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How Economists Should Respond to Trumpian Disdain for Experts

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Abstract

The models that the economics profession considers acceptable, particularly their assumptions regarding the precision with which we can know the future, create insuperable obstacles to formulating a rational response to the disdain for experts that President Donald Trump nourishes and exploits. This becomes clear from a critical discussion of the use of prevailing models to analyze the consequences of the 2017 tax overhaul. The profession would benefit from a novel approach, applied here to understanding stock-price movements, that recognizes that economists—like everyone else—face unforeseeable change about the future. Acknowledging the inherent limits of what we can know about the future would go a long way toward restoring public trust in what economists' knowledge can actually contribute to policymaking.

This paper addresses two issues concerning the consequences of Donald Trump's presidency for the economics profession.¹ The first is how economists have responded to Trump's irrational attacks on so-called experts. The second is how we can rationally assess the economic consequences of his policies.

To address either question requires considering the currently prevailing methodology in macroeconomics and finance theory. My main point is that the class of models the profession considers acceptable, particularly the assumptions we make regarding the precision with which we can know the future, have important implications for public debate, the credibility of our expertise, and assessments of the consequences of Trump's economic policies.

At a campaign rally in La Crosse, Wisconsin, on April 4, 2016,² Trump declared his disdain for those on whom our society depends to gather and interpret the facts that voters and policymakers need to make informed decisions:

“You know, I've always wanted to say this—I've never said this before with all the talking we all do—all of these experts, ‘Oh we need an expert.’ The experts are terrible.”

Since Trump became president, it has become a cliché that he is zealously attempting to reshape public discourse and policymaking to conform to his belief that any interpretation of facts that contradicts his own—no matter how well reasoned—is “fake news.” Trump has urged his infatuated supporters to replace rational thinking with his “alternative facts” and his “true” interpretations of them.

Administration officials have followed Trump in pronouncing on the “true” consequences of the policies they propose. Nowhere has this been more evident than in the debate surrounding the tax cuts enacted at the end of 2017. As the *New York Times* reported, Treasury Secretary Steven Mnuchin repeatedly asserted that the \$1.5 trillion tax overhaul would pay for itself through a surge of economic growth, and that one hundred people in Treasury were “working around the clock on running scenarios for us.”³

In the event, Treasury produced no analysis of the impact of the tax overhaul on the fiscal deficit. Mnuchin's pronouncements that the tax bill would pay for itself turned out to be another test of the well-worn propaganda tactic that repeating an unfounded assertion

¹ This paper was prepared for the 16th Annual Conference, Center on Capitalism and Society, Columbia University, September 17, 2018.

² Nick Gass, “Trump: ‘The experts are terrible,’” *Politico*, April 4, 2016, <https://www.politico.com/blogs/2016-gop-primary-live-updates-and-results/2016/04/donald-trump-foreign-policy-experts-221528>.

³ Alan Rappeport, “Ahead of Vote, Promised Treasury Analysis of Tax Bill Proves Elusive,” *The New York Times*, November 30, 2017, <https://www.nytimes.com/2017/11/30/us/politics/treasury-analysis-tax-bill.html>.

often enough turns it into “truth.”

Economists, both those supporting and opposing the Trump administration’s plan, have injected some rationality into the tax debate. In a series of commentaries prepared for *Project Syndicate*, for example, both sides produced precise projections of the effects of the bill on economic growth and discussed those projections in ways accessible to the broader public.⁴

This debate exemplifies the current approach to economic analysis of the consequences of policies such as the tax bill. To carry out such analyses, economists typically rely on standard macroeconomic models, such as the stochastic Penn-Wharton overlapping generations model.⁵

Like any economic model, OLG models formalize an economist’s understanding of the growth process. Because economists’ understanding of this process summarizes the accumulated wealth of empirical and theoretical insights, standard macroeconomic models are based on what we usually refer to as ‘rational considerations.’

Mischaracterizing the Future

The problem with such models is that, as Karl Popper argued long ago, “Quite apart from the fact that we do not know the future, the future is objectively not fixed. The future is open: *objectively* open” (emphasis added).⁶ Standard macroeconomic models, however, assume that the future is objectively closed. They dispense with what Frank Knight referred to almost a century ago as “true uncertainty,” which arises from unforeseeable change.⁷ As Knight defined it, such change cannot be characterized in advance with probabilistic rules, and its consequences for market outcomes cannot be fully comprehended—even in hindsight.

The consequences of historical events, such as a \$1.5 trillion tax cut, are clearly unforeseeable in Knight’s sense. At the time the tax bill was enacted, there were simply no past data to specify a stochastic model that would predict *ex ante* the timing and magnitude of the tax changes’ impact on the economy’s growth path. Neither Treasury economists nor anyone else could have predicted precisely the future consequences of the tax bill.

Like other standard macroeconomic models, conventional growth models rest on the core premise that the consequences of tax changes can be characterized precisely as a

⁴ See Barro 2017, and Furman and Summers 2017.

⁵ See University of Pennsylvania, Penn Wharton, Budget Model, <http://budgetmodel.wharton.upenn.edu/faq/#purpose-and-use>.

⁶ Popper 1990, 18.

⁷ Knight 1921, 321.

random deviation around a deterministic growth path over a period as long as ten years.⁸

Importantly, once an economist assumes that he can represent the growth process precisely—in probabilistic terms—he effectively assumes that he can compute the consequences of the tax bill precisely. Moreover, the individual rationality that such predictions presume distorts the usual meaning of the term.⁹

In a recent paper, Frydman et al. (2018) show that, whenever an economist formulates a model that assumes away Knightian “true uncertainty,” he has no option but to assert that his *own* understanding represents precisely how *every* rational individual understands and forecasts outcomes.

In the context of predicting the tax overhaul’s consequences, this assertion takes a striking form. By assuming away unforeseeable change, the standard growth models hypothesize that future political developments will not lead to a reversal of the overhaul’s major provisions. Remarkably, these models also assume that if the economy’s participants are rational in how they make consumption, investment, and other decisions, they, like economists, will assume that the tax changes will remain the law of the land, essentially unchanged, indefinitely.

However, Frydman et al. (2018) show, by jettisoning precise predictions of market outcomes, economists could build models that recognize that rational individuals’ understanding of the economy is different from economists’ own understanding. This would enable economic analysis to recognize that the future is objectively open and that rational individuals will devise diverse ways to understand it.

Toward a New Methodology

Recognizing that economists face Knightian uncertainty and that market participants have autonomous understandings of future economic and political developments opens a new path to interpreting the consequences of Trump’s policies for future stock-price movements.¹⁰ My analysis draws on a novel mathematical framework for building macroeconomic and finance models, which my colleagues and I have developed to enable economists to recognize that they face Knightian uncertainty.

⁸ For a recent summary of rigorous arguments that standard growth models miss the essential aspects of the growth process, and how reliance on such models has distorted the public debate about the consequences of the recent tax bill, see Frydman and Phelps 2017.

⁹ According to the Merriam-Webster Dictionary, an individual is “rational [if he] has a latent or active power to make logical inferences and draw conclusions that enable [him] to understand the world about him and relate such knowledge to the attainment of ends.”

¹⁰ For an early argument that understanding how macroeconomic outcomes unfold over time requires recognizing that participants’ forecasts play an autonomous role in driving them, see Phelps 1970.

A commonly used metric to assess whether equity prices are too high, and whether the market is thus close to reversal, relies on the price-earnings ratio.

The table below presents two measures of this ratio, together with interest rates on 10-year government bonds, which are typically used to proxy “safe” alternatives to equities, for some of the main dates marking the 2008 crisis. The election of Barack Obama in 2008, his reelection in 2012, and the election of Trump in 2016 also are included.

Time line	S&P 500	Earnings	10-year P/E	12-month P/E	Long-term rates
Last month prior to onset of 2008 financial crisis: August 2008	1,401	53	20	20	3.69
Lehman Brothers collapse: Sept. 15, 2008	1,474	55	21	20	3.89
Barack Obama elected: Nov. 4, 2008	1,047	30	15	17	3.53
Barack Obama reelected: Nov. 6, 2012	1,526	94	21	16	1.65
Donald Trump elected: Nov. 8, 2016	2,260	96	27	25	2.14
March 2018	2,729	116	32	25	2.84

Source: Robert Shiller’s data set, http://www.econ.yale.edu/~shiller/data/ie_data.xls.¹¹

¹¹ Notes: All indices relative to 2000. March 2018 is the latest month to date for which comparable data are available. S&P 500 (P) = Inflation-adjusted index. Earnings = Inflation-adjusted aggregate earnings of the companies comprising the index. 10-year P/E ratio = S&P 500 Index divided by the 10-year moving average

A few points stand out. For starters, the 10-year P/E ratio has increased dramatically, despite rising interest rates during Obama's second term. Moreover, corporate earnings rose nearly 70% during the 2010-15 period of Obama's presidency. This sharp increase resumed after Trump's election, with corporate earnings rising nearly 20% over the 18-month period from November 2016 to March 2018. Finally, the 12-month P/E ratio shows the same tendency, though the increase is much more moderate.

These points suggest that, in addition to company earnings, a relatively strong autonomous expectational effect has been driving prices to rise faster than earnings, despite an upward interest-rate trend.

Does this (admittedly) cursory look at the evidence indicate a "Trump boom," in the sense that the election of Trump provided a strong positive boost to the market's optimism?

The market's extreme volatility in the months since the period covered by the table casts doubt on such optimistic assessments. It is too early to say, but thus far, the increase of the P/E ratio during Trump's tenure has been about the same as that during Obama's second term.

What does our theory say about future movements?

Although the 10-year P/E ratio is very high by historical standards—32, compared to 20 just before the onset of financial crisis—the 12-month ratio stands at only around 25. Given the expected increases in interest rates, our framework suggests two contingent predictions.

One possibility is that the economy will return to the earlier, less unequal distribution of income, and/or interest rates will rise, likely triggering the market's decline. The other is that regressive policies and stagnant wage growth will continue, thereby sustaining the bull market even in the face of higher interest rates. Remarkably, as of September 2018, market participants seemed to be forecasting the continuation of the regressive tendencies that began in the Obama era, even if Democrats gain the upper hand electorally.

The Necessity of Imprecision

The contingency of these predictions has implications for the debate regarding the impact of the 2017 tax legislation. In particular, it highlights the perils of relying on models that assume we can deliver precise predictions regarding the consequences of policies, such as a \$1.5 trillion tax overhaul.

The precision promised by such predictions, followed by their eventual inaccuracy,

of earnings. 12-month P/E ratio = S&P 500 Index divided by the 12-month moving average of earnings.
Long-terms rates = 10-year government bond interest rate.

owing to unforeseeable change contributes to voters' impression that economists' considerable knowledge and expertise about the way the economy works can be dismissed. Trump has skillfully exploited that impression to disguise his ignorance as "truth." Acknowledging the inherent limits of what we can know about the future would go a long way toward undermining demagogic claims that economists' expertise is useless and restoring public trust in what economists' knowledge can actually contribute to policymaking.

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