CHAPTER 9

Summing Up

[It is my] belief that in the present period economics as a practical art is ahead of economics as a science.

—T. J. KOOPMANS.

Unless economics explains how the real economy works, it is not a science. Science is concerned with reality. To the extent that economics is a successful practical art it is, in fact, economic science. Empirical economists have often acquired a better understanding of the economy by dealing with the problems of the real world than can be gained from current economic theory. Economic theory can do better and secure a more effective grasp on the real economy by focusing on the real world. The National Bureau of Economic Research (NBER) organized a field project on sources of productivity change in industrial companies, and Martin Feldstein, president of NBER, reported rapturously on this unique venture into the real world:

When I have described this project to non-economists, they were invariably surprised that the process of visiting companies, looking at production, and asking questions is an unusual part of economic research. It seems like such a natural thing to do. But as economists all know, it is unusual. We economists are generally accustomed to getting our insights by reading economic literature, going to seminars, and thinking hard about problems. We elaborate these insights in more or less formal models and then sometimes test these theories with aggregate statistics or micro data.

But we rarely go and look and ask—I think that is a pity. Looking and asking provide insights and suggest hypotheses—and can shoot-down wrong ideas—in ways that go beyond introspection and reading. (2000, iii)

The lesson that to theorize about the real economy it is useful to actually look at it is one that I hope more theoretical economists will take to heart. As a first step and the first lesson after escaping from autism, it is necessary to accept that because of the difficulties inherent in all measurement and because economics is concerned with human adaptive and reactive activity it can never be precisely accurate. The best it can do, and it is sufficient, is to be roughly accurate.
Second, while economics can contribute to helping other social sciences in doing their job, economics also needs to call on the resources of other disciplines to help it understand the economy, for “the part of economics that is independent of history and social context is not only small but dull” (Solow 1997b, 54).

Finally, and this has been the main thrust of this book, in interfacing with the real economy theory needs to modify its fundamental assumptions to make them more realistic and it needs to discard the canonical and misleading hypothesis of “equilibrium,” replacing it with the more accurate and less polarized concept of “outcome”—which carries no baggage of the implication that it is necessarily desirable in itself, that it will persist, and that if disturbed it will reassert itself.

The economy is an adaptive and complex but not a stable, balanced, or unchanging system. There is no fixed point, no stable equilibrium, toward which the economy is moving or to which it returns when it is disturbed. Everything is in the process of change away from the present and toward an unknown future. Change is the very essence of the capitalist market system; it is not only the result but the engine that drives the system and the growth of the economy.

The self-centered self-interest of neoclassical theory, as a positive description and normative prescription, should be replaced with Adam Smith’s interpretation of self-interest as including regard for others. In addition to being affected by needs for food, shelter, sex, comfort, and enjoyment, human beings also crave recognition by others as being worthy of respect. People have various needs: to feel useful, to work toward an ideal, to avoid social shame, to live up to societal and community expectations, and to have prestige and power.

Human beings are more likely to be satisfied with acting “reasonably” (i.e., with bounded rationality, using rules of thumb, or satisficing) rather than driven by a maximizing hyper-rationality. Most transactions do not conform to the assumption of perfect rational maximization. The closeness of results in a transaction to perfect rational maximization, ceteris paribus, is likely to vary directly according to:

1. The size (or importance) of the stake
2. The degree of professionalism or specialization of the agent
3. The degree of impersonal relationships among the parties
4. The pressure of competition
5. The availability of useful, pertinent knowledge
6. The simplicity of the transaction
Beliefs as to how the economy works, herd psychology, and consumer and producer confidence all affect behavior and are crucial in influencing the way the economy works.

The market is a useful social and economic instrument, and its major, indispensable, and true contribution is as a means of collecting and disseminating information among its participants. This information is provided in the form of price signals or, if prices are not allowed to fluctuate freely, by the emergence of shortages or surpluses. The market is also a coordinating mechanism. As desires, technologies, and resources change, the market provides incentives to move resources to places where they are needed and from places where they are not.

Markets are social and historical constructs. The effective functioning of markets requires an orderly framework policed by the state or some other coercive power and a reasonable degree of implicit agreement among the participants on self-discipline and ethical behavior. Ethics are essential for a well-performing economy. Effective markets depend on the freedom of the individual to pursue self-interest as he or she wishes, but they also depend on a system of law and ethical and political systems that constrain people from pursuing self-interest too far or by antisocial methods. Ignoring this was one of the causes of Russia’s disastrous transition from a centrally planned economy.

Pure atomistic competition exists in reality only in agriculture (and not even perfectly there). Monopolistic competition or differentiated oligopoly, the search for economic rents, nonprice competition in product and factor markets, and long-term relations with workers, customers, and suppliers are all more accurately characteristic of the real world than the conventional model that assumes atomistic pure competitive markets and competitive firms with production functions of diminishing or constant returns to scale that operate in a world of perfect information. Because of imperfect and asymmetric information and inequalities in power and capabilities, market outcomes are not necessarily optimal or socially just.

This also graphically demonstrates that the pursuit of personal ends, contrary to an unvoiced assumption of economics, is not always to the benefit of society. People can choose to try to accomplish their ends by producing or, if they are in a position to do so, may use power to try to live off the productive contributions of others. Even in the most law-abiding society, transactions motivated by power take place and predators and parasites are present. The standard of living and the growth or decline of an economy are results of the work of the productive factors, on the one hand, and the destructive behavior of the predators and parasites on the other.
Economics wandered off into a quicksand when, denying that one cannot compare the utility or welfare of one individual with that of another, it concluded that therefore one cannot rank one social state above another. This leaves the possibility of taking actions that may make one person better off only as long as this does not make anyone else worse off. There are very few such possibilities. In order not to be totally useless, attempts to avoid this Pareto-limitation have suggested various strategies for compensation to be paid (actually or hypothetically) to losers. This whole imbroglio can be avoided by going back to the original classical focus on material welfare. We do not need try to compare the mental state of one person to that of another but rather whether A is richer or poorer than B in command over goods and services. If we need to tax Bill Gates to provide housing for the homeless in Seattle, we do not need to worry that the few millions he will lose will make him more unhappy than the happiness the homeless will derive from having a roof over their heads and some warmth in the Seattle winter. Finally, only on the material welfare basis do national accounts (income distribution statistics) make sense and can policy be made rationally.

The market cannot set national and social ends. Conscious human thought has to be involved. The modern global and national economies are so complex and the responsibilities unavoidably placed on the governing authorities are so exacting that economists, if they are to be useful, need to use every bit of knowledge that affects the economy in making their diagnoses and providing policy help.