national product equals national expenditure, "The annual labour of every nation is the fund which originally supplies it with all the necessaries and conveniences of life which it annually consumes."

Schelling's proposition is not likely to thrill most economists. They reckon they are quite a lot smarter than their colleagues in the Department of Accounting, who do not deal with Deep Behavioral Propositions such as $Q_D = D(P)$ or $Max U$ s.t. $B = 0$. The trend

in academic accounting, actually, is to remake the field into economics of the *Max U* sort. Like political scientists and some sociologists the accountants are econowannabes.

But when you get inside an economic argument you are likely to bump into accounting. Schelling himself provides an example in his eye-opening little book, *Micromotives and Macrobehavior* [1978]. To quote the blurb, "brake lights flash, cars slow down, traffic crawls. An accident has occurred in one of the *outbound* lanes. Why is it the *citybound* traffic jams up? Drivers have reduced their speed to get a glimpse of the wreckage on the other side of the divider. Each driver pays ten seconds for his own look and nine minutes, fifty seconds for the curiosity of the drivers ahead of him." Schelling's argument is crucial to understanding the externalities of congestion. The behavioral premises are trivial. So is the accounting: each driver pays for the cumulated time spent by each person ahead of him in the queue. But the economics is startling, first-rate stuff, one way that economics makes progress.

Schelling and I are claiming that if you examine important economic arguments you will find nine times out of ten an accounting identity overlooked by the man in the street, or even by the economist in the study. Take Marty Feldstein's point about the way Social Security pushes the saving rate down. Any economist knows there's something in it. Set aside the controversy about the magnitude of the effect. Surely we as economists know — really, truly know, if we know anything — that private saving for one's old age is fungible with public saving for the same purpose. Maybe it's not perfectly fungible, but no economist worthy of the name will assume unthinkingly that the presence of Social Security has *no* effect of reducing people's saving for their old age. It's right there in the accounting. A pension from the government is an asset, too.

The identical point is involved in the long-running controversy over the burden of the government debt. (By the way, why haven't economists complained about its treatment in political discussions recently? The men and women in the street, and in Congress, don't get the accounting even roughly straight.) Bob Barro's point long ago was that if the public had an ounce of accounting common sense it would see that the interest on a government bond is matched by some nasty liabilities down the road called "taxes". That's what the empirical dispute is about: do people have an ounce of accounting sense?

It's hard to find an economic argument of any importance that is not dominated by a more or less tricky point in accounting. At any rate the point will be tricky enough to elude most economists until some other economist notices it. The first generation of economists with formal training in graphical analysis thought that they could prove on a blackboard that society would be better off if we prevented speculators from smoothing prices. The consumers preferred varying prices in good and bad years, in the way that people prefer sales in clothing stores: they buy more when the price is low, and gain on balance from the varying price. The proposition was taken seriously, a new theorem. Then Paul Samuelson pointed out that the accounting was wrong. To be sure, if some "outside Santa Claus," as Samuelson put it, could be found to buy high and sell low, against his self-interest, then the consumers for their part would be enriched by varying prices. But if you do the accounting correctly the enrichment of the consumers is more than outweighed by the impoverishment of producers and speculators. For the consolidated accounts, stable prices are better.

In the same spirit and at about the same time it was announced that income taxes could be proven on a blackboard to be superior to excise taxes. Such were the products of the first generation of formalists in economics. Almost immediately, however, I.M.D.

Little and Milton Friedman, separately, made the point that the accounting was wrong. The alleged superiority, it turned out, came from assuming that the society could violate its budget constraint. Another outside Santa Claus shot down by an accountant.

Everywhere you look in economics you find a balance sheet or an income statement or a convention about the value of housewives' time staring you in the face. Seeing the burden of inflation, for example, depends on a close accounting. It is not the case, as the newspapers assert, that everyone is hurt by inflation. A crude accounting would note that every dollar expended in higher prices ends up a dollar on the income side. So much for people being hurt on average. But wait, said Phillip Cagan: the account is not quite complete; look at the balance sheets, too. The holder of dollar bills is hurt by inflation, even if he is better off on some other account. Early and late, it was an accounting argument.

The untangling of mistaken or incomplete accounting has been one of the chief activities of late 20th-century economists. The IS-LM curves, for instance, were invented in 1939 by Hicks as a rough-and-ready summary of Keynes's theory of national income. But the idea is defective accounting, as Hicks himself was later to point out: it mixes up capital accounts in the LM curve with income-expenditure accounts in the IS curve, as it had to if it were going to represent Keynes's muddled insight. The theorists of macroeconomics have spent much of the next fifty years attempting to repair the accounting.

Likewise, Ronald Coase's "theorem" of 1960 was merely a careful accounting of the costs and benefits from pollution. His point is routinely misunderstood to be that if property can move around easily then it will get into the hands of the people who value it the most; if not, not. Such a proposition should be called rather Adam Smith's or Edgeworth's or Arrow's Theorem, and is the opposite of what Coase thinks the world is like. Coase's real contribution, as he has argued, was the accounting framework imposed, in explicit contrast to an earlier accounting by Pigou and Samuelson. Coase says, in effect, "You have been accustomed to accounting the smokestacks as the 'cause' of pollution, and therefore assuming automatically that they deserve to pay fines. Has it occurred to you that one might just as well account the breathers of the polluted air as *the* cause? And that leaving the pollution on the breathers might lead to the cheapest avoidance of the evil, when indeed it should be viewed on balance in the social accounts as an evil?"

The notion of "human capital," invented by Theodore Schultz, is nothing more than an agreement to account human skills the same way that plant and machinery is accounted. In 1946 Schultz spent a term based at Auburn University interviewing Alabama farmers in the neighborhood. One day he interviewed an old and poor farm couple and was struck by how contented they seemed. Why are you so contented, he asked, though poor? They answered: You're wrong, Professor. We're not poor. We've used up our farm to educate four children through college, remaking fertile land and well-stocked hog pens into knowledge of law and Latin. You can see that we're rich. The parents had informed Schultz that the *physical* capital, which economists think they understand, is in some sense like the *human* capital of education. The sense is accounting.

We economists spurn accounting — another course I never took. But we end up reinventing it. Maybe we should study the subject a little, or at least make our students learn it. After all, it's what we Really, Truly Know.

Other Things Equal, a column by Donald N. McCloskey, appears regularly in this *Journal*.