

The Defense of Economic Theory: Reply to Phillips

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In providing his opinions on game theory, Fred Phillips claimed that economic theory is not used because it has “ridiculous assumptions and dubious applicability.” I beg to differ, partly because I am a libertarian by philosophy – I have long believed that economic theory is useful and that it often produces conclusions that are surprising to those who do not believe economic theory. Many years ago, Julian Simon, another believer in economic theory, put me up to offer a forecasting challenge to Paul Samuelson and Milton Friedman. Julian and I thought that Friedman would win such a contest because he uses economic theory, whereas Samuelson allows sentiment to affect his judgment. Friedman was all for it, while Samuelson was not, so the contest never happened. Nevertheless, much empirical evidence exists. Clifford Winston provided a systematic comparison of economists’ forecasts of the effects of deregulation with those of non-economists. The public often perceives that deregulation is harmful to them, so the economists’ forecasts were at odds with those by non-economists – as was the case in Johnson's Great Society programs and the unification plan for East Germany. Winston reported a *Business Week* survey in 1988 showing that only 32% of the respondents thought the airline deregulation of 1987 was a good idea, whereas the economists predicted favorable outcomes. In evaluating the impact of deregulation, Winston relied on objective measures of the outcomes and these showed that deregulation was beneficial. The deregulation of airlines, railroads, trucking, telecommunications, cable TV, and banking led to economic gains of at least 8% in the parts of the GNP affected by the reforms. I provide a discussion of Winston’s study along with references at <http://fourps.wharton.upenn.edu/forecast/summary/winston93.html>

Additional evidence comes from studies of econometric methods. My review of empirical studies found that quantitative models based on economic theory provide an effective way to forecast, certainly compared to models based on methods that ignore economic theory. For example, theory-based econometric models were more accurate than stepwise regression models. These findings are reported in Chapter 15 in *Long-Range Forecasting* (in full text at <http://forecastingprinciples.com>)

I expect that data mining, another procedure that ignores economic theory, will also prove to be a fruitless quest.