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In this issue:

How should the collapse of the world financial system affect economics? *Part II*

- Mad, bad, and dangerous to know
Steve Keen 2

- A financial crisis on top of the ecological crisis:
Ending the monopoly of neoclassical economics
Peter Söderbaum 8

- Toward a new sustainable economy
Robert Costanza 20

- After the bust: The outlook for macroeconomics and macroeconomic policy
Thomas I. Palley 22

- A non-formal look at the non-formal economy
Sean Mallin 36

The financial crisis *Part IV*

- The triumph – and costs – of greed *(Part I)*
Clive Dilnot 42

- Statement to the U.S. House of Representatives
James K. Galbraith 62

- Lawson's reorientation
Edward Fullbrook 73

Comment

- The real dirt on happiness economics:
A reply to 'The unhappy thing about happiness economics'
Dan Turton 83

- Reply to Dan Turton
Helen Johns and Paul Ormerod 91

- Past contributors, etc. 94

- Comic relief: Troubled Asset Relief Program http://www.paecon.net/PAEReview/issue49/TARP.pdf

How should the collapse of the world financial system affect economics? Part II

Mad, bad, and dangerous to know

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The most important thing that global financial crisis has done for economic theory is to show that neoclassical economics is not merely wrong, but dangerous.

Neoclassical economics contributed directly to this crisis by promoting a faith in the innate stability of a market economy, in a manner which in fact increased the tendency to instability of the financial system. With its false belief that all instability in the system can be traced to interventions in the market, rather than the market itself, it championed the deregulation of finance and a dramatic increase in income inequality. Its equilibrium vision of the functioning of finance markets led to the development of the very financial products that are now threatening the continued existence of capitalism itself.

Simultaneously it distracted economists from the obvious signs of an impending crisis—the asset market bubbles, and above all the rising private debt that was financing them. Paradoxically, as capitalism's "perfect storm" approached, neoclassical macroeconomists were absorbed in smug self-congratulation over their apparent success in taming inflation and the trade cycle, in what they termed "The Great Moderation". Ben Bernanke's contribution to this is worth quoting at length:

> … the low-inflation era of the past two decades has seen not only significant improvements in economic growth and productivity but also a marked reduction in economic volatility…, a phenomenon that has been dubbed "the Great Moderation". Recessions have become less frequent and milder, and … volatility in output and employment has declined significantly… The sources of the Great Moderation remain somewhat controversial, but … there is evidence for the view that improved control of inflation has contributed in important measure to this welcome change in the economy … Bernanke, 2004 (http://www.federalreserve.gov/boarddocs/speeches/2004/20041008/default.htm)

It is all very well to have economic theory dominated by a school of thought with an innate faith in the stability of markets when those markets are forever gaining—whether by growth in the physical economy, or via rising prices in the asset markets. In those circumstances, academic economists aligned to PAECON can rail about the logical inconsistencies in mainstream economics all they want: they will be, and were, ignored by government, the business community, and most of the public, because their concerns don't appear to matter.

They can even be put down as critics of capitalism—worse still, as proponents of socialism—because it seems to those outside academia, and to neoclassical economists as well, that what they are attacking is not economic theory, but capitalism itself: "You think markets are unstable? Shame on you!"

The story is entirely different when asset markets crash beneath a mountain of debt, and the ensuing fallout threatens to take the physical economy with it. Now it should be possible to have the critics of neoclassical economics appreciated for what we really are:

critics of a fundamentally false theory of the operations of a market economy, and tentative developers of a new, realistic analysis of the nature of capitalism, warts and all.

Changing pedagogy

Given how severe this crisis has already proven to be, the reform of economic theory and education should be an easy and urgent task. But that is not how things will pan out. Though the “irresistible force” of the Global Financial Crisis is indeed immense, so to is the inertia of the “immovable object” of economic belief.

Despite the severity of the crisis in the real world, academic neoclassical economists will continue to teach from the same textbooks in 2009 and 2010 that they used in 2008 and earlier (laziness will be as influential a factor here as ideological commitment). Rebel economists will be emboldened to proclaim “I told you so” in their non-core subjects, but in the core micro, macro and finance units, it will be business as usual virtually everywhere. Many undergraduate economics students in the coming years will sit gobsmacked. as their lecturers recite textbook theory as if there is nothing extraordinarily different taking place in the real economy.

The same will happen in the academic journals. The editors of the *American Economic Review* and the *Economic Journal* are unlikely to convert to Post-Keynesian or Evolutionary Economics or Econophysics any time soon—let alone to be replaced by editors who are already practitioners of non-orthodox thought. The battle against neoclassical economic orthodoxy within universities will be long and hard, even though its failure will be apparent to those in the non-academic world.

Much of this will be because neoclassical economists are genuinely naïve about their role in causing this crisis. From their perspective, they will interpret the crisis as due to poor regulation, and to government intervention in areas that should have been left to the market. Aspects of the crisis that cannot be solely attributed to those causes will be covered by appealing to embellishments to basic neoclassical theory. Thus, for example, the Subprimes Scam will be portrayed as something easily explained by the theory of asymmetric information.

They will seriously believe that the crisis calls not for the abolition of neoclassical economics, but for its teachings to be more widely known. The very thought that this financial crisis should require any change in what they do, let alone necessitate the rejection of neoclassical theory completely, will strike them as incredible.

In this sense, they are like the Maxwellian physicists about whom Max Planck remarked that “A new scientific truth does not triumph by convincing its opponents and making them see the light, but rather because its opponents eventually die, and a new generation grows up that is familiar with it” (Kuhn 1970, p. 150).

But physics is charmed in comparison to economics, since it is inherently an empirical discipline, and quantum mechanics gave the only explanation to the empirically quantifiable black body problem. Planck's confidence that a new generation would take the place of the old was therefore well-founded. But in economics, not only will the neoclassical old guard resist change, they could, if economic circumstances stabilise, give rise to a new generation

that accepts their interpretation of the crisis. The is how the success of the Keynesian counter-revolution came about, and it is why we have we entered this crisis with an even more rabid neoclassicism than confronted Keynes in the 1930s.

The first thing that the global financial crisis should therefore do to economics is to galvanise student protest about the lack of debate within academic economics itself, because dissident academic economists will be unable to shift the tuition of economics themselves without massive pressure from the student body.

I speak from my own experience, when I was one of many students who agitated against neoclassical economics in the early 1970s at Sydney University, and campaigned for the establishment of a Political Economy Department. Were it not for the protests by the students against what we then rightly saw as a deluded approach to economics, the non-neoclassical staff at Sydney University would have been unable to affect change themselves.

Though we won that battle at Sydney University, we lost the war. The economic downturn of the mid-1970s allowed for the defeat of what Joan Robinson aptly called the Bastard Keynesianism of that era, and its replacement by Friedman's “monetarism”. Our protests were also wrongly characterised as being essentially anti-capitalist. Though there were indeed many who were anti-capitalist within the Political Economy movement, the real target of student protest was a poor theory of how capitalism operates, and not capitalism itself.

Similar observations can be made about the PAECON movement today, where student dissatisfaction with neoclassical economics in France spilled over into a worldwide movement. Though the initial impact of the movement was substantial, neoclassical dominance of economic pedagogy continued unabated. The movement persisted, but its relevance to the real economy was not appreciated because that economy appeared to be booming. Now that the global economy is in crisis, student pressure is needed once more to ensure that, this time, real change to economic pedagogy occurs.

Business pressure is also essential. Business groups to some degree naively believed that those who proclaimed the virtues of the market system, and who argued on their side in disputes over income distribution, were their allies in the academy, while critics of the market were their enemies. I hope that this financial catastrophe will convince the business community that its true friends in the academy are those who understand the market system, whether they criticise or praise it. As much as we need students to revolt over the teaching of economics, we need business to bring pressure on academic economics departments to revise their curricula because of the financial crisis.

Changing economics

The pedagogic pressure from students and the wider community has to be matched by the accelerated development of alternatives to neoclassical economics. Though we know much more today about the innate flaws in neoclassical thought than was known at the time of the Great Depression (Keen 2001), the development of a fully-fledged alternative to it is still a long way off. There are multiple alternative schools of thought extant—from Post Keynesian to Evolutionary and Behavioural Economics, and Econophysics—but these are not developed enough to provide a fully fledged alternative to neoclassical economics.

This should not dissuade us from dispensing completely with the neoclassical approach. For some substantial period, and especially while the actual economy remains in turmoil, we have to accept a period of turmoil in the teaching of and research into economics. Hanging on to parts of a failed paradigm simply because it has components that other schools lack would be a tragic mistake, because it is from precisely such relics that a neoclassical vision could once again become dominant when—or rather if—the market economy emerges from this crisis.

Key here should be a rejection of neoclassical microeconomics in its entirety. This was the missing component of Keynes's revolution. While he tried to overthrow macroeconomics shibboleths like Say's Law, he continued to accept not merely the microeconomic concepts such as perfect competition, but also their unjustified projection into macroeconomic areas—as with his belief that the marginal productivity theory of income distribution, which is fundamentally a micro concept, applied at the macro level of wage determination.

From this failure to expunge the microeconomic foundations of neoclassical economics from post-Great Depression economics arose the “microfoundations of macroeconomics” debate that led ultimately to rational expectations representative agent macroeconomics, in which the economy is modelled as a single utility maximising individual who is blessed with perfect knowledge of the future.

Fortunately, behavioural economics provides the beginnings of an alternative vision as to how individuals operate in a market environment, while multi-agent modelling and network theory give us foundations for understanding group dynamics in a complex society. They explicitly emphasise what neoclassical economics has evaded: that aggregation of heterogeneous individuals results in emergent properties of the group which cannot be reduced to the behaviour of any “representative individual” amongst them. These approaches should replace neoclassical microeconomics completely.

The changes to economic theory beyond the micro level involve a complete recanting of the neoclassical vision. The vital first step here is to abandon the obsession with equilibrium.

The fallacy that dynamic processes must be modelled as if the system is in continuous equilibrium through time is probably the most important reason for the intellectual failure of neoclassical economics. Mathematics, sciences and engineering long ago developed tools to model out of equilibrium processes, and this dynamic approach to thinking about the economy should become second nature to economists.

An essential pedagogic step here is to hand the teaching of mathematical methods in economics over to mathematics departments. Any mathematical training in economics, if it occurs at all, should come *after* students have done at least basic calculus, algebra and differential equations—the last area being one about which most economists of all persuasions are woefully ignorant. This simultaneously explains why neoclassical economists obsess too much about proofs, and why non-neoclassical economists like those in the Circuit School (Graziani 1989) have had such difficulties in translating excellent verbal ideas about credit creation into coherent dynamic models of a monetary production economy (c.f. Keen 2009).

Neoclassical economics has effectively insulated itself from the great advances made in these genuine sciences and engineering in the last forty years, so that while its concepts appear difficult, they are quaint in comparison to the sophistication evident today in mathematics, engineering, computing, evolutionary biology and physics. This isolation must end, and for a substantial while economics must eat humble pie and learn from these disciplines that it has for so long studiously ignored. Some researchers from those fields have called for the wholesale replacement of standard economics curricula with at least the building blocks of modern thought in these disciplines, and in the light of the catastrophe economists have visited upon the real world, their arguments carry substantial weight.

For example, in response to a paper critical of trends in econophysics (Gallegatti et al. 2006), the physicist Joe McCauley responded that, though some of the objections were valid, the problems in economics proper were far worse. He therefore suggested that:

> the economists revise their curriculum and require that the following topics be taught: calculus through the advanced level, ordinary differential equations (including advanced), partial differential equations (including Green functions), classical mechanics through modern nonlinear dynamics, statistical physics, stochastic processes (including solving Smoluchowski–Fokker–Planck equations), computer programming (C, Pascal, etc.) and, for complexity, cell biology. *Time for such classes can be obtained in part by eliminating micro- and macro-economics classes from the curriculum.* The students will then face a much harder curriculum, and those who survive will come out ahead. So might society as a whole. (McCauley 2006, p. 608; emphasis added)

The economic theory that should eventually emerge from the rejection of neoclassical economics and the basic adoption of dynamic methods will come much closer than neoclassical economics could ever do to meeting Marshall's dictum that “The Mecca of the economist lies in economic biology rather than in economic dynamics” (Marshall 1920: xiv). As Veblen correctly surmised over a century ago (Veblen 1898), the failure of economics to become an evolutionary science is the product of the optimising framework of the underlying paradigm, which is inherently antithetical to the process of evolutionary change. This reason, above all others, is why the neoclassical mantra that the economy must be perceived as the outcome of the decisions of utility maximising individuals must be rejected.

Economics also has to become fundamentally a monetary discipline, right from the consideration of how individuals make market decisions through to our understanding of macroeconomics. The myth of “the money illusion” (which can only be true in a world without debt) has to be dispelled from day one, while our macroeconomics has to be that of a monetary economy in which nominal magnitudes matter—precisely because they are the link between the value of current output and the financing of accumulated debt. The dangers of excessive debt and deflation simply cannot be comprehended from a neoclassical perspective, which—along with the inability to reason outside the confines of equilibrium—explains the profession's failure to assimilate Fisher's prescient warnings (Fisher 1933; few people realise that Friedman's preferred rate of inflation in his “Optimum Quantity of Money” paper was “a *decline* in prices at the rate of at least 5 per cent per year, and perhaps decidedly more”; Friedman 1969, p. 46, emphasis added).

The discipline must also become fundamentally empirical, in contrast to the faux empiricism of econometrics. By this I mean basing itself on the economic and financial data first and foremost—the collection and interpretation of which has been the hallmark of

contributions by econophysicists—and by respecting economic history, a topic that has been expunged from economics departments around the world. It, along with a non-Whig approach to the history of economic thought, should be restored to the economics curriculum. Names that currently are absent from modern economics courses (Marx, Veblen, Keynes, Fisher, Kalecki, Schumpeter, Minsky, Sraffa, Goodwin, to name a few) should abound in such courses.

Ironically, one of the best calls for a focus on the empirical data *sans* a preceding economic model came from two of the most committed neoclassical authors, 2004 Nobel Prize winners Finn Kydland and Edward Prescott, when they noted that "the reporting of facts—without assuming the data are generated by some probability model—is an important scientific activity. We see no reason for economics to be an exception" (Kydland & Prescott 1990, p. 3). The failure of these authors to live up to their own standards[1] should not be replicated in post-neoclassical economics.

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1 See Prescott 1999, in which he blamed the Great Depression on "a great decline in steady-state market hours" which was "the unintended consequence of labor market institutions and industrial policies designed to improve the performance of the economy", though he was unable to specify what these were: "Exactly what changes in market institutions and industrial policies gave rise to the large decline in normal market hours is not clear." (Prescott 1999, p. 29)

A financial crisis on top of the ecological crisis:

Ending the monopoly of neoclassical economics

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Introduction

A number of unsustainable trends, such as those related to climate change, biological diversity, environmental pollution, depleting fish stocks, deforestation, accumulating radioactive waste threaten people in different parts of the world and globally. In addition to this we are experiencing a financial crisis. Something appears to be seriously wrong with the mental maps of influential actors in different parts of the world. In both cases of crisis, the tendency is to blame market actors for their greediness and risk behavior or national governments for the lack of relevant regulation, or both.

I will here argue that among potential explanatory factors we also need to include ideas about the role of science in society, paradigms in economics, established political ideologies (and other ideologies) as well as institutional arrangements. This means that also science and universities are involved. It is argued that the monopoly position of neoclassical economics at university departments of economics has played a significant role by influencing the mental maps of many actors and making them more legitimate. Even the so called Nobel Prize in economics is part of this picture.

Economics as a socially constructed language

Traditionally, science has been seen as being separate from politics. Positivism as a theory of science has dominated the scene to the exclusion almost of other perspectives. Science is then about searching for the truth, and what is thought of as reliable knowledge is provided to colleagues in the scientific community, politicians and other actors in society through educational activities, books, articles, research reports etc. The positivistic tradition is one where the scholar is standing outside observing what goes on in society, formulating and testing hypotheses. The scholar is responsible mainly to the scientific community. It is a limited responsibility doctrine.

But positivism is only one of many theories of science. Brian Fay has coined the term ‘perspectivism’ (1996) to counteract the idea that only one theory of science and one disciplinary paradigm at a time represents the ‘truth’. Normally there exists more than one relevant vantage point and perspective in relation to a specific category of phenomena. Viewing reality from a second perspective often adds to the understanding offered by the first.

While objectivity is celebrated as part of positivism, the role of subjectivity and ideology is seriously considered as part of some of the alternative or complementary theories of knowledge. In hermeneutics (Ricoeur 1981), ‘interpretation’ is a key concept and as human beings we largely interpret the world through our languages. And languages can be regarded as objectively existing phenomena but also as being ‘socially constructed’ (Berger and Luckman 1966). Mainstream neoclassical economics is a standardized language that claims to be helpful in understanding the world. Standardized or not; each language points in specific directions concerning relevant objects, relationships, processes etc. to focus upon. The

language is socially constructed for specific purposes, for instance to deal with specific problems in specific ways. Neoclassical economics, as an example, is specific not only in 'scientific' but also in 'ideological' terms. 'Ideology' stands for a 'means-ends philosophy' and is not limited to more or less established political ideologies like socialism, social democracy, social liberalism or neo-liberalism. In this sense, neoclassical economics clearly qualifies as an ideology and as such is more specific and precise than the political ideologies mentioned.

Neoclassical economics tells us about the relevant actors in the economy (consumers, firms and government); about how to understand markets (supply and demand of commodities and of factors of production); about decision-making (optimization) and efficiency (usually a monetary concept or at best cost-efficiency). This way of understanding economics is clearly not neutral but specific in ideological terms. Gunnar Myrdal has argued that "values are always with us" (1978 p.778) in social science research and in my understanding "economics is always political economics". This suggests that the neoclassical attempt to develop a 'pure' economics from about 1870 onwards as opposed to 'political economics' (which was the language used by classical economists) was a mistake. At issue is now whether neoclassical theory as a conceptual framework and ideological orientation is useful in dealing with the ecological crisis and/or the financial crisis.

The ideological features of neoclassical economics also suggest that it becomes relevant to inquire into the similarities between neoclassical economics as ideology and the established political ideologies referred to. Has neoclassical economics contributed, for example, to make neo-liberalism more legitimate? Alternatives to the neoclassical conceptual framework and paradigm, such as some version of institutional economics, feminist economics or ecological economics are equally specific in ideological terms but may perform better in relation to the ecological crisis and/or the financial crisis. This is – again – a matter of subjective judgment. The important thing now in economics is to open the door for pluralism and competing (or complementary) theoretical perspectives and approaches.

Normal imperatives of democracy are applicable

Understanding that economics is socially constructed and specific in ideological/political terms suggests that economics can be manipulated for specific purposes. Economists and departments of economics are part of society and specific actors and interest groups within the academia and outside it may use their power to change economics in specific directions or to support a status quo 'business-as-usual' position for the discipline. Such pressures in different directions cannot be avoided but since ideology and politics are involved, it follows that actors both within and outside universities should observe normal imperatives of democracy. If economics is political economics then democracy will inform us about the rules of the game. In a democratic society, there are normally more political parties than one and many more ideological orientations are represented among citizens than those internalized into political parties. This suggests that the conceptual and ideological pluralism that exists in society should to some extent be reflected in our ways of doing research and teaching economics.

It appears fair to argue that the present situation at university departments of economics in Western countries (and other countries as well) is far from such a desired state of affairs. Education and research is limited to one paradigm – the neoclassical one. Rather than democracy, one may speak of dictatorship where only one theoretical perspective with

connected ideology is permitted. Neoclassical economists celebrate freedom of choice and are against 'protectionism' but protect their own theoretical perspective vigorously. They point in the direction of competition as good for society but paradoxically defend the neoclassical monopoly; they see the 'opportunity cost principle' as central to their message but do not want to apply this principle at the level of paradigms; When discussing portfolio investments, they repeatedly tell us that it may be unwise to put "all eggs in one basket" but have themselves neglected this wisdom. A more pluralistic economics might have saved us from some of the problems that we now experience.

Democracy is also about the responsibilities and accountability of each actor in society. The limited liability doctrine (of positivism) where economics is only about science and truth is comforting, but no longer valid. As economists we should instead be ready to admit and discuss our ideological orientations and how we can deal with them while working systematically in research and education. It turns out that the rules of democracy will supply some of the criteria for good research. A department of economics that has taken important steps in a pluralistic direction will be a stronger and more legitimate department.

Neoclassical economics and the sustainability crisis

As mentioned in the introduction, a number of unsustainable trends concerning the state of the environment can be observed and have been widely reported. The status of individuals in terms of health and poverty is another concern of sustainable development. Inequality in terms of monetary income and financial position appears to be increasing. At issue is whether or not neoclassical economics is helpful in dealing with the sustainability crisis. Hopefully some ideas from neoclassical economics are useful but what about other theoretical perspectives in economics? How can they contribute? Is the present monopoly for neoclassical economics justified?

One 'hypothesis' is that neoclassical economics is closely connected with a 'business-as- usual' attitude to development, and that present unsustainable trends are largely explained by this business-as-usual strategy and ideology. Neoclassical 'environmental economics', an extension of neoclassical theory, attempts to deal with sustainability issues by merely modifying the present political-economic system. But it seems unlikely that this is enough. In my understanding, the UN, the EU, Sweden as a nation, various regions and cities, etc. have adopted sustainable development as something new with openings for more radical changes and I will now try to point to my understanding of this newness. A number of questions that I believe are relevant for a dialogue about sustainable development will be formulated. I will point to how these issues are dealt with within the scope of neoclassical economics and then indicate a political economics approach to sustainability, so called 'sustainability economics' (Söderbaum 2008) that I believe is more useful.[1]

[1] I came across the term 'sustainability economics' for the first time as part of a project at the Deutsches Institut für Wirtschaftsforschung , DIW, (www.sustainabilityeconomics.de) in 2003. The German Ministry of Education and Research had turned to DIW, Berlin, a neoclassical economics research institute, arguing that neoclassical economics is inadequate for sustainable development. DIW was urged to respond to this challenge and arranged a number of workshops with ecological economists and others. It is not clear whether this project had any lasting impacts on the research work of the institute.

What are the relationships between ‘economics’ and ‘politics’?

Neoclassical response: Economics and politics can and should be separated. A value-neutral, ‘pure’ economics is possible

Sustainability economics perspective: Economics is always political economics. It is an illusion that economics can be separated from politics and ideology. Each theoretical perspective in economics is specific not only in scientific but also in ideological terms. Limiting economics to one paradigm, for example the neoclassical one, is contrary to normal ideas of democracy. Since there is a diversity of ideological orientations in society, some part of this diversity should be reflected in research and education at universities. Limiting education to one paradigm at university departments of economics means that these departments acquire a role as political propaganda centres. This is essentially the situation we are facing today.

Who are the relevant actors in the economy?

Neoclassical response: ‘Consumers’ and ‘firms’ are the relevant actors and they are connected by markets for commodities and factors of production. In addition, the national government is an important actor regulating markets, raising taxes etc.

Sustainability economics perspective: The sustainability crisis concerns individuals in all their roles and not just in their role as consumer and other market-related roles. The individual is also a parent, a professional and a citizen. Firms or business organizations participate in the development dialogue but so do actors connected with universities, environmental organizations, churches. Individuals and organizations are regarded as actors participating in the economy and society where the primacy of democracy over market is observed.

What is the role of the national government in the economy and in society?

Neoclassical response: Politics and policy-making is essentially in the hands of the national government. Two categories of policy instruments are available, so called ‘command-and-control’ instruments and market instruments. Market instruments are generally preferred by neoclassical economists as being more flexible.

Sustainability economics perspective: The national government has a specific and important role in the economy but is only one among policy-makers. All actors in the economy are regarded as policy-makers. The individual is guided by her ‘ideological orientation’ and understood as a ‘political-economic person’ (PEP) whereas an organization (the ‘firm’ included) is assumed to be guided by a ‘mission’ and understood as a ‘political economic organization’ (PEO). To reflect this multiple-actor and also a multiple-level perspective (the latter referring to organizational as well as territorial aspects), the term ‘governance’ is used (see also Bache and Flinders 2004). Relationships between actors in the economy and internationally have to reflect the principles of democracy. Participation, responsibility and accountability are among these ideas of a functioning democracy.

How do we understand the objectives and values of actors in the economy?

Neoclassical response: The individual as consumer is assumed to choose that combination of commodities (within her monetary budget constraint) that maximizes her utility. Consumer preferences are assumed to be given and are in no way questioned by the economist who claims neutrality in this and other respects. A larger income means that the budget will allow more commodities to be bought and a higher level of utility. The organization (which is assumed to be a firm) maximizes monetary profits. The possibility of non-monetary objectives is not discussed. At the macro level, focus is on national accounting and 'economic growth' in GDP-terms and economic growth tends to be seen as the main idea of progress in society. Neoclassical economists themselves sometimes warn against the use of GDP as an indicator of welfare but have little to say about other ideas of progress.

Sustainability economics perspective: As already indicated, it is assumed that the individual is guided by her ideological orientation and the organization by its mission. Neither ideological orientation, nor mission should be understood as a mathematical objective function to be optimized. The ideological orientation is fragmented, uncertain and consists of qualitative, quantitative as well as visual elements and something similar holds for the mission of an organization.

The ideological orientation of individuals as actors and the mission of organizations cannot be dictated by science but is a matter for each actor. Ideological orientation and mission can be modified or change radically over time. The individual may for example more or less internalize the ideas of sustainable development and a business company may focus on narrow interests in terms of profits or 'shareholder value' or internalize some idea of what is now referred to as Corporate Social Responsibility (CSR). Similarly, a university may consider its University Social Responsibility (USR) in relation to the challenge of sustainable development or other demands from the larger society.

An individual is part of many 'we-categories' (Cf. 'I & We Paradigm' in Etzioni 1988) including communities and networks. Relating one's own position to that of larger groups becomes an important part of ethical and ideological considerations. An actor may as part of her ideological orientation consider GDP-growth as more or less important in relation to other ideas of progress in society. This is something to be investigated by the scholar rather than assumed to be given.

What is the role of the monetary dimension in the economy?

Neoclassical response: The consumer is limited by her monetary budget constraint and chooses among commodities characterized by their price (in monetary terms). Firms are assumed to maximize their profits in monetary terms or shareholder value, i.e. the price of company shares. Progress of the national economy is measured in monetary terms (as GDP-growth) and decision-making at the societal level is a matter of monetary calculation in the form of cost-benefit analysis (CBA). This focus on money and monetary analysis has made many individuals as actors think that "economics is about money" and little else.

Sustainability economics perspective: When looked upon from the vantage point of sustainable development, the neoclassical emphasis on the monetary dimension becomes questionable and can be referred to as 'monetary reductionism'. Instead a multidimensional

perspective is preferred where the monetary dimension is only a part. The idea that all impacts can be traded against each other is abandoned. Monetary and non-monetary impacts are kept separate and analysis is carried out in profile terms rather than as one-dimensional calculation.

Shifting to a sustainability economics perspective means that non-monetary factors such as ecosystems, natural resources and human resources are as 'economic' as financial or monetary resources. Impacts on ecosystems, land-use, water resources and fish stocks are economic impacts as such (and not only through their implications in the monetary domain). Reference can be made to changes in non-monetary resource positions.

On the non-monetary side, the issues of inertia, path-dependence, irreversibility and connected uncertainties come to the fore and have to be discussed and analysed separately from monetary analysis. House construction on agricultural land is a largely irreversible process that has to be illuminated in non-monetary positional terms (Söderbaum 2008 pp. 106-107) and the same holds for depletion of fish stocks or degradation of water quality.

How is decision-making and efficiency understood?

Neoclassical response: In neoclassical economics, an assumption is made about a specific mathematical objective function to be optimized. The consumer maximizes utility in some sense; the firm maximizes its profits. Cost-benefit analysis is similarly an attempt to maximize in monetary terms at the level of society. Efficiency in neoclassical economics is closely connected with optimality in the mentioned sense. Profits in business, for example, is regarded as an indicator of efficiency.

Sustainability economics perspective: Looking for optimal solutions is a possibility (if all actors concerned agree about an objective function) but is regarded as a special case. The main idea of decision-making is one of 'matching', 'appropriateness' or 'suitability'. The decision-maker is guided by her ideological orientation and this ideological orientation is 'matched' against the expected impact profile of each alternative considered. In relation to a specific decision situation, the ideological orientation of an actor as decision-maker may be sharp or vague and the expected impacts of choosing one specific alternative may be certain or uncertain. This suggests that search activities to further articulate one's ideological orientation, or to reduce uncertainty about impacts, is always an option.

In a decision situation with more than one decision-maker, for example a political assembly, the analyst has to consider those ideological orientations that appear relevant among decision-makers and suggest conditional conclusions based on each of the ideological orientations considered. This information is then supposed to be useful for each decision-maker, for instance as part of voting in a political assembly. The politician will then be responsible for her voting behaviour and other actions.

Science can no longer dictate correct ideas of efficiency for purposes of resource allocation. There may still be some standardized ideas of efficiency such as profits in business but there are always potentially competing ideas. Efficiency within the scope of neoclassical economics is one thing and efficiency in relation to sustainable development another. Eco-efficiency, for example, may refer exclusively to non-monetary variables as in

ecological footprints (Wackernagel & Rees 1996). To conclude, efficiency is a matter of the observer's ideological orientation.

How are decisions prepared at the societal level?

Neoclassical response: A distinction is made between welfare theory and applied welfare economics. Welfare theory suggests that welfare is increased if at least one person is made better off as a result of choosing an alternative while no one is losing. Applied welfare theory on the other hand claims to be more useful in practice and is connected with cost-benefit analysis in monetary terms (CBA). Some individuals may then be losing in monetary terms if only the aggregated impacts are estimated to be positive. Neoclassical economists dictate that current market prices should be used to estimate a so called 'present value' for each alternative considered, thereby excluding other ethical or ideological standpoints. A specific market ideology is applied.

Sustainability economics perspective: A distinction can be made between approaches to societal decisions with respect to degree of aggregation and ideological closed/openness. This leaves us with four categories of approaches:

I. Highly aggregated, ideologically closed
II. Highly aggregated, ideologically open
III. Highly disaggregated, ideologically closed
IV. Highly disaggregated, ideologically open

Neoclassical economics clearly belongs to the first category. Impacts of different kinds and expected for different periods of time are summarized in monetary terms at correct market prices. Category II refers to an approach where impacts are aggregated in one-dimensional terms but prices or other values are open to the judgment of each decision-maker while category III may stand for a multidimensional approach where acceptable performance in each dimension is decided beforehand.

From the point of view of sustainability economics, category IV, highly disaggregated and ideologically open, is judged to be the most relevant and compatible with normal ideas of democracy. Although limited in scope to environmental impacts and often used late in the decision process, Environmental Impact Assessment (EIA) essentially belongs to this fourth category. A more holistic approach (in terms of scope) is 'positional analysis' (PA) which is preferred by the present author (Söderbaum 2008, Brown 2008). The purpose is to illuminate an issue for decision-makers, for example politicians, who differ among themselves with respect to ideological orientation. Actors or interested parties in relation to the issue or decision situation are identified and approached by the analyst to learn about their understanding of the problems faced and how it can be dealt with. Potentially relevant ideological orientations are articulated and alternatives systematically compared with respect to impacts in multidimensional terms. Inertia in the form of, for example irreversible impacts, are illuminated in positional terms. Also conflicts of interest are illuminated. Conclusions (in the sense of ranking alternatives) are conditional in relation to each ideological orientation articulated. As part of sustainability economics, it becomes natural to include an interpretation of sustainable development among ideological orientations.

How is the market and international trade understood?

Neoclassical perspective: A market is understood in terms of supply and demand of single commodities. Monetary costs of producing are related to the price consumers are willing to pay. The market analyst is standing outside watching what goes on. Prices and commodities exchanged are seen as objective phenomena and are never or seldom questioned from ethical points of view. According to this perspective, it does not matter if one market actor is 'successful' in monetary terms by exploiting another actor or if two market actors attempt to be fair in relation to each other in their market interactions. International trade is similarly understood in reductionist terms where one commodity is discussed at a time and where its price is the main consideration. International trade theory furthermore arrives at a conclusion that free trade is good while 'protectionism' (i.e. attempts to protect home industry through tariffs and quotas) is bad.

Sustainability economics perspective: From this point of view, market actors are understood as political economic persons and political economic organizations in their specific social, institutional and ecological context. A market transaction takes place within a social context where the ideological orientation of each market actor plays a role. Emphasis on self-interest, even greediness, is a possibility but so is also fairness or a wish to contribute to sustainability or the common good in some sense. The impacts of a market transaction is understood in multi-dimensional terms and related to activities of different groups of individuals.

A similar analysis is relevant for the international level. Impacts of different kinds can be scrutinized in each of the two trading countries as well as impacts on specific activities and thereby groups of individuals. Given such estimated impacts, it is an open issue and a matter of the observer's ideological orientation whether trade is good or bad for specific parties and for the nations involved. In each of the trading countries, there may be both winners and losers and general assertions about trade as bad or good can seldom be made. Environmental degradation or exploitation of mineral or other natural resources in one country are possible implications of trade and a person as actor may in a specific situation find good reasons to argue that protectionism is a reasonable trade strategy.

How is institutional change understood?

Neoclassical response: Institutional change is largely regarded as a matter of new laws and regulations. Special interest groups may lobby for rules that are favourable for them as suggested by neoclassical public choice theory (Mueller 1979).

Sustainability economics perspective: In general terms, a theory of science, the disciplinary paradigm in economics and more or less established ideologies may make specific institutions legitimate. Neoclassical economics has contributed to make greediness in business and focus on shareholder value legitimate. Simplistic neoclassical international trade theory has similarly made exploitation of people and natural resources legitimate and is reflected in the rules that guide the World Trade Organization (WTO) in their decisions and actions.

At a more specific level, each model used to understand or interpret specific phenomena may be part of a process where existing institutions are strengthened or new institutions emerge. At this level:

- interpretation of a phenomenon
- naming it
- other manifestations of the phenomenon
- acceptance among actors of the interpretation and its manifestations are important partial processes

The profit maximizing firm as a model in neoclassical microeconomics plays a role in making narrow ideas of the purpose of business legitimate. Also existing laws about the joint stock company become more legitimate. A stakeholder model of the business firm opens the door for new thinking in some respects (for example the admittance of tensions and conflicts of interest between individuals as stakeholders and stakeholder groups) and the same is true of the 'political economic organization'. The existence of financial management systems may make some actors realize that 'environmental management systems' (EMS) based on a similar logic is possible. In this way the ideological orientations of individuals a actors and the models they use play a key role in institutional change processes.

Conclusions about the ecological and financial crisis

Climate change is perhaps the most threatening aspect of the ecological crisis but not the only one. Reduced biological diversity, reduced water availability and deteriorating water quality in some regions exemplify other relevant dimensions. On the financial side, the 'market mechanism' has been unable to come up to expectations.

How can these problems be understood? Many factors have certainly contributed but in my judgment neoclassical economics as disciplinary paradigm and neo-liberalism as ideology are among the most important. If actors in society have failed, this can largely be attributed to the mental maps they have used for guidance and these mental maps are largely connected with dominant ideas about economics (as conceptual framework and ideology) and neo-liberalism as a dominant ideology in many circles. Thousands of students, now in professional positions, have learnt neoclassical micro- and macroeconomics over the years and have supported each other and been supported by their professors to further strengthen the neoclassical perspective.

Studying neoclassical economics would have been less of a problem if also alternative theoretical perspectives had been taught at university departments of economics. But the strategy has instead been to strengthen the neoclassical monopoly. It is up to the reader to judge whether neoclassical economics by itself and in combination with neo-liberalism explains some parts of the ecological and financial crisis that we now experience. Since neoclassical economics emphasizes the monetary dimension, one might expect that at least monetary issues are well considered in the paradigm but these days we even doubt if this is the case. Something may be missing in terms of interdisciplinary openings, including social psychology and also ethical considerations.

In any case, neoclassical economists in leading positions should be held responsible and accountable for limiting research and education to one paradigm. As I have argued previously, each paradigm is specific not only in scientific terms (with respect to conceptual framework and theory) but also in ideological terms. Limiting education in economics to one paradigm means that university departments of economics are degraded to political propaganda centres.

A way out of this is to admit that the political aspect is always part of economics and to use a political-economics approach when attempting to respond to the questions asked earlier in this article. Individuals, organizations, markets, decisions, efficiency, assessment of alternatives – all this can be approached in political economic terms.

A political economics approach means a more humble attitude to economics where it is understood and admitted from the very beginning that there are more than one approach to economics. Neoclassical economists have often used their power to eliminate competition concerning professional positions and to reduce choice for students. But outside university departments of economics, the interest in heterodox economics is proliferating. There are social economists, socio-economists, feministic economists, institutional economists, ecological economists, Green economists, even interdisciplinary economists, many of which are openly critical of the neoclassical paradigm.[2] For this reason, a pluralistic strategy at university departments of economics is the only realistic one. A move from neoclassical technocracy to a democratized economics is called for. Since neoclassical economists have become accustomed to their monopoly, such a change will not come about easily.

Neoclassical economics may be useful for some purposes but in relation to the challenge of sustainable development, it is – as I have tried to show – probably among the worst possible theoretical perspectives. The emphasis on a monetary dimension is contrary to the perspectives needed to deal seriously with environmental problems. Also the tendency to emphasize the self-interest of all kinds of actors is far from a widening of horizons to also include community interests. The emphasis on markets while downplaying other relations and democracy is a third deficiency of neoclassical economics.

The power game will continue and should not only include orthodox and heterodox economists as actors. Individuals in all kinds of roles are stakeholders and although neoclassical economists often try to hide behind mathematical equations, the language of economics need not be complex. In some sense we all have experiences as economists making decisions with impacts on the future state of affairs for us and for others.

Some neoclassical economists realize that they are in trouble in relation to the present crisis situation. One strategy is to act in a 'pragmatist' or even opportunist way. The Stern Report (2006) is a case in point where the author and his team produce precise figures about the estimated monetary costs as a percentage of GDP for counteracting climate change now compared to waiting and acting at a later point in time. Most people understand that action is urgent but structuring the problem in terms of monetary GDP appears a bit desperate and as much an attempt to save and protect neoclassical theory against competing perspectives.[3]

I will end this article by pointing to an assumption about heterogeneity in each actor category (Söderbaum 1991). Although sharing the same paradigm, neoclassical economists are not a completely homogenous group. Some participate actively in public debate, such as Joseph Stiglitz (2002) and Paul Krugman which is a positive feature. However, very few of the leading neoclassical economists refer to their own economics as 'neoclassical' (since that would be a first step towards admitting that there may be other kinds of economics) or speak of pluralism as a step forward. Control of journals and awards is another way of protecting the

[2] For an overview, see Fullbrook ed. 2003, 2004, 2007, 2008.

[3] For a critical evaluation of the Stern report, see Spash 2007.

status quo. The Bank of Sweden (Riksbanken) Prize in Economic Sciences in Memory of Alfred Nobel is based on positivism as a theory of science, neoclassical economics and has so far not facilitated a move towards a more pluralistic economics. The ideas of excellence in social science of those in charge of this prize are still far from the political economics perspective advocated here. But this is another story.

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Toward a new sustainable economy

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The current financial meltdown is the result of under-regulated markets built on an ideology of free market capitalism and unlimited economic growth. The fundamental problem is that the underlying assumptions of this ideology are not consistent with what we now know about the real state of the world. The financial world is, in essence, a set of markers for goods, services, and risks in the real world and when those markers are allowed to deviate too far from reality, "adjustments" must ultimately follow and crisis and panic can ensue. To solve this and future financial crisis requires that we reconnect the markers with reality. What are our real assets and how valuable are they? To do this requires both a new vision of what the economy is and what it is for, proper and comprehensive accounting of real assets, and new institutions that use the market in its proper role of servant rather than master.

The mainstream vision of the economy is based on a number of assumptions that were created during a period when the world was still relatively empty of humans and their built infrastructure. In this "empty world" context, built capital was the limiting factor, while natural capital and social capital were abundant. It made sense, in that context, not to worry too much about environmental and social "externalities" since they could be assumed to be relatively small and ultimately solvable. It made sense to focus on the growth of the market economy, as measured by GDP, as a primary means to improve human welfare. It made sense, in that context, to think of the economy as only marketed goods and services and to think of the goal as increasing the amount of these goods and services produced and consumed.

But the world has changed dramatically. We now live in a world relatively full of humans and their built capital infrastructure. In this new context, we have to first remember that the goal of the economy is to sustainably improve human well-being and quality of life. We have to remember that material consumption and GDP are merely means to that end, not ends in themselves. We have to recognize, as both ancient wisdom and new psychological research tell us, that material consumption beyond real need can actually reduce well-being. We have to better understand what really does contribute to sustainable human well-being, and recognize the substantial contributions of natural and social capital, which are now the limiting factors in many countries. We have to be able to distinguish between real poverty in terms of low quality of life, and merely low monetary income. Ultimately we have to create a new model of the economy and development that acknowledges this new full world context and vision.

This new model of development would be based clearly on the goal of sustainable human well-being. It would use measures of progress that clearly acknowledge this goal. It would acknowledge the importance of ecological sustainability, social fairness, and real economic efficiency. Ecological sustainability implies recognizing that natural and social capital are not infinitely substitutable for built and human capital, and that real biophysical limits exist to the expansion of the market economy.

Social fairness implies recognizing that the distribution of wealth is an important determinant of social capital and quality of life. The conventional model has bought into the assumption that the best way to improve welfare is through growth in marketed consumption

as measured by GDP. This focus on growth has not improved overall societal welfare and explicit attention to distribution issues is sorely needed. As Robert Frank has argued in his latest book: *Falling Behind: How Rising Inequality Harms the Middle Class*, economic growth beyond a certain point sets up a “positional arms race” that changes the consumption context and forces everyone to consume too much of positional goods (like houses and cars) at the expense of non-marketed, non-positional goods and services from natural and social capital. For example, this drive to consume more positional goods leads people to reach beyond their means to purchase ever larger and more expensive houses, fueling the housing bubble. It also fuels increasing inequality of income which actually reduces overall societal well-being, not just for the poor, but across the income spectrum.

Real economic efficiency implies including all resources that affect sustainable human well-being in the allocation system, not just marketed goods and services. Our current market allocation system excludes most non-marketed natural and social capital assets and services that are critical contributors to human well-being. The current economic model ignores this and therefore does not achieve real economic efficiency. A new, sustainable ecological economic model would measure and include the contributions of natural and social capital and could better approximate real economic efficiency.

The new model would also acknowledge that a complex range of property rights regimes are necessary to adequately manage the full range of resources that contribute to human well-being. For example, most natural and social capital assets are public goods. Making them private property does not work well. On the other hand, leaving them as open access resources (with no property rights) does not work well either. What is needed is a third way to *propertize* these resources without privatizing them. Several new (and old) common property rights systems have been proposed to achieve this goal, including various forms of common property trusts.

The role of government also needs to be reinvented. In addition to government’s role in regulating and policing the private market economy, it has a significant role to play in expanding the “commons sector”, that can propertize and manage non-marketed natural and social capital assets. It also has a major role as facilitator of societal development of a shared vision of what a sustainable and desirable future would look like. As Tom Prugh, myself, and Herman Daly have argued in our book “*The Local Politics of Global Sustainability*,” strong democracy based on developing a shared vision is an essential prerequisite to building a sustainable and desirable future.

Conclusion

The long term solution to the financial crisis is therefore to move beyond the "growth at all costs" economic model to a model that recognizes the real costs and benefits of growth. We can break our addiction to fossil fuels, over-consumption, and the current economic model and create a more sustainable and desirable future that focuses on quality of life rather than merely quantity of consumption. It will not be easy; it will require a new vision, new measures, and new institutions. It will require a redesign of our entire society. But it is not a sacrifice of quality of life to break this addiction. Quite the contrary, it is a sacrifice not to.

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After the bust:

The outlook for macroeconomics and Macroeconomic policy*

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Introduction: crisis, economists, and change

The current moment of financial crisis and the prospect of deep recession offer a historic window of opportunity for change in economics and in economic policy. The combination of crisis and accumulated popular resentments following two decades of wage restraint, widening income inequality, and increased economic insecurity makes for a political atmosphere conducive to change.

In the 1930s and '40s, the Great Depression and World War II provided the launch pad for the Keynesian revolution in economics. In the 1970s, monetarists and New Classical economists used the economic crisis created by the OPEC oil shocks to launch a counterrevolution (Johnson 1971).

Milton Friedman, the intellectual godfather of American neoliberal economics, understood the role of crisis in fostering change:

> There is enormous inertia—a tyranny of the status quo—in private and especially governmental arrangements. Only a crisis—actual or perceived—produces real change. When that crisis occurs, the actions that are taken depend on the ideas that are lying around. (Friedman 2002, pp. xiii–xiv)

He went on to describe the role of economists as follows:

> . . . to develop alternatives to existing policies, to keep them alive and available until the politically impossible becomes politically inevitable. (Friedman 2002, p. xiv)

The good news is, current conditions may have created a crisis moment in which policy and thinking can change. The bad news is, deep recession means there will likely be enormous economic suffering, and the economics profession will be profoundly resistant to change.

The post-bust policy challenge

European governments and the U.S. president face three challenges:

(1) *Stop the bleeding*—which means stopping the liquidation trap (Palley 2008a) that currently grips markets. This requires putting a floor under the financial crisis by stopping further wholesale asset price deflation and restoring credit flows.

(2) *Jump-start the economy*—which means getting the economy and employment growing again. This requires further monetary easing and massive fiscal expansion.

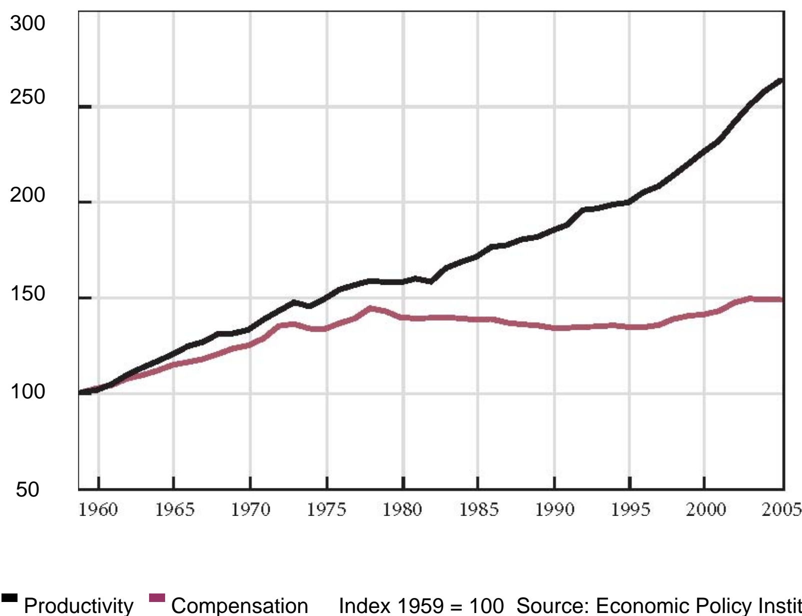
(3) *Ensure that future growth is characterized by full employment and shared prosperity*—which means having wages grow with productivity and reducing current high-income inequality to levels that prevailed 30 years ago, before the neoliberal economic policy experiment.

Among policymakers, there is significant agreement on challenges (1) and (2), but significant disagreement on challenge (3).

Regarding the first two challenges, any differences are largely a matter of degree—such as, What is the best way to thaw credit markets and stabilize asset prices? How far should interest rates be lowered and how fast? How much should taxes be cut, and whose taxes should be cut? How much should government spending be increased and what form should it take?[1] These are important differences, but as President Nixon famously observed in 1971, "We are all Keynesians now." The truth of that statement is being confirmed by current policy developments, though Nixon should more accurately have said, "In a recession, we are all Keynesians."

However, there is significant disagreement regarding the challenge of ensuring economic growth with shared prosperity. For most mainstream economists, the crisis is being represented as a perfect storm, the result of a rare probability event. From a post-Keynesian perspective (Godley 2000, 2001, 2005; Palley 1998, 2001, 2005, 2006a, 2006b), it is a predictable outcome of the economic paradigm that has driven growth since the neoliberal era was inaugurated, in the early 1980s, by Prime Minister Thatcher and President Reagan. That paradigm is now exhausted. It was never able to generate growth with shared prosperity; now it is unable even to generate growth with inequality.

Figure 1 Index of Productivity and Hourly Compensation of Production and Non-supervisory Workers, 1959−2005

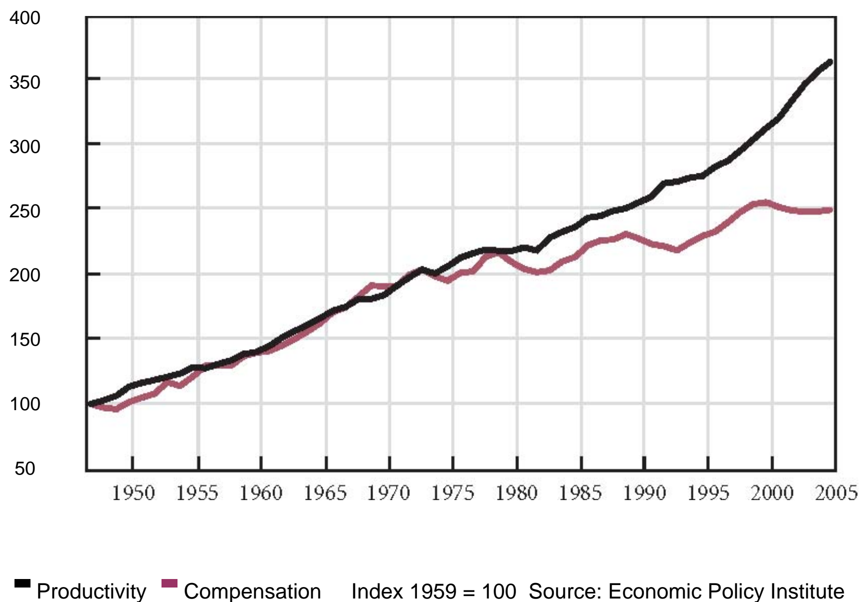


Productivity Compensation Index 1959 = 100 Source: Economic Policy Institute

The neoliberal paradigm and mainstream economics

The single most salient feature of the neoliberal economy is the disconnect between wages and productivity growth, as exemplified by the U.S. experience. Figure 1 shows an index of U.S. productivity and average compensation (which includes all benefits) of non-supervisory workers, who represent 80 percent of the workforce. Until the late 1970s, the two series grew together; since then, they have grown apart, with compensation stagnating even as productivity has continued to rise. Figure 2 tells the same story for the relation between U.S. median family income and productivity.

Figure 2 Median Family Income and Productivity, 1947−2005



This disconnect in turn explains widening income inequality. With wages stagnating at the bottom of the distribution but productivity still rising, income has been shifting to the top of the distribution. This pattern is captured in Figure 3, which shows income growth at the 20th and 95th percentiles of the U.S. income distribution. The two income series grew in tandem until the late 1970s but separated after 1980, when inequality also started rising.

The neoliberal economic policy paradigm can be described in terms of a box, as illustrated in Figure 4.2 Workers are “boxed in” on all sides by a policy matrix consisting of globalization, labor market flexibility, a focus on inflation rather than full employment, and the erosion of popular economic rights (as exemplified by the 1996 welfare reform act) in the name of “small government.” Similarly, there has been an erosion of government’s administrative capacity and its ability to provide services, with many government functions being outsourced to corporations. This has created a “predator state” (Galbraith 2008) in which corporations enrich themselves on the back of government contracts while the workers who provide these privately produced–publicly funded services are placed in a more hostile work environment. The result is the appearance of Big Government. The reality is a government whose capacity has been significantly cannibalized.

Figure 3 Index of Low Family Income and High Family Income, 1947−2005

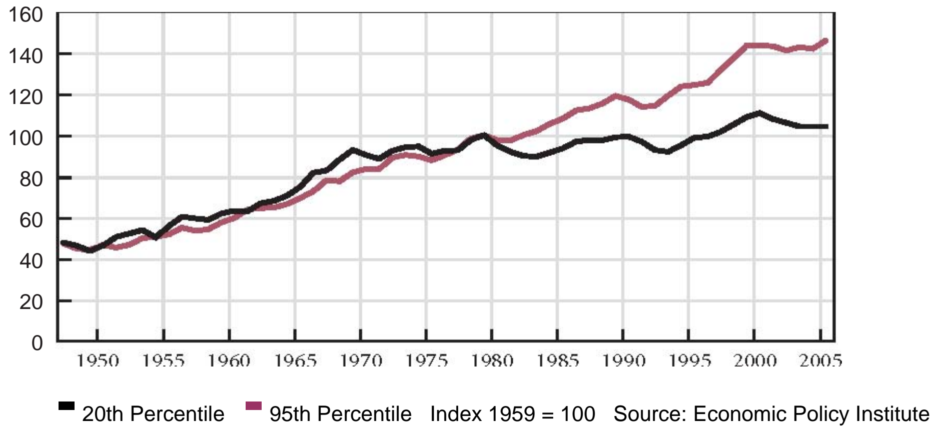
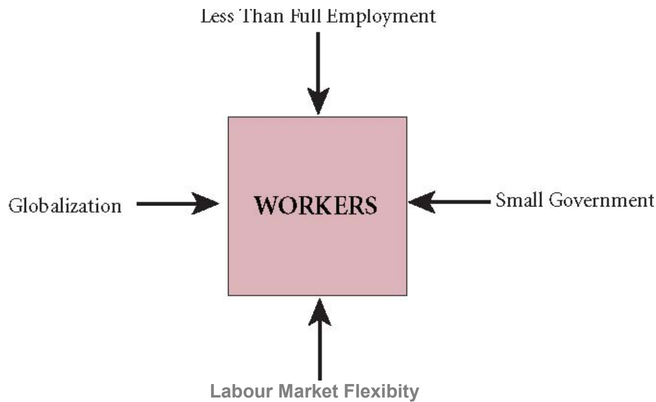


Figure 4 The "Neoliberal" Policy Box



The strength of the neoliberal policy box derives from a new relationship between the "side supports" of corporations and financial markets, as illustrated in Figure 5. This new relationship has been termed "financialization" (Epstein 2001, Palley 2008b), and the box would collapse without it.

Figure 6 shows the economic workings of financialization. The basic logic is that financial markets have captured control of corporations, which now serve market interests along with the interests of top management. That combination drives corporate behavior and economic policy, creating an economic matrix that puts wages under continuous pressure and raises income inequality. Viewed from this perspective, financialization is the economic foundation of neoliberalism. Reversing the neoliberal paradigm therefore requires a policy agenda that addresses both financial markets and corporations, with the aim of bringing their behavior in line with the greater public interest.

The structure of the policy box has been supported by mainstream economic theory,which has provided justification for these outcomes. Neoliberal globalization has been justified by appeal to the theory of free trade based upon comparative advantage, and to neoclassical arguments for deregulating financial markets and allowing uncontrolled international capital flows.

Figure 5 Lifting the Lid and Unpacking the Box

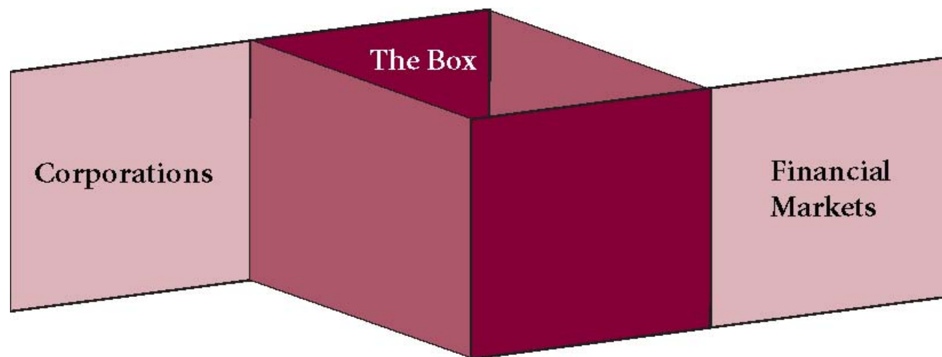


Figure 6 Dynamics of Financialization

The case for small government is based on Friedman's (2002) arguments for a minimalist, or night watchman, state. Moreover, the Chicago School of Economics recommends that even market failures be ignored, since government intervention to fix them can give rise to even more costly failures.

The retreat from full employment has been driven by New Classical macroeconomics, which substituted the notion of a natural rate of unemployment and a vertical Phillips curve for the negatively sloped long-run Phillips curve (Friedman 1968). In the process, concern with inflation has replaced concern about employment. The theoretical justification is that policy can have no permanent impact on employment, and that the market by itself gravitates quickly to full employment.

The push for so-called "flexible" labor markets has been driven by the neoclassical construction of labor markets based on marginal productivity theory (e.g., that competitive markets ensure labor is paid fairly for its contribution to production). That theory has fueled an attack on unions, the minimum wage, and employment protections, all of which are characterized as labor market "distortions."

Increased corporate power has been justified by the shareholder-value model of corporations, which claims that wealth and income are maximized if firms maximize shareholder value without regard to other interests. To the extent that there is a principal-agent problem with managers not maximizing shareholder value, this is to be solved by aligning managers' interests with shareholder interests via bonus payments and stock options.

Lastly, expansion of financial markets has been promoted by appeal to the theory of efficient markets (Fama 1970), claims that speculation is stabilizing (Friedman 1953), and the notion of a market for corporate control that ensures firms are disciplined by shareholders (Jensen and Meckling 1976). Kenneth Arrow and Gerard Debreu's (1954) contingent-claims approach to financial markets has been used to justify exotic financial innovations in the name of risk spreading and portfolio diversification, while q theory (Tobin and Brainard 1968) has been used to support the claim that financial markets do a good job of directing investment and the accumulation of real capital.

Figure 7 Repacking the Box

An alternative, progressive box

The neoliberal policy box is suggestive of an alternative, "progressive Keynesian" box that would supplant workers with corporations and financial markets, as shown in Figure 7. This requires redesigning and repacking the box as follows:

(1) Globalization, with labor and environmental standards that promote upward harmonization instead of a race to the bottom. Additionally, international economic governance arrangements are to be strengthened, especially regarding exchange rates, so as to prevent a repeat of the recent huge global imbalances. Capital controls must also be a legitimate part of the policy tool kit.

(2) A balanced approach to government that ensures government efficiently provides public goods, health insurance, social insurance, education, and needed infrastructure.

(3) Restoration of full employment as a policy priority.

(4) The promotion of labor markets that encourage creation of high-quality jobs that pay fair wages, which grow with productivity.

(5) A corporate agenda that restricts managerial power by enhancing shareholder control, places limits on managerial pay, limits unproductive corporate financial engineering, and represents other stakeholders.

(6) Financial market reform that consolidates and strengthens regulation, limits speculation, increases transparency, and provides central banks with tools (such as asset-based reserve requirements) to address asset price bubbles.

An opportunity for Post Keynesian economics

Mainstream macroeconomics completely failed to understand the fragility and unsustainability of the current macroeconomic regime. The extent of this failure cannot be overstated and it provides an opportunity for Post Keynesian economics. That is because Post Keynesians (Godley 2000, 2001, 2005; Palley 1998, 2001, 2005, 2006a, 2006b) predicted the outcomes that have come to pass.

The economics profession has talked widely of "the Great Moderation." According to that hypothesis, the economy has become more stable and the business cycle tamed through a combination of improvements in monetary policy driven by improved economic theory, and innovations in financial markets and business management that have spread risk, stabilized credit flows, and reduced inventory fluctuations. Federal Reserve Chairman Ben Bernanke is himself a strong proponent of the Great Moderation thesis: "My view is that improvements in monetary policy, though certainly not the only factor, have probably been the most important source of the Great Moderation" (Bernanke 2004, p. 2).

Yet, the current financial crisis has shown the Great Moderation to have been a period of artificial calm. Moreover, the crisis also lends credence to an alternative Post Keynesian interpretation (Palley 2008c) that the Great Moderation was driven by a retreat from full employment that reduced the income distribution conflicts that surround full employment, and by reliance on the temporary but unsustainable stimulus of borrowing to fuel growth.

Nothing epitomizes the mainstream's failure more than former Fed Chairman Alan Greenspan's admission to Congress, on October 23, 2008, that his economic ideology was flawed and that the self-interest of lending institutions had failed to protect shareholders. Greenspan's approach to financial regulation and the conduct of monetary policy was widely endorsed by the economics profession. Thus, when he retired from the Federal Reserve, in 2006, he was feted by the profession, with the liberal New Keynesian economists Alan Blinder and Ricardo Reis declaring that Greenspan "has a legitimate claim to being the greatest central banker who ever lived" (Blinder and Reis 2005).

The Federal Reserve, the International Monetary Fund (IMF), and leading economists on both sides of the Atlantic all provide clear evidence of the lack of understanding. In March 2007, current Fed Chairman Bernanke testified before the Joint Economic Committee of Congress that "the impact on the broader economy and financial markets of the problems in the sub-prime market seems likely to be contained" (Bernanke 2007). And throughout 2007 and into 2008, district Federal Reserve Bank Presidents Jeffrey Lacker (Richmond), Charles Plosser (Philadelphia), and Thomas Hoenig (Kansas City) all consistently played up the danger of inflation rather than financial crisis and slump.

The IMF has laid claims to being the global economy's early warning system. Yet in July 2007, just as the crisis was about to erupt, the IMF (2007) revised its global growth forecast upward, emphasizing that inflation risks had edged up and central banks would likely need to further tighten monetary policy. Even more than the IMF, the European Central Bank seems to have misunderstood the financial crisis, which explains its resistance to lowering interest rates in 2007 and much of 2008. The same also holds for the Bank of England.

Harvard professor and former IMF Chief Economist Ken Rogoff (2008b) also focused on inflation, writing as late as July 2008 that the global economy was a “runaway train” requiring tighter monetary and fiscal policy. Moreover, Rogoff (2008c) misunderstood the significance of the collapse of Lehman Brothers, celebrating it with an article titled “No More Creampuffs” that argued Lehman’s failure would put an end to moral hazard and restore healthy business incentives.

British economist Willem Buiter (2008) also failed to see the system’s instability, virulently criticizing the Federal Reserve for its decision in January 2008 to cut the federal funds rate by 75 basis points, from 4.25 to 3.50 percent. Likewise, the politically liberal Paul Krugman (2008) failed to appreciate the extent of speculation in oil and commodity markets, rationalizing the surge in oil and commodity prices in 2008 as the result of market fundamentals rather than speculation.

With regard to the global economy, proponents of the so-called “Revised BrettonWoods” (RBW) hypothesis (Dooley, Folkerts-Landau, and Garber 2003) claimed the huge global financial imbalances associated with the U.S. trade deficit were stable and sustainable. Another argument for sustainability came from Harvard professor and former Inter-American Development Bank Chief Economist Ricardo Hausman (2005), who, with his colleague Federico Sturzenegger, claimed the U.S. trade deficit was a non-issue because of “dark matter” investments that yielded huge excess returns to U.S. overseas investments.

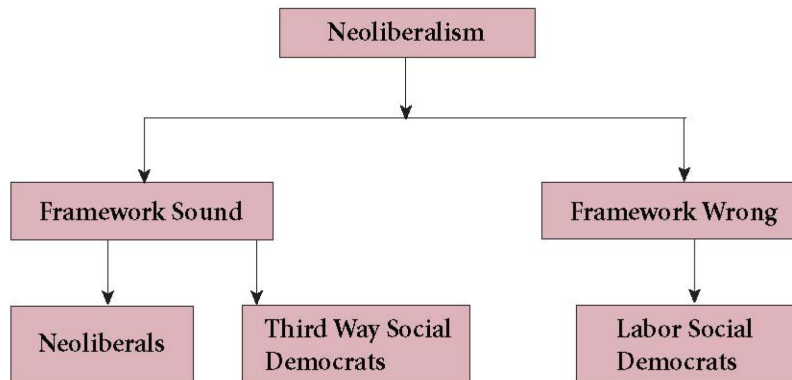
Where there was mainstream criticism regarding the U.S. trade deficit, it was strikingly wrong. Thus, some economists (Eichengreen 2004; Obstfeld and Rogoff 2007; Rogoff 2007, 2008a; Bergsten 2005) predicted a run on the dollar, while others (Goldstein and Lardy 2005) predicted China’s inflation would force a rebalancing.

None of this has come to pass. Instead, the U.S. economy has imploded from within as predicted by Post Keynesians, sending shock waves around the world. Far from collapsing, the dollar has actually strengthened during the crisis, as the extent of global economic dependence on the U.S. consumer as buyer of last resort has become clear.

Mainstream economists have been intellectually honest and guided by their theoretical models. The problem is, events have conclusively shown their theoretical analysis to be fundamentally flawed. Both in its theory and empirical analysis, mainstream macroeconomics failed to connect the dots linking the weak U.S. expansion, the U.S. trade deficit, and the U.S. housing bubble. It also failed to connect long-term developments in the U.S. economy concerning expanding debt, wage stagnation, and worsening income distribution.

This contrasts with Post Keynesian economics, which got it right and provides clear justification for the type of fiscal and monetary policies being implemented. For Post Keynesians, the challenge is to win recognition for this record, as the mainstream profession will try to airbrush the past and rewrite history by burying its own failures and ignoring the success of its critics.

Figure 8 The Political Dilemma of Neoliberalism



Obstacles to change

Though the current moment provides an opportunity for change in both economics and economic policy, there are a number of major obstacles to overcome.

A. Politics and the split among social democrats

A first obstacle concerns politics, and the fact that social democratic political parties—including the Democratic Party in the United States, the Labour Party in the United Kingdom, and the Social Democratic Party in Germany—are split regarding the neoliberal economic paradigm.

Figure 8 illustrates this split. At the most fundamental level there is a divide between those who see the neoliberal economic paradigm as sound (e.g., neoliberals and Third Way social democrats) and those who see it as intrinsically flawed (labor social democrats). The political problem is that these opposing views split social democrats, making it harder to dislodge the paradigm. Neoliberals continue to promote the paradigm, and their response to the crisis has been to try and shift blame onto government, arguing that the crisis is another example of government failure. For instance, U.S. conservatives (see, for example, Schiff 2008) are falsely blaming the government-sponsored mortgage giants Fannie Mae and Freddie Mac for causing the crisis. The Community Reinvestment Act (1977), which aims to promote homeownership among disadvantaged communities, has also been falsely blamed.[3]

Third Way social democrats also remain committed to the neoliberal model. The key difference separating them from neoliberals is that they support stronger financial regulatory reform as well as “helping hand” programs to assist those adversely affected by the market. In the United States, the Third Way “New Democrat” explanation of the Bush Administration’s economic failure is that it abandoned budget discipline and pursued inegalitarian tax and social policies. That is a critique of policy rather than a critique of the paradigm.

This Third Way acceptance of the neoliberal economic paradigm creates a division with labor social democrats who support progressive Keynesianism. That division in turn creates a major political conundrum. On the one hand, if labor social democrats split from Third Way social democrats, they risk bringing about a full-blown neoliberal triumph. On the other hand, if they maintain their fractious union, the risk is a gradual entrenchment of

neoliberalism. The only satisfactory solution is the creation of a new, progressive Keynesian consensus that places economics front and center on the political stage.

B. Intellectual opinion

The importance of economics points to a second obstacle to change: the intellectual dominance of neoliberal economics in academic and public policy discourse. Though the current crisis has created an opportunity to unseat neoliberalism and bring the "Age of Milton Friedman" to an end, events are running ahead of the climate of opinion, which remains dominated by neoliberalism. The political environment may have become more favorable, but a generation of miseducation impedes change. That miseducation affects policymakers, economic advisers, think tanks, and the media alike.

The dominant analytical framework among economists is the neoclassical, dynamic, general equilibrium, real-business-cycle model, which is adjusted to include price rigidities by so-called "New Keynesians." The assumptions of this model—competitive market clearing, the "loanable funds" theory of interest rates, and the neoclassical theory of labor markets—lace both professional and public discourse. These assumptions generate the conventional neoliberal prescriptions regarding labor market flexibility; balanced budgets; the desirability of unimpeded international financial flows and free trade; monetary policy guided by the natural rate of unemployment; and supply-side economics, which emphasizes tax cuts.

The implication is that, as long as economic thinking remains dominated by the neoclassical, dynamic, general equilibrium, real-business-cycle framework, mainstream economics will continue to be amajor obstacle to change.

C. The sociology of economics

The importance of intellectual understandings in turn spotlights a third obstruction to change: the sociology of the economics profession, which operates to exclude and ignore alternative points of view. This practice is justified by appealing to a myth that claims neoclassical economics is a scientifically proven truth, while opposing views are scientifically wrong.

The neoclassical "science" myth plays a critical function, which explains the repeated claim that neoclassical economics *is* science. This function supports the sociological practice that has mainstream economists labelling dissidents as wrong. That in turn justifies purging dissidents from orthodox economics departments and ignoring them in heterodox departments, thereby stripping dissidents of intellectual standing and diminishing their capacity to challenge the neoliberal paradigm.

The deeper sociological problem is that academic economics is a club in which new members are elected by existing members. Today, club members only elect those who subscribe to the current dominant paradigm, as this behavior is justified by the science myth. This poses an intractable sociological obstruction to alternative points of view and the possibility of fundamental change (Palley 1997).

D. Cuckoo economics

Lastly, there is the obstacle of “cuckoo” economics. The cuckoo bird surreptitiously places its eggs in the nests of other birds, which then raise its young. In many regards, neoliberal economics does the same to Keynesian economics. This serves to create confusion, blur distinctions, and promote the claim that Keynesian ideas are already fully incorporated in mainstream economic thought and have nothing further to contribute.

The practice of cuckoo economics is evident in the tendency of mainstream economists to recommend Keynesian policies in times of economic crisis. Thus, many economists support expansionary discretionary fiscal policy and robust interest rate reductions in such situations, even though their theoretical models are hard pressed to justify such actions.

New Keynesianism is the ultimate example of cuckoo economics. It is impossible to read John Maynard Keynes’s *General Theory* (1936) and believe that his theory of unemployment rests on the combination of imperfect competition and price adjustment “menu” costs. However, that is the New Keynesians’ claim, and their adoption of the “Keynesian” label serves to confuse debate and dismiss authentic Keynesian claims about the exclusion of Keynesianism (see, for instance, DeLong 2007). The reality is that New Keynesian economics is a form of real-business-cycle theory. It should really be called “New Pigovian economics,” as it is firmly in the tradition of Arthur C. Pigou rather than Keynes.

The latest example of cuckoo economics is “hip” orthodoxy and behavioral economics (Hayes 2007). Thus, some mainstream economists are now embracing ideas from social psychology that critics of the mainstream have long talked about. These ideas include concerns with relative standing (Veblen 1899, Duesenberry 1949), fairness, and less-than-perfect rationality. The trick behind the new behavioral paradigm is that it draws on arguments made by critics of the mainstream but adopts only those ideas that leave unchanged the core analytical assumptions driving modern neoclassical macroeconomics (Palley 2007).

This capacity to selectively incorporate ideas reflects the amoeba-like character of neoliberal economics, which, though dented by recent events, has an astounding capacity to reinvent itself without real change. The implication is that neoliberal economics has not been staked through the heart, and it therefore promises to rise again, like a zombie, when times stabilize.

Conclusion: The outlook for macroeconomics and macroeconomic policy

The depth of the current economic crisis means there will almost certainly be a policy turn in a Keynesian, or even a Post Keynesian, direction. However, there are profound political, intellectual, and sociological obstacles blocking any fundamental change to macroeconomics. In particular, the economics profession and its ideology remain unreformed. There is little indication of shifts in core understandings concerning labor markets, globalization, and the theory of the natural rate of unemployment. The only place where there is evidence of substantive intellectual change is in attitudes toward financial regulation (though even here, “market transparency” recommendations dominate “quantitative requirements”). These obstacles will mute the policy response to the crisis, and, if a deep

economic downturn is averted, will tend to encourage a return to the existing policy paradigm, which has failed disastrously.

Notes

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1. With regard to jump-starting the economy, one major disagreement concerns the treatment of debt. Progressive Keynesians prefer policies and legislation that facilitate cancelling household debts, whereas neoliberals strongly oppose this action and seek government bailouts of financial institutions without obligating those institutions to cancel outstanding debts.

2. The box analogy is attributable to Ron Blackwell, chief economist for the AFL-CIO.

3. See Ritholtz (2008a, 2008b) for a rejection of the claim that the housing crisis was caused by the Community Reinvestment Act and a failure to regulate the government-sponsored mortgage lenders Fannie Mae and Freddie Mac.

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A non-formal look at the non-formal economy[1]

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Non-formal economic exchange is not a relic of the distant past nor is it a practice limited to the most underdeveloped and economically "backward" of modern times. It is ubiquitous, yet frequently overlooked; under various guises, non-formal economies exist today alongside and intermixed with formal markets, even in the most advanced capitalist countries. From the trading of snacks in an elementary school playground to the trafficking of people all around the world, the workings of non-formal economies are embedded in our daily lives, actively shaping everything from bank policies to foreign policies. The world we know floats atop a tumultuous ocean of non-formal economics. It's about time economists—and the ordinary person on the street—take a look.

Every day, in the privacy of their homes people produce goods and services which are theoretically "non-economic". Every year almost three *trillion* dollars is laundered worldwide—also "non-economic" (Lilley 2007, 32). The "non-economic" are consigned to the margins of analysis by the definitional poverty of mainstream economics; it is the "other" of economics, existing outside of the formal purview. Mainstream economic analysis shines its dissertational light on an exceedingly narrow and superficial field. But the distinctions erected by the mainstream discourse are purely conceptual and often don't hold in reality; households depend on their informal activities such as non-wage labor to sustain their formal ones, and similarly, money launderers depend on formal banking institutions to transform their non-economic (i.e. illegal) activities into economic profits (Nordstrom 2007, 21). Non-formal economies do not operate independently of their formal counterparts, yet the idea of "co-existence" does not grasp the complex engagement and interplay between the two. The formal and non-formal face each other as dependants, each working with and through the other. In his analysis of modern black markets, R.T. Naylor finds that "what has emerged today is a set of interrelated, mutually supporting black markets (still usually thin and imperfect) within which there exists a mix of individual entrepreneurs along with 'firms' large and small, all engaged in essentially arms-length commercial exchanges. No longer isolated, these black markets are institutionally embedded in the legal economy" (Naylor 2005, 3). The mutually constituting realms of the formal and non-formal economies can no longer be clearly distinguished. Their boundaries overlap and obscure; economic reality is a messy one.

Despite this overlap, mainstream economists narrow their analytical focus to formal market exchanges. Economic indicators such as GDP only reflect the measured workings of the formal economy. Cobb et al. points out that GDP "looks only at the portion of reality that economists choose to acknowledge—the part involved in [legal] monetary transactions" (Cobb 1995, 60). The conscious omission of non-formal measures is often justified by economists in their claim that—at least in the more developed countries—the non-formal plays a negligible role in the larger reality of market economic exchanges.

[1] The difficulty in categorizing the different "types" of economies has translated into numerous, overlapping, and sometimes conflicting definitions of these boundaries. But, for the sake of some semblance of clarity, I propose "non-formal" to include: informal, illegal, extra-state – anything outside or opposite to "formal" and not measured in mainstream economic accounting (i.e. GDP). These definitions are by no means fixed through time or through space, so each must be interpreted within a specific context. In other words, what is illegal in one country may not be in another.

How substantial are these non-formal economies in their magnitude and influence on the formal economy? If the conventional wisdom is true and the non-formal has only a marginal role on the global economic stage, then it might be no foul play on the part of economists to overlook their impact. But if, as recent work by anthropologist Carolyn Nordstrom finds, 20%, 30%, or more than 50% of many national industrial economies are made up of transactions that occur outside of the recognized market, then this non-formal reality which has been largely ignored by mainstream economic analysis presents economists with a whole new set of problems and questions (Nordstrom 2004, 91-96).

The non-formal economy, long thought to be trivial in both substance and sway, now emerges as a critical force in the global economy. Economists have sought to explain the recent financial, housing and banking crises through a variety of formal viewpoints, but if we want real explanations, maybe we should ask real, non-formal questions: what is happening "behind the scenes?" What pressures do illegal, trillion-dollar financial flows put on the formal banking system? What is the effect of falsely hedging high-risk financial speculations? Who is watching, and, more importantly, who is looking the other way?

As the Société Générale or Bernard Madoff scandals show, non-formal activities can have substantial pecuniary effects on the formal economic scene. After the news broke about Société Générale, many analysts drew ties between the fraudulent trading and the current stock-market woes (BBC 2008). Jerome Kerviel, a mid-level trader, was able to illegally trade in tens of billions of dollars at one of the most well-respected (and presumably most well-secured) financial institutions in the world. Bernard Madoff, the former chairman of Nasdaq and current chairman of one of the largest investment securities firms in the world, was arrested in December of 2008 on charges of orchestrating a decades-long Ponzi scheme to the amount of $50 billion (Henriques 2008). The waves set in motion by Madoff's sinking hit financial institutions and charities formerly doted on by the now defunct Wall Street legend (Randall 2008). Madoff and Kerviel are just a few instances of such vice: Enron, WorldCom, and Xerox round out a list of examples of (uncovered) corporate corruption in our times. These scandals epitomize the graying line between illegal and legal market activities on a global scale—with global economic implications (Nordstrom 2007, 57-58).

Scholars such as Nordstrom and Naim have documented the rise of global crime and corruption in our contemporary world. Ranging from the disturbing (kidneys, nuclear weapons) to the more commonplace (cigarettes, lumber, intellectual property), the profits garnered in black market can dwarf the GDP's of entire countries (Naim 2006, 157-174; Nordstrom 2007, xvii). However, it isn't only the exotic, dangerous, or violent illegalities that should consume our worry. The everyday and altogether ordinary aspects of crime and corruption have risen to heights of power in business and government. The black market in pharmaceuticals deals in the hundreds of billions of dollars. Illegal markets in food, garbage, endangered animals, and art add billions more. In recent years, the global crime aspect of the non-formal economy "has not just soared in volume but, thanks to its ability to amass colossal profits, has become a powerful *political* force" (ibid., 13). Tyrants and traders, judges, generals, and executives now wield increasing amounts of power and influence. These actors and institutions are able to transcend the boundaries between the legal and illegal, but are only accountable in the former. Embedded in the formal economy, non-formal economies—unmeasured and unrecognized—are the real invisible hands of the market, leaving an indelible fingerprint on our everyday lives.

If informal and extra-legal markets not only exist, but have significant effects on formal markets, another question arises: why don't we see them? The popular media has brought light onto certain non-formal activities (drugs, arms, diamonds), but often downplays their breadth or romanticizes single individuals (drug dealers, arms dealers, Leonardo di Caprio), casting the non-formal into the realm of mere Hollywood fiction. Open up any introductory economics textbook and you will find little to no mention of informal gift-giving or the illegal global trade in body parts. Our non-formal blindness is a direct result of our formal education—in the most general sense of the word—through an obsolete worldview. Society today works under several conceptual dispositions:

1. Feeling local, acting global: Actions and interactions may appear to have geographic bounds but are actually tied up in a global web of interconnections. Economies and cultures are plugged into networks that span the globe. Take the production of a t-shirt: the cotton, grown in the southern United States, may travel to Latin America for dying, then to a Southeast Asian factory for assembly, then to store shelves in Europe or back in the United States (Rivoli 2005). Very few things these days are actually stay "local". What is needed is a new global awareness—one attuned to the ebb and flow of global interconnections.

2. State tunnel-vision: Our worldviews our highly state-centric. The past, present, and future are defined within the confines of a state-sanctioned world. But in the continually globalizing economy (both formal and non-formal), state borders, structures, and sovereignty are slowly losing force. Many of the current and contentious political debates, from trade policy to immigration, can be seen as symptomatic of a larger crisis of the declining sovereign state.

3. A preference for the quantitative over qualitative: The realms of the measurable and immeasurable are not mutually exclusive. There is a close relationship between what we can measure and what we can't. Emotions, history, and culture—each impossible to measure numerically—condition and are conditioned by the economic interactions that we quantify.

4. Static analysis: Learning often takes place by looking at frozen snap-shots of history, society, or the economy. History is taught in "periods," society is understood through "groups" or "states," and economics is understood through "equilibrium." Static analysis ignores the real "flow," or complexity, of social and economic processes—processes where the means are just as, if not more, important as the ends. Structures, commodities, people, and ideas are not fixed. They move, they interact, and they change, dissolving notions of stability and determinability. By ignoring "flow" reality is conceptualized devoid of the constant flux of place and meaning.

5. The legal/illegal dichotomy: The law is constantly entangled in both new and old moral paradigms and is confined to specific geographic boundaries; the law is not international or transhistorical. What is "illicit" in one country may not be in another and what is "illegal" at one time may not be at another. Similarly, punishments for specific crimes vary across times and regions. Laws regulating prostitution and drug use in the Netherlands are far removed from similar laws in the United States. This legal messiness extends throughout the global economy; from environmental standards to the production of pharmaceuticals, the "law" does not stand on equal grounds across countries and cultures (Naim 2006, 184-188).

These worldviews are, in many ways, reflective of Bourdieu's *habitus* (Bourdieu 1977, 22-30). As both methods of action and analysis, these dispositions act as the "structuring structures" that perpetuate existing structures. This circular relation beginning with interpretation (analysis) and ending in action reflect deeply internalized social expectations. The five conceptual dispositions listed above echo strategies adopted for action in and analysis of the economy. Unconscious and unreflective, the dispositions of *habitus* represent the overarching patterns of behavior which are expressed through all modes of perception and reasoning (Swartz 1997, 95). Strategies are incorporated by actors to practically engage the objective structures they face.

Bourdieu's idea of the "hysteresis effect," or structural lag, comes into play when the expectations embedded in *habitus* fall behind or come into tension with changes in objective social structures (Bourdieu 1977, 78-79). Naim notes the unexpected and radical changes in the global economic and political scene over the past two decades. Though the recent period of globalization has been the topic of scores of analysis, these have focused solely on its legal, formal, and market manifestations. Both Naim and Nordstrom charge that what has been unanimously overlooked, or *misrecognized*, is the non-formal and non-market forms of globalization that underlie everyday experience (Naim 2006, 12-18; Nordstrom 2007, xv-xxii). What is now occurring is a crisis in the conventional worldview. Relations of wealth and power are being uncovered that are inconsistent with the previous ways of seeing, thinking, and acting in the world. New strategies and methods of analysis, especially in the fields of the social sciences, are necessary to understand the changing features of contemporary life.

Paramount in mainstream economics but lingering in all forms of education, these five dispositions contribute to the continuing illusion of a static, state-centered, only-matters-if-we-can-measure-it world. We learn to group, categorize, and divide the world according to certain prescribed dualisms: local/global, state/non-state, quantitative/qualitative, stasis/flow, and legal/illegal. But in realty, these firm distinctions quickly fall apart. In her book, *Global Outlaws: Crime, Money, and Power in the Contemporary World*, Carolyn Nordstrom tells the story of Okidi, a boy of about nine, surviving in war-torn Angola by selling smuggled cigarettes. Tracing the connections from Okidi to the local smugglers and trade routes through which commodities—legal and illegal—flow to the transnational networks that make it all work, Nordstrom finds "a child selling foreign cigarettes on bomb-cratered roads far from the world's economic centers links into global extra-legal economies that reap trillions of dollars annually" (Nordstrom 2007, 7).

The framework of formal neoclassical analysis is ill-suited to study these uncertain meetings of the local and global, legal and illegal, mundane and monstrous, and interested and disinterested that makes up non-formal economies (Naim 2006, 15-20). Mainstream economics is not equipped with the tools to comprehend exchanges that are either extra-state or extra-legal (Naylor 2005). Neither can it grasp the transnational networks of trust, not contracts, which guide some of these exchanges. As Edward Fullbrook writes, "Theories, scientific and otherwise, do not represent the world as it is but rather by highlighting certain aspects of it while leaving others in the dark" (Fullbrook 2004, 1). In these shadows, the linkages power, crime, and corruption in our contemporary world are being overlooked.

In a sea of economic chaos, where do we cast the net? People give and take, buy and sell, share, hoard, and steal. Laws exist but are not always followed, borders are constructed but not always respected; a world of economic activity flows outside of our

textbook graphs and figures. While the global economy continues to expand, our definition of what is “economic” continues to taper. To being to answer the pressing questions of our time, a complete reframing of our traditional worldview needs to be effected. Most important in this reframing is the need for a new conception of economics—one not disposed to narrow worldviews and dated ideologies. A more inclusive definition of economics is in order, one that does not shed the “social” from its “science.” Edward Fullbrook notes that “in recent decades, this upside down ‘science’—this choosing what one sees in order to justify a theory and its ontology, rather than using theory to understand intransitive realities, became hegemonic” (Fullbrook 2001). Instead of grounding theory in reality, theory was constructed from (formal) fragments of reality.

Economics isn’t just supply and demand; it lingers in all social phenomena, and, above all, conveys the nexus of wealth, power, and ideology in our world. Naim warns us that “the lens through which we interpret world politics and economics need to be adjusted to this change—urgently” (Naim 2006, 13). It is now obvious that real gaps (or gorges) exist between our traditional economic theories and reality. But it is in these gaps that a new theory can develop, bringing to the forefront what had previously only existed on the margins. With a broader scope, the myriad of economic actions and interactions, formal and non-formal, legal and illegal, can be explored, explained, and accounted for.

The contemporary world is marred by financial crises, civil wars, black markets, and development catastrophes. Behind the scenes smuggling, dealing, insider trading, and despotism are a present and critical force in the economy. These, together with the “softer” non-formal activities such as bartering and household production, are shaping our lives in powerful new ways. The world today isn’t the same as it was only a few decades ago: globalization happened. It is now apparent that globalization has brought with it new challenges for both the formal and non-formal aspects of the economy. In turn, this requires new theories and new forms of social analysis. We need to *see* the non-formal before we can even set out to understand it. As Nordstrom puts it, “if we cannot perceive the true magnitude and dynamic character of both the legal and extra-legal, we are impotent to respond. People can see only what they have the conceptual tools to see” (Nordstrom 2007, 208). War, poverty, death, and deceit are all upheld through the continued ignorance of the non-formal dimensions of political economy. The stakes in the battle for a real-world economics are too high to ignore.

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The financial crisis

Part IV

The triumph – and costs – of greed *(Part I)**

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Problems of cause and consequence

The events of summer and fall 2008 have shown with stark clarity that the modes of accumulation pursued across the banking industries —not only, but particularly those of the US and UK—were so deeply flawed, so toxic in their consequences, that they call into question the fundamentals of the economics on which they were based. Yet to date there is precious little evidence of any fundamental rethinking, either in the industry or by the economics profession,—much of which still seems in denial about the character and gravity of the present crisis. With few exceptions, the argument from all sides—and from most in politics too—is for a return to business as usual as quickly as possible.

It is not difficult to see why this should be so. Crises of this scale, in opening severe uncertainty, call forth two contradictory impulses. The first is towards action. What was unthinkable may suddenly become, in heat of the moment, the applauded, bold and essential action of government. Such was, briefly, the response last September to the threat of a complete collapse of the banking system.[1] But hard on the heels of the impulse to act comes reaction, the adamant re-assertion that everything must, in the end—and preferably as quickly as possible—be just as it was before.

This was the surely the sentiment that lay behind the open letter sent to Congress by 166 economists in late September. Labeling the crisis as merely a 'short-run' disruption, the impulse to preserve what-is *at all costs* was captured in its central premise, that "for all their recent troubles, America's dynamic and innovative private capital markets have brought the nation un-paralleled prosperity. Fundamentally weakening those markets in order to calm short-run disruptions is desperately short-sighted."[2] What was sharply evident in this letter, as well as in the series of statements by a number of economists across the fall that followed this line, was that denial of the depth of the crisis was not based on an analysis of what was occurring but was rather introduced a priori as defense against change—on the obvious grounds that if you can deny that there is anything rotten in the state of Denmark then you obviate the need for action.

This desire for the earliest possible return to the status quo has significant implications for policy. Take how we are dealing (or failing adequately to deal) with the bank "bail-outs".

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*This paper is a much extended version of "The Triumph of Greed" first published in the *New Statesman*, 8 December 2008 pp. 37-39.

Lack of acceptance of the true state of the financial sector,[3] which is one side of the premature desire for restoration of what-was, goes along with its other—i.e. the policy failure to develop the necessary strategies to re-structure their operations (e.g., to address counter-productive incentive structures,[4] and more fundamentally to *compel* banks to withdraw from speculative trading in areas where they cannot assess risk)[5] is creating the conditions for a perpetuation of unacknowledged insolvency which has grave dangers for the revival of the economy as a whole. In this case the desire for continuity is overwhelming the necessity for structural action.[6] Are we then surprised that the policy of pumping money into the banks is taking on the character of pouring resources into a bottomless pit?[7]

The desire for the axiomatic restoration of what-is bears also on explanation. It is already clear that the kind of stories that we are beginning to tell ourselves concerning the causes and nature of the crisis are in fact centrally concerned to account for what occurred in ways that make possible a smooth return to the status quo. Even among liberal economists the preferred mode is to locate "cause" in the operations of the market, i.e. to have the faults be operational rather than fundamental.[8] On one level this is not surprising. If cause can be identified in an operational failure it can be rectified. Since it is essential that, whatever else happens, such failures *are* rectified there is a point to this. No surprise then that there is an impulse to seek cause in what can be quickly (and relatively painlessly) transformed. It was telling in this respect that Jeff Madrick concluded a recent analysis of the crisis by noting: 'Financial market participants created a financial bubble of tragic proportions in pursuit of personal gain. But the deeper cause was a determination among people with political and economic power to minimize the use of government to oversee the financial markets and to guard against natural excess.'[9]

Madrick is surely correct in his observation as to the importance of abdication of responsibility for oversight of these markets. The absence of regulation (and more the deliberate creation of that absence) is a significant aspect of the irresponsibility that ran through the operations of the financial markets, though it is by no means the only factor. But is it causal? Lax or non-existent regulation *enables* a market to operate in ways that are structurally irresponsible, but can it *alone* be causal with respect of the depth of the crisis we are now facing?

This is not an idle question, and on several grounds. Without adequacy in explanation—that is without facing up to the factors producing the crisis—policy will likely remain a band-aid at best. At worst it will not only contribute little to solving the crisis, it may even ensure inadvertent translation of the situation into a longer-term social and political as well as economic disaster.[10] The problem of the reparative instinct in this respect—both in policy and in intellectual terms—is that it cuts off questioning too soon and does not get to the generative heart of the matter. The analytical issue here is to distinguish levels and types of cause. A simple example: the absence of sufficient lifeboats and the absence of a common-practice of 24hr-manned radio facilities in ships crossing the Atlantic in 1912 were both major *contributing* factors to the death-toll in the sinking of the Titanic. But they were not *causal* in respect of the initial impact with the iceberg, nor do they bear on the insufficiently understood vulnerability of the Titanic to certain types of flooding of its hull. In other words, all these moments were causal in respect of the scale of disaster, but not in the same way. Of course the line between what we might call contributing or enabling causes ('conditions of existence'

for the crisis) and what we might call direct or generative causes (active cause) is a fine one and never in practice easily differentiated.

Nonetheless with respect to this crisis we can talk of enabling and generative causes. The first are those conditions which must to be in place for the markets to operate in the way they did. Lack of regulation is one of them; permission to leverage deposits in relation to loans is another; liquidity and the easy availability of capital is obviously essential, as is (in my view of central importance) the political tolerance and even encouragement of unprecedented levels of debt in, both in total (for the US 350% of GDP, or c$42bn, equal to not far short of 85% of pre-crisis world GDP) and particularly in household debt (100% GDP) and—even more telling—financial sector debt (c.117% GDP in 2007 up from c.20% of GDP in 1980) is yet another.[11]

The second group, 'generative causes,' can be described less as conditions and more as forces. But this is where we run into a problem, for as one looks at the explanations given for the collapse one senses not only the desire to latch onto a "fault," or an identifiable single cause ("Greenspan!"; "Regulations!") but avoidance, a marked reluctance to consider the *active* causes of the crisis. It is telling in this respect that as successive ways of naming the crisis and of offering explanations have been given—it was a housing crisis; it was a crisis caused by defaulting sub-prime mortgage owners; a crisis of the sub-prime mortgage sector; a crisis of operational failures in the shadow-banking and mortgage industries; a crisis induced by lax or non-existent regulation in the financial sector, a crisis of market hubris, even a crisis of inept government[12]—realization has come that the crisis-inducing potential of the named factor could not possibly match the depth of what has transpired. No housing crisis induces a credit-crunch; defaulting mortgagees could not possibly bring down a banking sector; a market collapse equal to 1/6th of US GDP does not itself create a global recession.

This touches on a general rule: attributed cause has to have the capacity—singly or in conjunction—to induce consequence. In the case of this crisis we know that the primary *trigger* was the successive and eventually almost complete failure of the shadow-banking mortgage brokers and debt-encumbered banks beginning from December 2006. The underlying *enabling conditions* have to do with the circumstances and mores that let those markets come into being, and which allowed the banks to operate in the distinctive ways that eventually induced disaster. These are the circumstances we can indentify with some ease. The trick is giving them the correct weight and placing them in the pattern of conditions and circumstances that underlay the collapse.

But these circumstances and conditions are scarcely dynamic. They are taken up, they become significant in their *use by* forces. We move towards the *active causes* then when we begin to think about the axioms and forces that drove the market. For example, the erroneous belief that a market driven wholly by and working as a force for short-term accumulation can (and should) be self-regulating and will naturally reproduce that ideal of competitive equilibrium. As a motivation and a legitimation for action this is not insignificant in the crisis.

But even belief pulls back before force. If we want to know the active force in the markets, and thus the forces behind the collapse—the forces therefore with which we have to contend in long-term policy terms— we have to look at what drove these markets. What drove them was unleashed financial accumulation based on the effective privatization and private organization of the banking sector and the credit- and debt-systems.[13] Such accumulation

cannot but be blind to consequence and cost, and it cannot be other than systemically unstable.[14] This means that *irresponsibility is a determining and structural characteristic of the modes of accumulation we have now sanctioned.*

It is not easy to deal with this. It means giving *systemic* weight to Madrick's first point, that 'Financial market participants created a financial bubble of tragic proportions in pursuit of personal gain.' The difficulty of doing this, of translating subjective drive into objective structures and mechanisms of accumulation and collapse is not easy. The question of 'personal gain' sits uncomfortably in modern economic discourse. That it does so is surely not unconnected with the difficulty of accepting over the last decades that the processes of financial wealth-creation have been transposed to become primarily structures of wealth-diversion, dispossession and extraction. It is the implications of this that are now in question.

This paper tries to address this question of active cause. It looks at the structure of accumulation that developed on Wall St and in the City and it analyses the problems of the operative logic of this 'temporary growth regime' and its costs and consequences—cognitive one might add, and moral, as well as economic. In particular it tries to look at this (disastrous) mode of accumulation not in terms of universal 'laws' but in terms of forces, of the dynamics of accumulation, coming out of and responding to particular economic and political conditions and resulting in a 'growth regime' that is un-precedented in certain of its features and by no means understood, even by its principal actors (and let alone by economists).

The paper begins this analysis from the issue of continuity, from the question of whether continuity in the operation of markets is what we want, need or *can afford*. The motif through which this is approached is the question of crime. This issue of what we can afford gives the paper its second thrust, which is to ask about the true costs of doing business. I am taking it that this question—raised acutely by this crisis but by no means confined to it—is perhaps *the* economic question for our time. It moves center stage in its wide form in terms of the *absolute* requirement for us to pursue this question in view of the rank un-sustainability, in "ecological" terms, of our current modes of our economic activity.[15] In terns of this crisis the question takes on a less overarching but scarcely less significant role. To ask whether the costs of 'doing business' in terms of privatized financial accumulation as we have done it over the last decade or so—and the moral and social costs as well as the financial costs—are more than we should be asked to bear is to open up the question of the *value* that we obtain from the economy. To ask about *cost* in relation to *cause* is to try to establish a broader understanding of how (and who) an economy benefits.

The argument proceeds in five steps. Beginning with the question of crime in the contemporary economy, i.e., of what is done in order to secure wealth—crime here taken in a wide extractive sense (sections I-IV), the paper looks at the nature of the modes of (extractive) financial accumulation created from the 1980s onwards and specifically at the modes and models of accumulation dominant in the current crisis (sections IV-VII). The third section then examines accumulation as a force and what I have called the "structures of irresponsibility" characteristic of the modes of accumulation that were dominant in the run up to the crisis. It looks particularly at debt, regulation, risk, responsibility for consequence and privatization and finishes with the question of greed (Sections VIII-X). Finally, the fourth aspect of the paper looks at the costs of greed, cognitive as well as economic, and considers how we might begin to think of the economy outside of the current *a priori* definition of the economy as, in effect,

only a vehicle for private accumulation (Sections X-XV). Because of the complexity of the argument, I have divided the paper in two. Part I, that takes in sections I-IV, essentially acts as a long introduction to the main argument, which focuses, as is noted above on the structures of irresponsibility internal to this mode of accumulation and on the multifarious—and unacceptable— costs it imposes.

The question of a charity

Consider, as a starting point to the double question of the causes of the crisis and its costs, this story. It concerns the collapse and subsequent nationalization, of Northern Rock, a British bank and mortgage lender and one of the UK leaders in the sub-prime market. First uncovered by the financial analyst Richard Murphy[16] the point of the tale lies in what the British government found as it opened the books. Here is Iain Macwhirter's summary from the UK *New Statesman* of 20th October 2008: "The Treasury minister Yvette Cooper discovered to her dismay that Northern Rock didn't own half its own mortgages: £50bn ($75bn)[17] had been hived off to a Jersey-based company, Granite,[18] *registered as a charity benefiting Down's syndrome children in the north-east of England*."[19]

The smile of incredulity that half-forms at the sheer audacity of the act—how could they conceive of doing that?—fades as the implications of this appropriation (an act of identity theft at the very least) sink in.[20] Even Brecht, one thinks, might have hesitated to ascribe such a tactic—though *The Threepenny Opera* provides perhaps the only suitable fictional parallel that come close to what is afoot here.[21]

Sanctioned at the highest levels in the company, and underwritten by some of the major US and UK banks,[22] Granite was not essentially different—save in its theft of DSNE — from many other (highly profitable) "structured" synthetic investment vehicles and valuation models developed, in the last decade or so, across the banking sector.**[23]** Located off-shore, in a schema of ownership that made it extremely difficult to discern by whom it was controlled, it was, in effect, all but impervious to taxation and, equally importantly, given what it held, detailed scrutiny.[24]

Even by the standards of the City, Northern Rock's appropriation of Down's Syndrome North East should have been an acute embarrassment to a financial industry that only three months before had been lauded, in an annual ritual, by the British Prime Minister—who congratulated them on 'remarkable achievements' that 'history will record as the beginning of a new golden age.'[25] Yet the story is more than an embarrassment. It is pathetic of course—there is no great financial acumen in hiding liabilities or in setting up what is essentially a fake charity; *The Producers* were more inventive, the stock-exchange games of the 1920s more complex—but it is revealing. [26] Whether technically illegal or not, most of us would say that what happened at Northern Rock was, at minimum, a serious moral crime. Instinctively (and surely correctly) we feel there is something fundamentally unforgivable in using a charity for Down's syndrome children as a tax-evasive parking lot for (ultimately distressed) mortgages just as there is something deeply shameful about making the "new economics" dependent on such gambits..[27]

But it is not only a moral problem—even though in the end this is a more significant dimension of the issue than we might think. Part of our reaction to this story is that if *this*, then there is no boundary, no limit; no place where it is possible to say, *here* legitimate business ends, *there* criminality begins.[28] Instead, we are faced with the opposite, a steady slide towards criminality becoming an internalized norm of business. But this is exactly what is revealed here.[29] Like Madoff, Enron—and today Stanford—and many others before it, a litany that is getting much too long for comfort, Northern Rock's act is in danger of blurring the line between business and crime.[30]

This is a line which is crossed with increasing frequency in the "new" economy: criminality, and near-criminality, runs throughout the financial system. Corporate scandals of the past few years have involved many, if not most, of the world's major global accounting firms as well as a goodly spread of major corporations and financial institutions.[31] Caribbean, British and European tax havens run on tax evasion and criminal money-laundering, a fact that the governments concerned no longer bother to deny. (Obama pointed out in his campaign that a single office building in Cayman Islands was the headquarters of 18,000 US companies—that's either, he said, 'the biggest building or the biggest tax scam on record. And I think we know which one it is').[32] In Europe, crime now constitutes one of the largest single sectors of business. The Mafia alone controls, through "legitimate" companies, something of the order of 20 per cent of Italian business or 15% of GNP worth (in 2000) around $800bn with a (then) annual turnover of $133bn.[33]

All of this—and more—is well known. Yet we tend to pretend—along with government —that the institutionalization of crime within the "mainstream" economy is not a matter of concern; that it doesn't come with acute political, social, moral and—in the end economic—costs. This is an unsupportable supposition. To put it bluntly, it is nonsense. Not only is there a danger of a moral vacuity (into which genuine criminality steps with ease—one thinks of the trade in body organs run so profitably by the Italian mafia—hence their investments in medical care facilities)[34] but crime costs—socially and politically and (in the not so long-run) economically. The global cost of corporate crime coupled with tax evasion and avoidance is estimated, conservatively, at around $400-500bn a year.[35] When more than 40 per cent of the value of African bank accounts is in Swiss banks, we know that looting and corruption — the 'politics of spoil', as Oswald Spengler named it nearly 80 years ago[36] —has taken place on a huge scale.[37] The (failed) reconstruction of Iraq, which has remarkably little new infrastructure or working institutions to show for investments that have topped $100bn, will be noted, when its history is finally recorded, as perhaps the largest site of embezzlement in history.[38]

One could go on. The list simply reminds that crime is indeed a redistribution of wealth, but there is nothing of Robin Hood about it. It is the most regressive form of "taxation" and the one most debilitating, in all its consequences, to social well-being.[39] (For the wider social—and economic— costs of crime, it should suffice to look, for example, at southern Italy, where criminality at this level has been in operation for generations and little or nothing escapes its take.).[40]

Crime in the new economy

We tend to turn our back on these issues; to romanticize crime as part of entertainment, while denying the wider cost of the slippage of the boundary between "legitimate" and criminal business. One result is that we scarcely understand the full consequences of what happens when crime and business begin to slide together at this scale. This is a particular problem for us in that it is increasingly difficult, if not impossible, to disengage crime from the mainstream economy.

Take the issue of corporate tax evasion. Why, we might ask, when states are losing colossal revenues to evasion and avoidance[41] is there an effective refusal by those governments who have at least nominal oversight over the centers of money-laundering and tax evasion (the US, the UK, Switzerland, Luxembourg, Lichtenstein) to do anything meaningful to regulate the movement of capital? Why have neither the World Bank nor the IMF tried to investigate or quantify capital flight and tax evasion?[42] One answer is that although we tend to assume that tax evasion occurs at it were after or post- legitimate business activity, in fact something of the order of half of all world trade is conducted, for accounting purposes, through tax havens. In other words, tax-havens are not merely for evading the social costs of doing business they are weapon of competitiveness. John Christensen of the London-based Tax Justice Network explains:

> The ability of multinational businesses to structure their trade and investment flows through tax-haven subsidiaries provides them with a massive financial advantage over nationally based competitors. Local firms, regardless of whether they are technically more efficient or more innovative, find themselves competing on an uneven basis. In practice this market distortion favors the large business over the small, the international business over the national, and the long-established business over the start-up. The outcome has been that both in theory and in practice the use of tax havens by virtually every major global bank and multinational business has nullified David Ricardo's doctrine of comparative advantage. Fundamentalist advocates of a no-holds-barred approach to free trade have persistently turned a blind eye to this problem. For those like Baker – and myself – who believe that free and fair trade can generate viable economic growth and spread its benefits across society, the blatant unwillingness of key players like the IMF, the World Bank and the UK government to tackle these global market failures says a lot about their real intentions.[43]

Christensen is surely correct on this point. But one wonders too if this increased acceptance of the fluid or porous border between mainstream economy and crime—and this is a global phenomena, visible in every major geographic center of accumulation—is only an accidental by-product of the process? There seem to be two aspects at work here. Once you not only allow but *insist* as the IMF began to from the 1980s onwards, that 'the world' be opened up to the operation of 'free-markets financial services' (meaning also the free flow of capital) there is no effective way of policing what occurs. You thus by necessity create an economy that is remarkably hospitable to organized criminality'[44]

At the same time, by setting in place a mentality in which it becomes *de rigueur* that any and all opportunities for accumulation should be seized, almost no matter what the

implications, you create an ethos in which, in effect, in terms of financial accumulation, there are few or no limits. What all this means is that while criminality in the operations of markets is not officially sanctioned, in practice much is permitted. After all, the nature of dis-possessive, diversionary and extractive accumulation operating at very high levels of short-term profits lends itself to operations disinclined to restraint and responsibility.[45]

All this suggests—and this is surely accurate—that the structures of (particularly) short-term privatized financial accumulation are permeable with respect to quasi-criminality. To put it in a more picturesque manner, the piratical seizing of opportunity for profit is not as dissimilar as some in business would like to pretend.[46] Of course capitalism has never been overly concerned about its source of profits. Results (i.e. returns) have always trumped scruples. The problem however, athough we tend to forget this, is that crime is not only socially regressive, it is economically incompetent. There is nothing surprising about this. Crime is by definition *nothing but* theft. It does not *make,* it *takes*; it is not wealth-creative, but wealth-destructive—or at best wealth-diversionary. It leaches monies out of economies that it in no way constructively contributes and it destroys the structures of trust that are the conditions for real economic life.[47] It is, to put it simply, extractive; a using-up of what is;[48] the diversion, or dispossession, of wealth earned elsewhere; in effect, it is a tax (and often a very large one) on the body politic. It is cost.[49]

But crime is not only economically incompetent as theft. The vanity and narcissism that fuel it—both qualities, note, massively evident in the banks and institutions that have collapsed[50]—is the same as that which demands realization *in the moment*. The question of time is fundamental here. The conditions for the generation of genuine wealth, i.e., increase in long-term sustainable productive *capacity*, are antithetical to modes of accumulation, like crime, that eschew time, that live for the moment and which are essentially extractive in their attitude to wealth creation. It is worth recalling that it was for just these reasons that Keynes was particularly impatient of arguments in favor of short-term financial accumulation. Duncan Foley offers a useful summary:

> "In Keynes' view the widespread use of money and the development of sophisticated financial markets and assets are in part a defensive reaction against the 'dark forces of time and uncertainty" on the part of wealth holders. Real investment requires commitment of the investor to the long-term, illiquid and risky prospect. Financial assets, on the other hand, represent more liquid wealth than can be sold at any moment, and allow the wealth holder to defer the decision as to the ultimate use of the funds involved. But Keynes believes that this is exactly why money and financial assets are potentially dangerous. In times of uncertainty,[[51]] wealth-holders will tend to flee from real investment into financial havens and money, thus lengthening the time lag between the sale and purchase of real goods and services, and creating a gap between aggregate supply and aggregate demand.[52] While laissez-faire reasoning argues for making available as wide a spectrum of financial assets as possible, and reducing costs of transaction as much as possible, in order to increase the liquidity of the economy, Keynes sees a case for restricting investors choices, and forcing them to commit themselves to some real investment. He goes so far as to suggest that investment of wealth should be something like a marriage: an investor should be forced to choose

> whichever real investment he or she thought had the best long-term prospects, and stick with it for the life of the project.[53]

The remarkable contrast between what Keynes advocates and the ethos on Wall St or in the City of London over the last decade could hardly be exceeded—no wonder the discomfort that the "re-discovery" of the Keynes causes in some quarters.[54]

But there is clearly another level at which the denial of time and capacity works and that has to do with the economics of institutions and modes of regulation and the ways in which the extractive is erosive of institutions. While it maintains its own (at least in myth—this is part of the illusory romance of the Mafia) crime, and more generally the extractive, is profoundly destructive of the institutions that it makes use of (as is, as we are seeing in the crisis, debt-fueled and leverage-induced financial accumulation which in this respect behaves with the same consequence.

One way to look at the financial crisis that we are now in is to see the system of privatized accumulation on Wall St and in the City as un-intentionally erosive of its own institutional base. All productive economies are dependent upon particular and complementary patterns of formal and substantive institutions and modes of regulation. Financial operations are particularly dependent on structures of trust embodied in institutions. Accumulation, in the modes we have seen it work on Wall St and the City is no exception, it was equally dependent on such trust. The proof of this dependency is given in the timing of the most serious moment of the collapse which occurred not when the markets began to fail but only when one of the institutions that marked that trust was (mistakenly as it turned out) allowed to fail. Mohamed El-Erian comments: "The manner in which Lehman Brothers failed disrupted the trust that underpins the smooth functioning of market economies. What was less well understood [in allowing it to fail] was that it matters a great deal how an institution's failure affects the capital structure. The way Lehman failed disrupted payments and settlements. Around the world, *market participants stepped back in mass from what, up to then, were standardized, routine, predictable transactions*.'[55]

It was not, note, simply that Lehman's possessed symbolic value—though clearly, too a degree, it did, hence the shock of its collapse. But it is more accurate to say that it represented what even accumulation in its most rampant form required, and that was the ability, at the simplest, to have transactions occur under a routine of trust and regulation. The problem, of course, is that this same mode of accumulation, which for even the possibility of the transactions on which it depended for its revenue required trust (and which also was dependent, wholly, on institutional identity to give its products a price —*there was after all in the end nothing else on which to base price*)[56] could not but also work to erode regulation (this was Madrick's point of course) and therefore could not but also erode the institutions and the basis of trust on which transactions could happen.

Put this another way and we can say that the move from what Peter Gowan calls the public-utility side of banking and financial services into a 'private capitalist credit system(s)'[57] focused on accumulation-through-speculation underwritten by individual incentives—was bound to give operational emphasis not to stewardship but to short-term maximization of returns, not matter what the institutional context. Bonuses at the operational level, profits at the supervisory (board) level provided sufficient lure for this emphasis. Not that in practice it

mattered, but this was in any case supported "theoretically" by the premise of the maximization of notional-net-worth-at-market-prices—no matter how illusory or, to put it a little more charitably "uncertain" these prices and profits might be (whether as prices paid for "assets" (loans), the 'profits' booked or the assessed market value of the institution).

This would not be the only moment in economics when the pursuit of short-term *notional* net worth proved catastrophic.[58] From the perspective of pure market theory even concern for something as *apparently* indirectly related to value as institutional worth (i.e., in the financial sector, trust in the institution on which all else depends) can be read as 'interference' with the realization of value, a hindrance to the 'spontaneity' of the market. The problem is that in the case of the sub-prime mortgage and other speculative "markets" the pursuit of short-term returns come what may, i.e., without reflection on costs or consequences, simultaneously hollows out the asset-base of the institution. Just as the Mafia extracts until the source is emptied, in Wall St and the City the lode—let us say, sub-prime mortgages and their related "asset-backed" securities—is mined for value (through leveraging and debt) irrespective of consequences for the institution *through which the wealth-creation depended.*[59] Hollowing out the asset base of the institution cannot but lead however to a hollowing out of trust.[60] But when trust goes, then the institution goes. One scarcely needs to add that once the requisite collective level of trust in the market is breached then the contagion—i.e., the seizing up of credit transactions—spreads with the speed of a bush-fire.

A new mode of accumulation?

Two conclusions can now be borne forward from these last sections. The first is obvious: it is that criminality, in the wide sense, is far more present (i.e., is far more structurally internalized) in the accumulative economy than, in general, we would like to concede. We said above that 'the structures of (particularly) short-term privatized financial accumulation are permeable with respect to quasi-criminality' (and more dramatically that 'the piratical seizing of opportunity for profit is not as dissimilar as some in business would like to pretend). But although this is not inaccurate, the last observations around the erosion of trust suggest that this way of seeing at once over-dramatizes, *but underplays*, the real consequences here. For while criminality is more present (i.e. is more structurally internalized) in the accumulative economy than, in general, we would like to concede, much of the reluctance to admit the relation comes from the fact that it is not simply a matter of criminal modes of extraction co-existing *within* the economy (which they do, and to massive extent); it is rather that the extractive model of wealth "creation" permeates the accumulative economy. In other words, to admit the real relation with criminality is also to have to concede that many of our current modes of so-called "wealth creation" are in truth less creative than extractive. The real problem therefore is not only criminality per se, but our effective shift into a mainstream economy dominated by models of wealth extraction and not wealth-creation and characterized by the pursuit of modes of accumulation focused on dispossession, diversion and extraction.[61]

Evidence for this is all around us in the debris of the crisis. It is now perfectly clear, for example, that for all their apparent sophistication, a significant percentage of what was sold in the sub-prime markets was considerably closer to the pyramid-selling or Ponzi rackets of door-to-door salesman than the industry would like to admit. In a telling instance that can stand for a raft of similar practices, the *New York Times* reported (January 20, 2009) on the attempt by one

small Connecticut-based US bank to sue Deutsche Bank. At issue was the latter's sale to it of $80m worth of Gemstone VII, a Cayman Islands based offshore "collateralized debt obligation," which contained such toxic and unreliable asset backed securities *that at the same time Deutsche Bank were selling it to the Connecticut bank they were 'encouraging others to bet against' it.*[62]

The issue here, again, is less the specific instance (which doubtless could be reproduced *ad nauseum*—the whole process after all lends itself to these maneuvers) than it is the extractive slide between the accumulative and the criminal; the creation of structures of accumulation (and lack of regulation) which allow—and to a degree encourage—practices that are sometimes criminal in the individual case, often borderline criminal, but widely accepted, and in all cases markedly deeply erosive of both institutions and markets.[63] It is this slippage—this slide into what we can call "structurally irresponsible accumulation"—that is so consequential for the debacle and hence for the collapse of the banking sector as a whole.

The second point that arises from the Deutsche Bank story is that such practices, or those close to them, will necessarily occur *whenever returns are demanded from models of "wealth-creation" that cannot supply the level of return demanded.* Packing and bundling sub-prime mortgages could never create the *additional* billions of value attributed to these "innovations" by the industry.[64] That they appeared for a time to do so derived from a cocktail of financial euphoria, debt-fuelled liquidity, crony capitalism and the pressure of huge incentives (i.e., individual and collective profit) to make-believe that this was possible.[65]

But this tells us, as we now know, that the extractable-value[66] supposedly won from these transactions—let us say some $400 billion on Wall St at the height of the bubble[67]—has proved largely illusory.[68] This should not surprise. The much vaunted "creativity" and innovation in the financial markets[69] post 2000- lay not in the production of wealth (for no increase in real wealth-producing *capacity* was in fact produced) but in the ability to generate *flows* of capital from which revenue could be extracted.

This suggests, as on reflection we might expect, that in the absence of real wealth-creation accumulation finds a *substitute*. For the banks and financial houses of Wall St. and the City what mattered was not the creation of wealth (a process infinitely too long-term to contemplate, even as their own project matured over a considerable period of time—for one should really see this crisis as 25 years in the making)[70] but the extraction of realizable value from capital that could be made to flow through the institution. This explains the 'relentless' drive for expanded balance sheets 'at all costs'—and for expansion on *both* sides of the balance sheet, assets and liabilities alike.[71] Value is here a cull. Innovation is creating the conditions under which, and from which, immediate[72] surplus can be won from flows of capital.

All of this suggests that we are dealing with a *distinct mode of accumulation*, a new 'growth regime' as Aglietta might call it[73] (though he of course uses it to refer to the economies he sees emerging in China/India—the economies that will now dominate the C21st—and we are by contrast talking here merely about some rather sordid trading in markets that probably should not have existed but which unfortunately have had the capacity, in their unfolding, to do untold damage).

Nonetheless his point, and especially his rider— '*whose rules we have yet to find out'*— is perhaps a useful pointer, and in two ways. First, it is clear that across the boom years a relatively new pattern of accumulation did in fact emerge. Desired behavior (increased short-term returns with the most rapid possible rate of return between (deferred) debt and bookable profit shifted the correlation of factors, and, second, did so in ways that were not immediately transparent, either to players or to (most) watching economists and politicians. In other words what occurred was nowhere near as "known" as was thought; the rules that players thought they were playing with, and certainly the ones that economists thought were being played to, turn out to be largely illusory. Another pattern was at work. As Paul Krugman recently put it, echoing Keynes, in this situation the "scarcity is understanding."[74]

Take for example the issue of the rate of return desired in relation to the basic proposition that revenue can be won by essentially offering (originating) products that allow institutions to skim a percentile take from flows of capital. Post-2000 the 'natural' flows of capital, through trade, pension funds and the like, although massive by historic standards and intensified by a large order through globalization, are still inadequate to what is required to meet what is now felt as both possible *and* necessary, i.e., considerably higher ratio's of return than those previously available or expected. To make possible these levels of returns additional flows of capital are required. The agency of this additional flow is debt.[75] Debt enables vast increases in the flows of capital through the institution. In so doing it *directly* secures accumulation.[76] But it brings in train two questions at some point which take us back to the underlying issue of whether, in all of this, wealth was ever created at all? The first question is whether the immediate profits won in such a situation are "created"—or merely *purchased*.[77] The second is whether the surplus extracted from the throughput is greater than the *real* costs of borrowing—and whether the cycle of short-term borrowing to finance long-term liabilities could be sustainable.[78]

Post-crisis, we know the answer to both questions. Profits were essentially "bought"—at the price of debt and a tranche of liabilities that are not at this point resolved as to their value. The cycle was clearly unsustainable—but *only*, we should note, when it became finally clear that the value of what was traded was wholly opaque, even to the creators of the structured investment vehicles themselves. The questions that we now have to ask are two-fold: what are the structures that underlay this mode of accumulation, and why do they take on the form of what I've called structural irresponsibility—an objective irresponsibility if you like, which condemns this mode of accumulation to collapse? And second, what are the costs and consequences of unbridled (financial accumulation)? What does this do to the economy? What does it do to society? And what are its cognitive consequences? What does accumulation obscure? In a certain, but deep, sense, how does accumulation in this form make us stupid, economically speaking? How does it become the opposite of what we fondly wish to think it is?

Notes

[1] Such was also the case in Sweden in the early 1990s when a similar, though more limited, collapse of the banking sector had the government step-in and boldly (if temporarily) nationalize the banks. In the Swedish case this allowed a rapid recovery--and the taxpayers to recover their investment.

[2] In the same vein a month later 16 UK economists also felt confident enough to deny that this was a crisis at all: "Occasional Economic slowdowns are natural and necessary features of a market economy" they wrote. (*Sunday Telegraph,* 26th October 2008). There is little to be alarmed about—and no need at all for any change in policy. "Insofar as [slowdowns] are to be managed at all, the best tool is monetary." Any 'additional state spending' would only "stunt the private sector's recovery once recession is past." In reality the signatories fears of disruption coming to the markets through government action seem as overblown as was their obtuseness towards what was startling evident to everyone else.

[3] As is well known, current estimates are that the loan and securities losses for US originated assets will total anywhere between $2 trillion and $3.6 trillion—of which the US banking sector is exposed to around half. At the high end of the estimates this is roughly equal to the current market capitalization of the sector. Since capital has evaporated, and the asset base of many still cannot be reliably priced or brought to market, 'restoration" seems to be a strategy in denial.

[4] Succinctly and sharply analyzed by Nassim Nicholas Taleb in "How bank bonuses let us all down," *Financial Times*, 25 February 2008, p. 9.

[5] It would be the height of folly to execute the bank-bail-outs at colossal cost merely to re-instate a *temporary* mode of accumulation? Should it not be rather argued that "originate and distribute" or "transaction based" models of banking have failed in practice and are in any case, late and aberrant models. Should not the point be to restore the public-utility dimension of banking?

[6] A deep problem with how we understand the current situation is that while the words "greed" "fraud" and "irresponsibility" are now used in conjunction with Wall St and its part in the crisis with a frequency unthinkable even a year-ago—itself an indicative sign in sea change in public attitudes—nonetheless there is a huge gap between this sentiment (and anger this induces) and changing policy on Wall St. Two issues seem to be interconnected here which bear on the overall thrust of this paper. The first, epitomized by the focus on the issue of bonuses, is the confusion over subjective impulse ("greed") and structural irresponsibility. The second, is the degree to which, in forgetting that the banking system is in fact a public utility, closer to the provision of telephones or water or electricity than the stock-exchange, we have not yet in mind another role for the banks. Too aware of their role in the economy (the fear of letting them go under) and not enough aware of their public function, policy focuses on "reform" but in fact structurally preserves the private "capture" of the banking system for short-term accumulation. *Nothing* that is being proposed so far adequately addresses this complex of problems. What we are not still facing up to is the degree of structural irresponsibility built into the mode of accumulation that the banking sector has now *internalized* as its modus operendi.

[7] It is worth noting that at least one economist has smelt a rat in this respect. David K. Levine of Washington University in St. Louis commented on the occasion of the letter from the 166 economists referenced above: "I suspect that part of what we're seeing in the freezing up of lending markets is strategic behavior on the part of big financial players who stand to benefit from the bailout."

[8] There is still a sense that "had I been in charge" none of this would have happened. .This illusion, one feels is carried through less by ego than by a refusal to admit the degree of structural un-sustainability in what is. There is clearly acute fear in admitting the degree to which extractive accumulation has become the driving force in the economies of the older and declining economies and as such constitutes *permanent* instability and potential for destructiveness. As is noted below, no one is yet prepared to admit that in the financial sector at least, the processes wealth-creation have now become structures of extraction.

[9] "How We Were Ruined and What We Can Do," *New York Review of Books*, February 12th 2009 p.15-18.

[10] The possibility of the latter was neatly summarized by Martin Wolf in early January in the *Financial Times*: 'Now think what will happen if, after two or more years of monstrous fiscal deficits, the US is still mired in unemployment and slow growth. People will ask why the country is exporting so much of its demand to sustain jobs abroad. They will want their demand back. The last time this sort of thing happened – in the 1930s – the outcome was a devastating round of beggar-my-neighbour devaluations,

plus protectionism. Can we be confident we can avoid such dangers? On the contrary, the danger is extreme. Once the integration of the world economy starts to reverse and unemployment soars, the demons of our past – above all, nationalism – will return. Achievements of decades may collapse almost overnight.' "Choices made in 2009 will shape the globe's destiny," January 6th 2009.

[11] As is made clear below, I see, the provision of debt as the key political as well as economic agent of the crisis. Debt is an instance perhaps of where an enabling cause or an enabling condition of existence becomes active in the generation of the crisis but itself becomes the equivalent to a pressure or a force to act in relation to it. Acting in relation to allowed-debt runs across behavior, from households to Wall St to government.

[12] 'The economic crisis should be regarded as an unavoidable consequence and hence a "just" price of we have to pay for immodest and over-confident politicians playing with the market.' Vaclav Klaus, "Do not tie the markets —free them" *Financial Times* Jan 7th 2009

[13] This is the shift from deposit-and-loan banking to "transactions-orientated" financial accumulation based (primarily) on inter-bank trading: "endogenous accumulation"?

[14] These points are discussed extensively below in Part II of this essay.

[15] A point that suggests that "accountancy"—*the ability to cost*, though scarcely not in the modes we know it today—will be an essential discipline in respect of any attempt to create a less unsustainable economy.

[16] See Richard Murphy's excellent and informative blog on these matters, *Tax Research*. For his notes on Granite see: http://www.taxresearch.org.uk/Blog/?s=Granite&searchsubmit=Find

[17] The more usual figure quoted is £40-45bn., but the given the recent inflation in monetary figures the difference has no impact on the implication.

[18] Richard Murphy accurately describes Granite as a 'wholly artificial construction, seeking to shift liability'. Granite was in fact owned and controlled by Northern Rock but with a pretence that it did not. There was particular hypocrisy in the description of the beneficiaries of the holding company: 'The entire issued share capital of Holdings is held on trust by a professional trust company under the terms of a discretionary trust for the benefit of one or more charities. The professional trust company is not affiliated with the seller. Any profits received by Holdings, after payment of the costs and expenses of Holdings, will be paid for the benefit of the Down's Syndrome North East Association (UK) and for other charitable purposes selected at the discretion of the professional trust company. The payments on your notes will not be affected by this arrangement.' However, as Richard Murphy notes, this is effectively countered by Northern Rock's own statement that 'The financial information of the Group incorporates the assets, liabilities, and results of Northern Rock plc and its subsidiary undertakings (including Special Purpose Entities). Entities are regarded as subsidiaries where the Group has the power to govern financial and operating policies so as to obtain benefits from their activities. Inter-company transactions and balances are eliminated upon consolidation.'

[19] It goes without saying that neither the charity nor the children received any money—though the company insists that it placed collecting boxes in the entrance to its offices. The summary I have quoted is from Ian Macwhirter "The mad world of the shadow bankers", *New Statesman* 20 October 2008.

[20] The charity concerned, the Down's Syndrome Association North East (UK) is a family support group run by about 300 parent volunteers. The charities trustees issued a statement when the news of Northern Rock's actions first broke: 'In connection with the current problems of Northern Rock, we would like to assure our members and supporters that Down's Syndrome North East (DSNE) has not been knowingly involved in any misuse of money. We are investigating why our charity appears to have been named as a beneficiary of a Trust without our consent. We have definitely not received any money from Northern Rock or affiliated companies, except for a one-off donation from a staff collection in 2001. Currently we have not received notification that any funds are being raised or collected by Northern Rock or affiliated companies on our behalf.' For more on the (non-)relation between Northern Rock and the charity see Paul Murphy, 'The (un)charitable core of Northern Rock' *Guardian*, October 8th 2007.

[21] Bertold Brecht, *The Threepenny Opera*. The novel, set in the context of the last great period of the dominance of financial capital, pre WWI London of the 1890s/1900s, remains perhaps the best guide to the current crisis, not least because the "primitive accumulation" it represents (amidst the sophistication of Imperial London) is far more akin than might be first imagined to what we are now encountering. The other novelist of relevance here, to be mentioned below, is the under-read Ben Traven. *The Treasure of the Sierra Madre* (famously filmed by John Huston) is an allegory of the entire crisis.

[22] 'Lead underwriters on the Granite program were Lehman Brothers, Merrill Lynch, and UBS. Underwriters were Barclays Capital, Citigroup, JP Morgan and Morgan Stanley.' Paul Murphy, 2007, op. cit.

[23] How profitable were such moves? Barclays, a major British commercial bank, in 2007 took all but half its profits from "special investment vehicles."

[24] By placing its mortgage liabilities off-shore Northern Rock did not need to "count" them on its balance sheet. It therefore allowed the company to leverage loans at even higher levels. At the same time, both located off-shore and registered as a charity, it was all but impervious to taxation—or, equally importantly given what it held, detailed scrutiny. For a succinct note to this effect that links offshore tax-havens and the current crisis, see Richard Murphy and John Christensen 'The threat lying offshore,' *Guardian*, 10th October 2008.

[25]Gordon Brown, UK Prime Minister, in the annual Mansion House speech made by to the city of London on 20 June 2007: " . . . And I believe it will be said of this age, the first decades of the 21st century, that out of the greatest restructuring of the global economy, perhaps even greater than the industrial revolution, a new world order was created.' The speech in full can be accessed at http://www.hm-treasury.gov.uk/2014.htm . Even more egregious, in the light of what has followed, are some of the lines in the speech of the year before: see http://www.guardian.co.uk/business/2006/jun/22/politics.-economicpolicy

It is indicative of the transformation in the situation that on the day this paper was revised (26th January) there was serious consideration being given as to whether the attempts to bail-out the UK financial sector might result in effective bankruptcy of the UK. While this possibility was thought remote, the very fact it could be raised as a serious consequence illustrates graphically both the speed—and cost—of the collapse. Is it necessary to add that the order that may emerge from all this will likely not be the order Gordon Brown intended, and not perhaps order at all. The combination of direct costs, 'secondary fall-outs' and worrying signs of protectionism, nationalism and lack of coherence in international responses to the crisis point to disturbing potentials for longer-term social and political crises

.

[26] In the wake of the subsequent collapses on Wall Street—and particularly of the financial empire of Bernard Madoff—there may seem little special about Northern Rock's act. There might be a temptation therefore to try to place this in the same class. But despite the scale of his operations (still much less, at $50bn, than Northern Rock) Madoff can be dismissed. He belongs simply in the long tradition of the crooked swindler. All financial scandals expose a number of these. As Sherlock Holmes might have said, apropos a particularly mundane murder, the case offers scant theoretical interest. Northern Rock is more complex, both economically and morally. It opens us to the more ambiguous capitalism of our time and its "costs" go well beyond a simple accounting of profit and loss. It is therefore of considerable interest to political economy (if an embarrassment to economics).

[27] This is where the question of the return to the status quo takes on a sharper bite. It should make us ask: does a return to "unparalleled prosperity" require us to buy into a model where appropriating charities for Down's Syndrome children becomes an acceptable strategy for keeping the financial economy afloat? Are we to accept that this is this what "dynamic and innovative private capital markets" now do?

[28] This is where the question of the return to the status quo takes on a sharper bite. Does a return to "unparalleled prosperity" require us to buy into a model where charities for Down's Syndrome children become the only means of keeping afloat the inverted pyramids of financial Ponzi-schemes? Is this what financial innovation now means? Note that the insistence that this is what it should *not* mean has no force.

Part of the intellectual problem here lies in seeing consequences (and costs) of modes of accumulation.

[29] What is felt as the mortal and social danger here is precisely this slippage: if *this*, then there is no boundary, no limit, no place where it is possible to say *here* legitimate business ends, *there* criminality begins. Instead, we are faced with the opposite, a steady slide towards criminality becoming an internalized norm of business. A defense will be that this has always been the case. But this neither legitimates was is occurring nor recognizes what is structurally peculiar to the relation today.

[30] Collusion between the overtly criminal and the those who also profit from their activities is a particularly virulent plague. On the Bernard Madroff scandal for example, while the company appears to have deliberately employed tiny accounting firms, major accountants like PriceWaterhouseCoppers and

KPMG were involved in accessing risk. And what are we to make of Greenwich Financial, the Connecticut-based company who acted as one of Madroff's prime agents—to the tune of obtaining $500m in fees, or the private Swiss bank UBP. Both companies, it appears, chose to ignore red flags signaled (if privately) by other companies as early as 2003.

[31] A good example is Citibank. Since its merger with Travelers and its investment banking arm, Saloman Smith Barney the company has been (i) penalized for its practices in the dot-com bubble of 2000-2001; (ii) faced losses and lawsuits over its connection with Enron and WorldCom; (iii) had problems over its links with the criminal collapse of Parmalat in Italy; (iv) had its private banking business in Japan closed by the government; (v) has been forced to recant over it "over-zealous" actions in the European Bond market. By 2005 even the ever-lenient Federal Reserve was refusing permission to it to make further acquisitions. And what the longer-term financial results of this activity? By January of 2009 the company had produced its fifth straight quarterly loss.

[32] For more on corporate tax-evasion as endemic to the economy, see Raymond Baker, *Capitalism's Achilles Heel: Dirty Money and How to Renew the Free-Market System* (Hoboken, 2005, Wiley). Baker's book was the subject of an excellent review article by John Christensen in the *London Review of Books*, 6th October 2005. The latter provides—in part through his personal experience in the industry in Jersey—a succinct overview of many of the issues around tax evasion and money laundering. Christensen directs the international secretariat of the Tax Justice Network, which is based at the New Economics Foundation in London. He is one of the authors of *Tax Us If You Can: The True Story of a Global Failure*.

[33] See BBC news, "Mafia 'gripping Italian economy'" Tuesday, 14 November, 2000
http://news.bbc.co.uk/2/hi/europe/1023221.stm

[34] There is nothing fictional about this reference. There was sufficient concern in regard to the market for global organ trafficking that University of California, Berkeley, held a conference to examine global organ trafficking, April 24th 2003. The goal was 'to bring attention to organ trafficking as a subset of a larger global problem in human trafficking' On shifts in Mafia organization see e.g. Jane and Peter Schneider, *Reversible Destiny: Mafia, Antimafia and the Struggle in Palermo* (Berkeley: UC Press, 2003).

[35] The web-site *Global Issues* has some interesting figures. Admitting that it is not at all clear how much money is held in tax havens they report that (in 2005) 'at least US $11.5 trillion is held offshore' this estimate reflecting largely high-wealth individuals. But, as they report, 'this does not include the laundered profits of businesses which operate through offshore tax havens to avoid tax. Nor does it include the financial assets of those whose wealth amounts to less than US$1 million. The total sum of money currently held offshore is not known.' $11.5 trillion dollars translates into around $255bn 'lost each year to governments around the world because of the no or low taxation of funds in offshore centers'—but this figure too 'does not include tax loses arising from tax competition or corporate profit-laundering.' How much profit laundering is there? On the latter *Christian Aid* reports that the total estimated "dirty money" flowing into the global banking system is $1 trillion, which breaks down to around $500m siphoned from the developing world, around $200 billion laundered by multinational companies, another $250 laundered by individuals and criminals and $50bn lost through corruption. None of these figures can be regarded as more than indicative. But they place the scale of the problem in some perspective. Christensen's review of Baker noted above is a useful beginning point for thinking about these issues.

[36] See Oswald Spengler, *The Decline of the West*, especially volume II, chapters XXII-XXIV

[37] Two indicative straws in the wind: it is thought that during his 5-year reign the Nigerian Dictator General Sani Abacha managed to send some $3bn to Swiss banks—an average of S600m per year. Another estimate says that for every $1 in aid to Africa, $3 is sent out of Africa as capital flight, mostly to Europe, the UK and the USA.

[38] An initial (unpublished) federal history of the American-led reconstruction of Iraq issued in December 2008 details spending in Iraq of around $117 billion. Achieved reconstruction was minimal. See James Glanz and T. Christian Miller in the *New York Times* December 13th 2008 "Official History Spotlights Iraq Rebuilding Blunders."

[39] One obvious instance is the "grand larceny' of the Russian sale of public assets (at rock-bottom prices) in the early 1990s. To public depredation was added the parallel rise of the Russian mafia. Applauded at the time by free-marketeers, the irresponsibility of the act carried through both symbolically and actually to the miseries of the 1990s in the former USSR. Studious avoidance of

acknowledging the human consequences of this public theft by those who were most prominent in urging "privatization" does not alter the facts.

[40] See e.g., Roberto Saviano, *Gomorrah: A Personal Journey into the Violent International Empire of Naples' Organized Crime System* (New York: Picador, 2008)

[41] The figures for the UK are indicative of the scale of the problem. Estimates of corporate tax evasion run as high as £13.7bn a year. 'Between 2000 and 2007 the proportion of tax paid by top companies fell.' 'A third of FTSE 100 companies (including 12 of the largest) paid no tax in 2005-2006, and another third paid a minute proportion of their operating profits. Scores more claimed tax losses.' *Guardian*, February 2nd 2009.

[42] Christensen, *London Review of Books*, 6th October 2005, op. cit.

[43] op. cit.

[44] As Neal Ascherson puts it in his review of the journalist Misha Glenny's book *McMafia: Crime without Frontier*s, is that the world becomes a perfect environment for mafias. 'Neo-liberal free trade meant that clean or dirty money could go anywhere. Meanwhile, the exceptions to free trade – commodities such as drugs, cigarettes, weapons, prostitutes and immigrants, which governments still feel obliged to regulate – could be smuggled in previously undreamed-of quantities. See "Gazillions" *London Review of Books*, 3rd July 2008

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[45] David Harvey has effectively summarized "accumulation by dispossession." See *Spaces of Global Capitalism: Towards a Theory of Uneven Geographical Development* (London, Verso: 2006) especially pp. 41-50.

[46] At the "respectable" end of the business, few banks, and no major firms of accountants—let alone hedge-funds, or the shadow-banking sector—have been counted amongst those calling for more than nominal supervision of the centers of money-laundering.

[47] A vivid example of the economic significance of trust was given to the markets by the manner of the collapse of Lehman Brothers. As Mohamed El-Erian has noted, the suddenness—and, to the market, the seeming arbitrariness—of allowing Lehman's collapse was more than simply disruptive of payments and settlements. As he put it, it shattered 'a given trust and confidence' in what had been up until then 'standardized, routine, predictable transactions.' Mohamed El-Erian, 'Only new thinking will save the global economy,' *The Guardian*, December 3rd 2008. We might add that the collapse in trust and resulting paralysis that the markets experienced in a sharp 24 hours is what is experienced as a generalized, if diffuse, condition in zones where the criminal erosion of social trust has become an embedded fact of life. On the societal implications of the destruction of trust see, e.g. Zygmunt Bauman, *Society Under Siege* (Cambridge: Polity, 2002) pp. 192-193; *Liquid Fear* (Cambridge: Polity, 2006) pp. 69-71.

[48] On "using-up" see Martin Heidegger "Overcoming Metaphysics" in *The End of Philosophy*, trans. Joan Stambaugh (Chicago: Univ. of Chicago Press, 1973) pp. 84-110. See especially pp 103-110.

[49] It is interesting that those most concerned with the "efficiency" of markets do not pay more attention to this point. The reason of course is that crime is a social tax. It is highly lucrative, on a personal basis, for those that profit from it. But then what is the measure of wealth in use here?

[50] As I write, RBS in Britain, a massive recipient of bail-out funds, is insisting it will maintain the bonus payouts even in sectors that lost billions in the past year, while the Wall St banks are reported to be ignoring the injunction to maintain loans to businesses while using their shares of the billions a cheap capital to finance acquisitions of smaller banks. The excesses of Bank of America in these respects are the current, but by no means the last, scandal in these terms.

[51] One of the conditions of the current crisis is that it is precisely financial speculation that has created 'uncertainty.' The capacity of the financial system—5% to 8% US GDP in most years—to effect the global economy as a whole confirms the historical shift from any notion that systems of financial accumulation acting as in some manner secondary to the real economy. Spengler got this as early as 1922: 'Only high finance is wholly free, wholly intangible. Since 1789 the banks, and with them the bourses, have developed themselves on the credit needs of an industry growing ever more enormous, as a power on their own account, and they will (as money wills in every Civilization) be the only power.' Oswald Spengler, *The Decline of the West, Volume II* trans. C. F. Atkinson (New York: Knopf, 1928) p.505-6.

[52] A gap that in this case had to be filled by debt: it was debt that in the short-term at least both allowed for the colossal accumulation that Wall St. manufactured in the boom years, and the maintenance of a tight connection between supply (loans) and demand (enforced consumption).

[53] Duncan Foley, *Adam's Fallacy* (Cambridge: Harvard University Press, 2006) p.194

[54] Cf. the full page advertisements that appeared in a number of US newspapers on January 28th 2009 the day before the House voted on Obama's economic rescue package. The Cato Institute, a right-wing Washington think-tank, funded a letter signed by some 200 US economists. The first sentence of the substantive statement read: "Notwithstanding reports that all economists are now Keynesians …." It went on: "we the undersigned do not believe that that more government spending is a way to improve economic performance … to improve the economy, policymakers should focus on reforms that remove impediments to work, saving, investment and production. Lower tax rates and a reduction in the burden of government are the …best ways to boost growth."

[55] "Only new thinking will save the global economy," *Guardian*, December 3rd 2008.

[56] The prices of the products sold in these transactions, since they were opaque as to value, were dependent for their valuation on the rating agencies and the reputations of the issuing bank.

[57] Peter Gowan, 'Crisis in the Heartland' *New Left Review* 55 Jan/Feb 2009 pp. 5-29.

[58] The difference, and it is one that we will have to pay increasing attention to, is that between notional paper wealth, profits booked in accounts, and real increases in (sustainable) productive capacity. One of the myriad costs of un-restricted financial accumulation is, as we will see, that this distinction is dangerously obliterated—to the point of real confusion, both in the minds of agents and in society as a whole (let alone by economists) .

[59] Traders, senior executives and board members within the Wall St Banks and City institutions acted, in relation to their (own) host institutions, much as the accumulative economy acts to the (real) economy as a whole., i.e., they pretended that their own actions were the generative source of wealth and denied dependency on the institution. But the "wealth-creating" activities of agents within the banks and financial houses could occur only because they were supported institutionally. In turn the entire process of accumulation could occur because of socially- and politically tolerated levels of debt. Hegel's dictum that all culture's deny what supports them absolutely comes to mind.

[60] There is a further useful reminder of the importance of trust in a series of interviews conducted with an "Anonymous Hedge Fund Manager" and published in N+I magazine, #7, Fall 2008, pp., 21-53 see especially 51-52. See also Luke Johnson, 'A tragedy for champions of free markets' *Financial Times*, Wednesday February 4, 2009.

[61] "Models" because what we are talking about here is ideology as well as reality. The comments by Gordon brown alluded to above are telling here. What Brown sees is that it is today the financial system that captures the imagination as the source of (instant) wealth. The problem is made more complex because although the financial sector is actually *not* the dominant sector of the economy, quantitatively speaking, its central role in the economy as a whole increases its ideological weight. If models of wealth-extraction ("seeking short-term treasure") dominate in this sector; if it admits and slides towards quasi-criminal extraction and practices that are both structurally irresponsible and profoundly erosive, this has incalculable effects—as we are discovering—across the economy as a whole. Part of the irresponsibility of economics over the last decade has been its seeming inability to chart these kinds of relations—but then these have dimensions that go beyond the 'main business' of economics as Edward Nell memorably characterized it some years ago, i.e., 'the *demonstration* that a well-oiled market mechanism will produce the most efficient allocation of scarce resources among competing ends.' See Nell, 'Economics: The Revival of Political Economy' in Robin Blackburn ed., *Ideology In Social Science* (new York: Vintage, 1973) p. 76.

[62] See "After Sure-Bet Investment Fails, A Bank Contends It was Duped" *New York Times*, January 20, 2009.

[63] "It is classic historically that financial crises reveal criminal fraud in the system, and it is actually nothing new that when one person does a Ponzi scheme it is viewed as criminal fraud and when a lot of people collectively do exactly the same thing (passing the money around among themselves) it is regarded as market instability. This kind of crisis is latent in capitalism, just as much part of it as the developmental booms." Ducnan Foley, personal communication.

[64] A simple but succinct explanation is offered by John Kay: "How can a package of loans be worth more than the sum of their individual values? … Securitization in lending may add value by allowing the risk characteristics of the new instrument to be precisely tailored to the risk characteristics sought by the buyer … There is something in that argument. But could there be tens of billions of dollars a year of profit in it? Could the advantages of slightly more elaborate differentiation of an already wide range of fixed-interest products really be so large? If differences in risk appetite determined the market, you would not expect the list of institutions that bought securitized products to be so similar to the list that sold them. There was never an economic rationale for structured products on the scale on which the financial services industry created them. They were the result of a frenetic search for commissions and bonuses. See "Wind down the market in five-legged dogs," *Financial Times*, January 20, 2009.

[65] More prosaically it was also due to the failure—but also the near-impossibility given the opacity of what was traded—of performing due diligence on what was being purchased. That failure, seemingly innocuous at the scale of issues we are now facing, is nonetheless indicative of the structural irresponsibility at the heart of the crisis and of this mode of accumulation.

[66] "Extractable value" because what was "created" here (e.g. in CDO transactions) were levels of notional profit that could be immediately booked and thus extracted. No true pricing of the costs of the debts necessary to fund such transactions occurred—nor were the risks of such transactions either understood or assessed. For a useful explanation of one part of this process, around so-called "super senior" debt, see Gillian Tett, "Misplaced bets in the carry trade," *Financial Times*, 17 April 2008. The combination of high-levels of debt and the *difference* between the fact that profits in this situation were super-liquid but that (as the banks discovered to their surprise) the "super senior" debt was not, accounts in large part for the crisis.

[67] The figure is derived from difference between historic rates of returns on Wall St and the rates of return in the last three years or so of the boom.

[68] All of this makes nonsense of course of the claim, quoted above, that "For all their recent troubles, America's dynamic and innovative private capital markets have brought the nation unparalleled prosperity."

[69] Innovation that Greenspan, Summers et al would not disturb by regulation lest the latter curtail the former. The principle fails to differentiate useful from dangerous innovation: it assumes what should the question: namely, is innovation in models of accumulation *always* necessarily beneficial?

[70] The is a very interesting relation between the (relatively) slow accretion of power by Wall St over last three/four decades; an accretion thought strategically and the product of much thought and investment and the remarkable capacity of its contemporary actors to focus only on the most immediate returns. To be sure, it was, for its protagonists, a remarkable party. And one that is not over yet. But it adds further food for thought, and makes those who clamor only for return to what-was, appear both more foolish and more short-sighted than they would wish to thought.

[71] There is an interesting question here as to whether there was not, in much of this situation, a perennial confusion as to what was "asset" and what "liability"—and for whom, and when?

[72] Immediacy is key here, the most liquid possible profit, realizable within a quarter; bookable at the conclusion of a trade. Not only the culture of the bonus and the short-term is important here. As will be noted later, much of Wall St and the City behaved from the beginning as if the trading culture that offered these profits was essentially unsustainable; that profits must be "grabbed" as opportunity arose.

[73] Michel Aglietta, "Into a New Growth Regime" *New Left Review*, 54, Nov/Dec 2008, 61-74, p. 63.

[74] ' The true scarcity in Keynes' world—and ours—was therefore not of resources, or even of virtue, but of understanding.' Paul Krugman, "What to Do" *New York Review of Books*, December 18th 2008. p.10.

[75] One telling statistic, at least for the UK banks, is that the difference between the amount on deposit and the amount on loan escalated from close to zero in 2000 to £530bn by the end of 2006. The difference is almost wholly accounted for by debt. Northern Rock was a typical example of this shift. It financed its mortgage program almost entirely by borrowing commercial money.

[76] Overall, as already noted above financial industry debt in the US escalated from c.21 per cent of GDP in 1980 to c.83 per cent in 2000 to c.116 per cent in 2007. The major increase in this debt is to facilitate of inter-bank trading.

[77] "Purchased" because this value was not created but, essentially, *bought*. In the sub-prime loan system increased debt purchased the *appearance* of profit. Repayment was of course indefinitely deferred. Monies paid under TARP are essentially the *public* repayment of this *private* debt.

[78] At one point 73% of Northern Rock's balance sheet was due in 3 months: a debt-dependency that almost beggars belief.

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Statement by James K. Galbraith:

before the Committee on Financial Services, U.S. House of Representatives, Hearings on the Conduct of Monetary Policy, February 26, 2009

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Mr. Chairman and Members of the Committee, it is again a privilege to appear today at these hearings, which as a member of the staff I worked on from their inception in 1975.

In 1930, John Maynard Keynes wrote, “The world has been slow to realize that we are living this year in the shadow of one of the greatest economic catastrophes of modern history.” That catastrophe was the Great Crash of 1929, the collapse of money values, the destruction of the banking system. The questions before us today are: is the crisis we are living through similar? And if so, are we taking adequate steps to deal with it? I believe the answers are substantially yes, and substantially no.

This statement covers six areas very briefly:

Why the baseline forecast is too optimistic, and why the recovery bill was too small.
Why low interest rates will have limited effectiveness going forward.
Why the banking plan will not work.
Why Social Security and Medicare are not part of the problem, but of the solution.
How to keep people in their homes, and
Why our long-term infrastructure and energy needs should be addressed now.

1. The baseline forecast is too optimistic and the recovery bill was too small.

In early February the CBO baseline projected a “GDP gap” averaging about six percent over the next three years (Table One). They also expect a recovery beginning late this year and a return to normal by 2015. That was the baseline: the forecast even if the ARRA [American Recovery and Reinvestment Act of 2009} had not passed.

The baseline rests on a mechanical assumption: that there is a “natural rate of unemployment” of exactly 4.80 percent. The assumption is that labor-market adjustments will return us to this rate over time. By labor-market adjustment, economists usually mean a fall in real wages, sufficient to make workers more attractive to employers.

This assumption is unfounded. No fall of wages will restore employment. Employment does not depend materially on wage rates, but on the prospect for sales and profits. And these require credit. Flow-of-funds data for December show that the fall-off in new borrowing is the greatest in 40 years. The Levy Institute’s accounting-based macro model, based mainly on the rate at which households are liquidating their debts, now suggests that the GDP gap will be as much as 12 percent of GDP, with no recovery in sight. This is shown in Figure One. This gap is compatible with unemployment rates near ten percent, indefinitely.

The ARRA should add between 2 and 3 percent to total demand, per year for two years. With normal multipliers (about 1.5 for spending) the total boost to GDP might be

between 3 and 5 percent. This would be enough to turn a baseline recession averaging 6 percent into something quite mild. But if the true collapse is twice as bad, the stimulus was too small. And the multipliers are probably overstated, because in a deep crisis liquidity preference grows stronger. A 12 percent GDP gap might require a stimulus of, say, 10 percent including automatic stabilizers to cope with it. The bill as enacted was far short of that.

Chairman Bernanke, in his speech at London in January, said “the global economy will recover.” He did not say how he knows. And the truth is, this is merely a statement of faith. In present conditions the most dangerous position is that of the unfounded optimist. Those who use this position to defend a program of inaction, or of little action, or to defend a program of action that is geared to a forecast of automatic recovery, might possibly turn out to be right. There might be a deliverance. But to rely on that possibility in the design of policy is surely unwise, for at least two reasons.

First, we know that bad news has been outrunning the forecasts for months. Professional economists, working with the normal models, failed to predict the crisis. In many important cases, including high officials, they actively denied it could happen. Chairman Bernanke was typical: through July of 2007, he argued that the Federal Reserve Board’s predominant concern was inflation; thus the Federal Reserve was unable to give Congress a foretaste of a crisis that was to erupt within days. And as the crisis has unfolded, events have repeatedly come in worse than expected or caught us by surprise. This should tell us something.

Second, we know that the origins of the crisis lie in a breakdown of the banking and financial system, following a breakdown in the regulation of mortgage originations, in underwriting, and in credit default swaps. This is something we have not seen in our lifetimes. We know that the actions already taken in response – the TARP [Troubled Asset Relief Program], the nationalization of the commercial paper market and the swap agreements with the ECB and other central banks – are unprecedented. We know that these measures have, at best, only averted a deeper catastrophe. And we know that the baseline forecast, which is a mechanical procedure based on statistical relationships between non-financial variables, for the most part, takes none of this into account.

We therefore have no basis for confidence in the baseline forecasts, and we should prepare ourselves, as Churchill said to Parliament at the time of Dunkirk, “for hard and heavy tidings.”

2. Monetary policy alone cannot restore growth and employment.

Chairman Bernanke deserves respect for his forceful interventions since the crisis broke. A failure, last October, to nationalize the commercial paper market would have been disastrous. Increasing deposit insurance limits warded off a run on the banks. The extension of currency swap agreements to Europe and elsewhere helped stabilize global markets temporarily, though there is a grave question, as to whether those swaps can be unwound.

I also supported this Committee’s version of the TARP, despite its limitations. At that time, a collapse of the payments system in the last months of a dying presidency was to be

avoided at all costs. And the most unworkable idea in TARP, the outright repurchase of bad assets at inflated prices, was abandoned in favor of a step – the purchase of preferred equity in banks – that was possibly unnecessary but not the worst that might have happened.

Despite the fact that these steps were able to ward off complete disaster, monetary policy today has little power to restore growth. In the Depression they called it "pushing on a string." With interest rates already at zero, there is little more the Federal Reserve can do. Chairman Bernanke's London speech grasps at a number of straws, including "policy communication" and the reduction of long-term interest rates. But the former is a weak reed and the latter is of very doubtful effect in a liquidity trap. If rate cuts do not lead to new borrowing – as they have not – then their effect is actually counterproductive, since they reduce the interest income flowing to the elderly and others who hold the national debt, or (what is the same thing, economically) cash and cash-equivalents in the banks.

The phrase "quantitative easing" – or in Chairman Bernanke's formulation, "credit easing" – is often heard these days. What does it mean? Not much, in my view. Can it be relied on to produce a return to economic growth? No. Credit easing, at its heart is about liquidity – a problem monetary policy can deal with. But the problems of the economy go far beyond liquidity. Chairman Bernanke's discussion of "heterogeneous effects" --the supposed differences between lending to banks, to the commercial paper market or elsewhere, strikes me as a keen example of wishful thinking. It is unlikely that the Federal Reserve can, merely by making judicious distinctions, materially reduce the perception of risk in these markets and therefore the credit spreads that are strangling them today.

The deeper problem obviously lies in the lack of demand for output, in the collapse of confidence, in the grim prospects for profit, and in the absence of collateral to support new loans. These problems will require much more work – work to persuade the public and the business community that effective, long-range, sustained, visible action is underway. The Federal Reserve is not the agency that can persuade the world of this.

Thus, in this situation the main responsibility for pulling the ox from the ditch is not Chairman Bernanke's. Let me turn next to the question of whether Secretary Geithner's plan to restart the "flow of credit" can take up the slack.

3. The bank plan will not work.

The scale of the ARRA was predicated on the baseline and also on the idea that lending by the banking sector can be made to return to normal. That is, it assumed, implicitly, that Secretary Geithner's plan for the banks will succeed. So we must ask, will it?

The bank plan appears to turn on a metaphor. Credit is "blocked" or "frozen." It must be made to "flow again." Take a plunger to the toxic assets, a blowtorch to the pipes, it's said, and credit will flow. This will make the recession essentially normal, validating the baseline forecast. Add the stimulus to a normalization of credit, and the crisis will end. That's the thinking, so far as I can tell, of the Treasury department in this new administration.

But common sense begins by noting that the metaphor is wrong. Credit is not a flow. It is not something that can be forced downstream by clearing a pipe. Credit is a contract. It requires a borrower as well as a lender, a customer as well as a bank.

The borrower must meet two conditions. One is creditworthiness, meaning a secure income and, usually in the case of a private individual, a house with equity in it. Asset prices therefore matter. With a chronic oversupply of houses, prices fall. Collateral disappears, and even if borrowers were willing many of them would not qualify for loans.

The other condition is a willingness to borrow, motivated by the "animal spirits" of business enthusiasm or just the desire for more worldly goods. In a slump such optimism is scarce. Even if people have collateral, they want cash. And it is precisely because they want cash that they will not deplete their reserves by plunking down, say, a down-payment on a new car.

The "credit-flow" metaphor implies that people came flocking to the auto showrooms last November and were turned away because there were no loans to be had. This is not true. What happened was that people stopped coming in. And they stopped coming in because, suddenly, they felt poor, uncertain and afraid.

In this situation, stuffing the banks with money will not change their behavior. Banks are not money-lenders. Banks are money-creators. They do that by making loans. And the bank chiefs have made it very clear, in testimony here and elsewhere: they will not return to ordinary commercial, industrial and residential lending until they can see a reasonable way to make money at it. If given the chance, they may go off on another bender in commodities or some other quick way to repair losses. More likely, they will hunker down, invest in Treasuries and prime corporate bonds, and rebuild capital for the long-term, as they did from 1989 to 1994. Only this time, with the yield curve as flat as it is and the insolvencies as deep as they are, it could take a decade or longer.

Seen in this light, the latest version of the plan to remove bad assets from the banks' balance sheets is a costly exercise in futility. It will protect incumbent management, for a time. It will keep the equity values above zero, for the benefit of those who did not sell their shares when they were high and those who now speculate on a public rescue. It will do this at the expense of driving public debt, as a share of GDP, to very high levels. But there is no reason to believe that the "flow of lending" will be restored, nor that banks which long ago abandoned prudent and ordinary lending practices will now somehow return to them, chastened by events. Why should they change behavior, if their losses are in effect guaranteed by the Treasury Department?

The Treasury plan, if put in place as described, would have a perverse effect on the distribution of wealth. To guarantee bad assets at rates above their market value is simply a transfer to those who hold those assets. It would enable them to convert those assets, sooner or later, to cash. The plan would thus preserve the wealth of bank insiders and financial investors, while failing to prevent the collapse of the wealth of almost everyone else. I cannot believe that the American public will tolerate this, for very long.

There is an argument, made by those who would suspend mark-to-market accounting, that the true value of the mortgage-backed securities has been depressed by fire-sale conditions, and that a guarantee would help to restore confidence and would be validated, in changing economic conditions, by improved performance of the loans. This is something that does, in fact, sometimes happen: good loans go bad in bad times, but become good again when conditions improve. But it is not an appropriate argument for the current case.

Why not? Because the sub-prime securities that are at the bottom of this problem were, and are, in very large measure, corrupt, abusive and even fraudulent from the very beginning. They should never have been issued, and they should never have been securitized, and the ratings agencies engaged in fraud, on the face of it, by giving them AAA ratings in certain configurations, without actually inspecting the loans. No private buyer, with responsibility to do due diligence on these loans, will ever purchase them simply because due diligence is going to reveal the truth. So far as we know, the loans, almost uniformly, lack documentation or show prima facie evidence of fraud or misrepresentation. The ratings agency Fitch so determined, when it reviewed just a small sample of loan files in 2007: there was fraud or misrepresentation in practically every file. The default rates on these loans will be very high no matter what happens. It is only a matter of time. Therefore, there is no reason to think that the Treasury's guarantees, at any price above the market price, are likely ever to be made into a profitable investment by changing economic conditions.

Finally, one has to worry about the long-term consequences of issuing new public debt just to wash away the sins of the banks. Those in the larger world who have, in the past, trusted the transparency, efficiency and accountability of the U.S. financial system – and have therefore been willing to treat the US as a haven of financial safety and stability – are bound to take note. It can't be good for the long-term reputation of the government, and therefore for the long-term stability of the dollar. Moreover, while there is no reason to treat these asset exchanges as new public spending, it is certain that adding ten or twenty percent of GDP to the public debt (fruitlessly) will complicate the political problems associated with the effective fiscal expansion measures that getting out of the crisis may require. In short, the Treasury plan will not achieve its stated goals, and meanwhile risks both triggering inflation and obstructing growth.

If we are in a true collapse of finance, our models will not serve and our big banks will not serve either. You will have to replace them both. Since several very big banks are deeply troubled, there is in my view no viable alternative to placing them in receivership, insuring their deposits, replacing their management, doing a clean audit, isolating the bad assets. Since these banks were clearly too large, in my view they should be broken up, and either sold in parts or relaunched as multiple mid-sized institutions with fresh capitalization and leadership.

And meanwhile, how do we keep the economy running? There should be a public bank to provide the loans to businesses – small, medium and large – sufficient to keep them running through the crisis. This was the function, in the Depression, of the Reconstruction Finance Corporation. While the need for this today is very clear in the automotive sector, as time goes on a much larger part of American industry and commerce will face similar problems and similar needs. The resulting forced liquidation of the productive sector is a distinct possibility, and is not in our national interest.

4. Social Security and Medicare are not the problem.

A repeated theme from certain quarters holds that the financial meltdown is only a side-show, that the real "super sub-prime crisis" is in the federal budget, and that the most urgent need today is "entitlement reform," which is code for cutting Social Security and Medicare, in the guise of saving those programs. Some of this was heard earlier this week at the White House meeting on "fiscal responsibility."

These arguments are both mistaken and dangerous.

By long-standing political convention Social Security and Medicare are attached to designated funding streams – portions of the payroll tax. It was the original intent that Social Security benefits would be largely matched by these taxes, but this was never true for Medicare, and as the aging population grows and lives longer it has become contentious for Social Security as well. Thus we have frightening estimates of "unfunded liabilities" running to the scores of trillions of dollars over long or infinite time horizons, with dire warnings that these will drive the entire government of the United States into bankruptcy, whatever that means.

These arguments are testimony to the power of accounting to cloud men's minds, and not much else. Let me make some obvious points.

First, a transfer program reassigns claims to output. It neither creates nor destroys production. What comes from somewhere, goes somewhere else. Thus Social Security liabilities to the government are matched by assets in the hands of the aged and those who will become aged that is to say, in the hands of citizens of the country. From the standpoint of the country, the two sides of the balance sheet necessarily balance. Talk about "unfunded liabilities" without discussing the corresponding assets is intrinsically misleading: the liabilities in question are owed to citizens of the United States, and represent to them a very modest degree of income security and as well as access to medical care in old age.

There is no operational reason why the country cannot transfer income to its elderly, as a group, as much or as little as it wishes. The supposed inter-temporal aspect of this transfer is meaningless, for two reasons. First, the goods and services actually provided to the elderly at any point in time are always produced only shortly before they are used. Second, the workers on whom the liabilities supposedly fall today, are the same people who accrue the assets that they will enjoy later. It is true that Social Security's real burden will rise as the population ages: from about 4.5 percent to about 6.5 percent of GDP over the century ahead. There is no reason to be afraid of this, it is simply the mechanical consequence of the fact that there will be more old people to care for. Those people would exist, and would be cared for to some degree, without Social Security. But the process would be much more erratic, much less fair, and subject to the neglect and petty cruelties of private financial relations.

The only issue posed by a deficiency of payroll taxes, now or later, is whether the funds devoted to Social Security and Medicare might be described as coming, in part, from other sources: from the wealthy, or from bondholders. So what if they are? There is no reason in principle why income or estate taxes (as the late Commissioner Robert Ball suggested), or a financial transfer tax, could not be assigned to cover Social Security and Medicare costs. The

Social Security compromise of 1983, which raised payroll taxes on my generation, plainly envisaged that the obligations to cover my generation's retirement would come, in due course, from somewhere else. That is what "paying back the Trust Fund" is all about.

Part of the worry about "entitlements" relates to borrowing, and thus to future deficits. Are these "unfunded liabilities" so large as to threaten the creditworthiness of the government? Clearly this is not the case. Despite immense efforts by the gloom-and-doom chorus on this question, the government of the United States is today funding itself, long term, for less than it did in the 1950s. Solvency was not a question then and is not a question now. This also suggests that the long-term deficit projections for the government as a whole, though much discussed at the fiscal responsibility summit, are not a worry for the financial markets, either.

The preoccupation with Social-Security-and-Medicare is actively dangerous to the prospects for economic recovery. Why? Because it raises concern and anxieties among today's working population, who have been told repeatedly that these programs will not be present for them when they will need them. The rational individual response, in that case, is to save more and spend less. I don't think this effect is very large, right now, but it is a risk. There are cases in the world (notably in China) of distressed populations over-saving obsessively, to try to provide for security that could be provided much more cheaply by social insurance.

More immediately, our elderly population is under a tremendous squeeze, from the stock market collapse, from falling house prices and from falling interest rates. It has already lost, through these channels, a major part of its wealth. The economist Mark Zandi told the House Democratic Caucus in December that this alone could subtract around $200 billion per year from total spending, and the situation is worse now than it was then.

Talk about the supposed need to cut back on Social Security and Medicare thus gets in the way of the discussion we should be having. This is over how to use these programs to get us out of the hole we are in. Each them could be powerful and useful. To wit:

- a permanent increase in Social Security benefits would help offset the losses that the elderly population, as a group, is suffering on its equity investments and its cash holdings. A thirty percent increase in Social Security benefits would not repair individual losses, but it would keep the elderly out of poverty as a group, and relieve severe difficulties in many individual cases.

- a payroll tax holiday would powerfully ease the financial situation of America's working families, giving them roughly an 8.3 percent pay increase and their employers a comparable reduction in the cost of keeping them on the job. Many mortgages would be paid, and many cars purchased, that otherwise would default or go unsold.

- a reduction in the age of eligibility for Medicare would be a powerful response to the industrial crisis, permitting many older workers who would like to retire but who cannot afford to lose health insurance to do so. This would relieve health burdens from private industry, while not infringing on the employer-insurance systems still in effect for the prime-age workforce. Note that transferring workers from private health care to Medicare in this age bracket has no real economic cost: the same health care is

provided to the same people. In fact, the reduction in private insurance claims and bookkeeping constitutes a real saving.

These measures are among the most promising available at this moment. Congress should be prepared to use them if and when it becomes clear that the present policies are insufficient. And the historical linkage between Social Security and Medicare benefits and the payroll tax should then be broken. Social Security and Medicare obligations should be treated, henceforward, as simply the bonded obligations of the government – like net interest, backed by the full faith and credit – thus making explicit what is obvious to any careful observer, which is that these programs cannot go "bankrupt" anymore than the government of the United States can go bankrupt, which it cannot.

And of course the United States Government has not gone bankrupt, in more than two centuries of continuous operations and through much bigger deficits and greater trials than we are experiencing just now.

5. Keep people in their homes.

The housing crisis is at the root of our difficulties, for since the Tax Reform Act of 1986 our economy has been strongly biased toward collateralizing lending with homes. This model, which built up a structure of debt over a very long period of time, has now collapsed. It has collapsed, moreover, in ways that not only have destroyed the market for sub-prime securities, but that also have compromised secondary markets for prime mortgages.

There is no way for public policy to stabilize housing prices as such in the near term. House prices are private contracts for idiosyncratic goods, and cannot be controlled. Therefore, policy must focus on the proximate problem, which is chronic excess supply. The only way to do that, short of buying up surplus homes and knocking them down, is to find a means to stop the wave of evictions, vacancies, trash-outs and forced sales that is overwhelming the system.

In economic terms the problem is simple: how to align, in a way that is fair and sustainable, the payments people are required to make on their houses with their actual capacity to pay? But there is a corollary which is not so simple: how to do so in ways that do not encourage irresponsible behavior on the part of homeowners who are not in trouble?

The administration's plan of action in the housing sphere is a bright spot on the policy horizon. It meets, so far as I can tell, the tests of fairness and sustainability reasonably well. But it does so only for a limited class of borrowers, who are not too deeply underwater already on their homes. It will provide a measure of relief, but it will not, so far as I can tell, either stop the wave of foreclosures or prevent a continued decline in prices.

There are, I think, two basic alternatives that might work. One would be to declare a comprehensive moratorium on new foreclosures, and then to turn over the entire portfolio of troubled mortgages to an entity like the depression-era Home Owners Loan Corporation for triage and renegotiation on a case-by-case basis. The advantage of this approach is that, if done on a large enough scale, it would work. An HOLC could distinguish honest from fraudulent borrowers, fit legitimate homeowners into appropriate work-out categories, and

manage or dispose of the properties of the rest. Meanwhile people would enjoy a presumptive right to stay in their homes. The difficulty is that this would take a long time and a lot of money and manpower, and the system would still be prone to manipulation, at least to some degree.

An alternative, suggested by Warren Mosler, is to allow the ordinary foreclosure process to work. But, after foreclosure, owner-occupied properties would be bought at the lower of the appraisal price or mortgage balance by a new federal entity, and the previous owner allowed to stay in the house for a fair market rent, with the option of repurchasing the home at a fair appraisal value later on. This would have the advantage of protecting against moral hazard, while at the same time preserving occupancy, to the maximum extent possible.

6. The long term starts now: infrastructure, energy and the dollar.

Finally, though these remarks depart from the realm of monetary policy in a strict sense, it is important to make them briefly.

First, no recovery program will work unless crude oil imports in the upswing are effectively curtailed. Failure to do this simply leaves the power to set oil prices in the hands of speculative markets and the swing producers – Saudi Arabia and possibly Russia. This is the channel that poses the most serious inflation risks going forward.

Second, a growing economy down the road will need new focal points for public and private investment. Infrastructure and energy are clearly the great challenges ahead: infrastructure because this vital contributor to efficiency and competitiveness has been severely neglected for decades, and energy because of the danger of climate change. The correct approach to infrastructure remains a National Infrastructure Fund – a permanent facility that can provide funds to state and local governments and to regional authorities independently of market conditions, while serving as a source of standards and providing a measure of oversight.

Third, energy conservation and the production of sustainable energy are areas with potential for great gains; since the United States is the world's greatest per capita greenhouse gas emitter we have the capacity to make the largest improvements. But there is also the potential here for economic gains: if we do this job right, we can develop new industries which will set standards for efficient and sustainable energy production and use, and reduce our trade deficits, over time, both by curbing imports and by exporting these new products to the world. These new industries will help sustain the international position of the dollar in the long run.

For the time being, the world crisis has revealed the relative strength of the dollar and the structural weakness of the euro and of other major currencies. This situation, which has surprised many, removes the concern that the dollar will lose its reserve status – at least for the moment. But it awakens an equally serious danger, which is that instability between world currencies could produce a cumulative spiral of global economic collapse. This is an important danger, for which we are ill-prepared. There needs to be a new attention to the financial architecture, both to achieve a coordinated fiscal expansion and to admit the serious possibility of an even larger crisis, preparing for the moment when major reforms may be required.

The time to start work on all of these issues is now. Let's face it. We are not in a temporary economic lull, an ordinary recession, from which we will emerge to return to business-as-usual. We are at the beginning of a long, profound, painful process of change. Of irreversible change. For better or for worse. We need to start thinking and acting accordingly.

Thank you very much for your time and attention.

Table One. CBO's Baseline Forecasts, February 11, 2009, from a letter from Douglas Elmendorf, Director, to Senator Judd Gregg

Table 1.

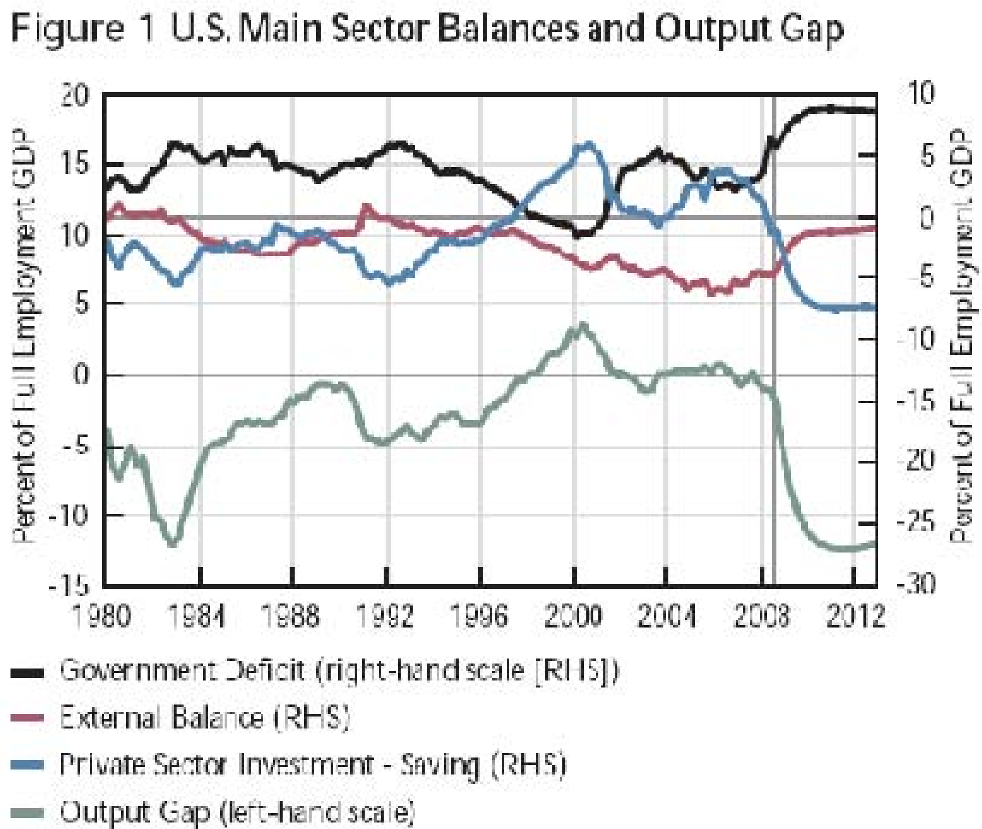
Estimated Macroeconomic Impacts of a Stimulus Package (Average of House-Passed and Senate-Passed Versions of H.R. 1), Fourth Quarters of Calendar Years 2009 Through 2019

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Real GDP (Percentage change from baseline)											
Low estimate of effect of plan	1.4	1.1	0.4	0.1	0.0	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2
High estimate of effect of plan	3.8	3.3	1.3	0.7	0.4	0.3	0.0	0.0	0.0	0.0	0.0
GDP Gap[a] (Percent)											
Baseline	-7.4	-6.0	-4.1	-2.2	-0.7	-0.1	0.0	0.0	0.0	0.0	0.0
Low estimate of effect of plan	-6.2	-5.3	-3.7	-2.0	-0.6	-0.1	0.0	0.0	0.0	0.0	0.0
High estimate of effect of plan	-3.9	-3.2	-2.9	-1.7	-0.4	0.0	0.0	0.0	0.0	0.0	0.0
Unemployment Rate (Percent)											
Baseline	9.0	8.7	7.5	6.4	5.5	5.0	4.8	4.8	4.8	4.8	4.8
Low estimate of effect of plan	8.5	8.1	7.2	6.3	5.4	5.0	4.8	4.8	4.8	4.8	4.8
High estimate of effect of plan	7.7	6.8	6.5	6.0	5.3	4.9	4.8	4.8	4.8	4.8	4.8
Employment (Millions of jobs)											
Baseline	141.6	143.3	146.2	149.3	152.1	153.9	154.9	155.7	156.4	157.0	157.7
Low estimate of effect of plan	142.4	144.5	146.8	149.6	152.2	154.0	154.9	155.7	156.4	157.0	157.7
High estimate of effect of plan	143.9	146.0	148.1	150.1	152.5	154.2	154.9	155.7	156.4	157.0	157.7

Source: Congressional Budget Office.

a. Real GDP is gross domestic product, excluding the effects of inflation. The GDP gap is the percentage difference between gross domestic product and CBO's estimate of potential GDP. Potential GDP is the estimated level of output that corresponds to a high level of resource (labor and capital) use. A negative gap indicates a high unemployment rate and low utilization rates for plant and equipment.

Figure One. The Output Gap: Levy Institute Strategic Analysis, December 2008



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Introduction to

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Lawson's Reorientation

Edward Fullbrook

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Tony Lawson has become a major figure of intellectual controversy on the back of juxtaposing two relatively simple and seemingly innocuous ideas. In two books and over fifty papers he has argued:

1. that success in science depends on finding and using methods, including modes of reasoning, appropriate to the nature of the phenomena being studied, and
2. that there are important differences between the nature of the objects of study of natural sciences and those of social science.

Taken together, these two ideas lead to the conclusion that the methods found to be successful in natural sciences are generally not the ones that should be used in social science.

By relentlessly focusing on this pair of ideas, Lawson has in a short space of time changed one of economics' key conversations. His chapter, "A Realist Theory for Economics", published in Roger Backhouse's 1994 landmark collection *New Directions in Economics Methodology*, stands out like someone standing alone at a party. As recently as then the ideas of three thinkers, none of them economists, none social scientists and all of them dead, dominated economics' literature on methodology. The index of Backhouse's wonderful book powerfully illustrates this. It lists 47 pages that refer to Thomas Kuhn, 69 to Karl Popper and 73 to Imre Lakatos. Twelve of the book's sixteen chapters (excluding Lawson's) refer to one or more of the three and eight, as well as the back cover, to all three. Lawson does not refer to any of them. More significant, Lawson's key reference point is *ontology*, a word that, except in the Introduction when Backhouse is introducing his collection's odd man out, appears in none of the other chapters. Notably, when Lawson first uses "ontology" he feels it necessary, despite his highly specialized audience, to explain what the word means: "enquiry into the nature of *being*, of what exists, including the nature of the objects of study." [Lawson 1994, p. 257]

Thirteen years later and anyone in economics who knows anything about methodology knows what "ontology" means. They also have come to realize that if Lawson's basic conclusion were applied it would entail a programme of reform that would fundamentally change economics. A quick check with Google shows just how phenomenally successful Lawson has been at changing the conversation. Below are listed the number of web pages turned up for four trios of words. [30/03/07]

Popper, economics, methodology	300,000
Kuhn, economics, methodology	391,000
Lakatos, economics, methodology	82,300
Lawson, economics, methodology	264,000

ontology, economics, methodology 1,050,000

To appreciate the significance of the huge debate begun by Lawson, we need to look at its historical background.

Physics, economics and the philosophy of science

For those of you too young to remember, philosophy of science took off in a big way in the 1960s. Not for the first time, philosophy struggled to update its teachings to make them consistent with developments in science. Traditionally philosophers told the story, and the educated classes repeated it, that science, especially physics, progressed on the basis of the application of theories empirically proven true beyond question. But the first half of the 20th century witnessed two "revolutions" in physics that made a mockery of that narrative. Physicists came to accept the theory of relativity and then quantum theory, both of which contradicted in fundamental ways Newton's theory, the most empirically confirmed theory in the history of science.

In an ideal world epistemologists would have jumped at this chance to develop new ideas. But even after the solar eclipse of 1919, which disproved Newton and confirmed Einstein, philosophers of science, under the banner of "logical positivism", persisted in telling the same old story. It was not until late 1934 that Popper published, in its original German, *The Logic of Scientific Discovery*, a book that ventured to rewrite epistemology in line with the no longer so recent events in physics. But two more decades passed before Popper and other innovators succeeded in forcing themselves past the gate keepers of the philosophical establishment. When resistance to the need for new ideas about how science succeeds and fails finally crumbled, a half-century of repressed questions shot to the surface. In consequence, the decades that followed rank among the most productive and interesting in modern philosophy.

Inevitably, economists joined the fun. So too did other social scientists, but for economists there was a special and virtually irresistible attraction, especially to the Popper-Kuhn-Lakatos triad. From the mid 19th century onward economics has fancied itself as methodologically akin to physics. Therefore, almost inevitably economists saw the physics-related revolution in the philosophy of science as relevant to economics as well. Meanwhile the identification of economics with physics in the economist's mind had became so strong that it almost completely obscured *the most fundamental difference* between the practice of physics (and indeed of all the natural sciences) and the practice of economics. Whereas physics invents and chooses its methods on the basis of the nature of the phenomena that it studies, economics does not. Let me explain.

1843 to today

John Stuart Mill not only turned economics primary concerns away from production and distribution to those of value, he also made the case that economics, and the social sciences in general, should ape the methodology of astronomy and physics. In *System of Logic* Mill appealed to Newton and in particular to a "law of nature" that

> is called, in dynamics, the principle of the Composition of Forces: and in imitation of that well-chosen expression, I shall give the name of the Composition of Causes to the principle which is exemplified in all cases in which the joint effect of several causes is identical with the sum of their separate effects. [1843, Book III, Ch. VI, sec. 1]

Mill then cautions that "This principle, however, by no means prevails in all departments of the field of nature." [1843, Book III, Ch. VI, sec. 1] But later in the book when considering the social sciences, without supporting argument, Mill divinely declares: "In social phenomena the Composition of Causes is the universal law". [System of Logic, Book 6, chapter VI section 1] He has previously identified this linear relation between causes as what enables the application of the deductive method. [Book III, Chapter XI, Section 1] So in this *a priori* and pre-emptive way Mill declared that what he understood to be the method of Newtonian physics was the only proper one for economics.

Within a couple of decades major economists had got the message. Jevons and Walras certainly had when in the 1870s they set about inventing neoclassical economics. In the preface to his *The Theory of Political Economy* (1871) Jevons wrote:

> But as all the physical sciences have their basis more or less obviously in the general principles of mechanics, so all branches and divisions of economic science must be pervaded by certain general principles. It is to the investigation of such principles – to the tracing out of *the mechanics of self-interest and utility*, that this essay has been devoted. The establishment of such a theory is a necessary preliminary to any definite drafting of the superstructure of the aggregate science. [emphasis added] [Jevons 1970, p. 50]

Walras began and proceeded in the same vain in his *Elements of Pure* Economics. (1874-77) Alluding to the role of force and velocity in mechanics, he says: "Similarly, . . . this pure theory of economics is a science which resembles the physico-mathematical sciences in every respect." [Walras 1984, p. 71]

Walras does not have just any mathematics in mind, but rather that of classical mechanics. Like Mill, Walras, beyond some rhetorical flourishes, offers no argument in support of the presumed isomorphism between the mechanical and economic realms. What matters to Mill, Jevons and Walras is not the methodological fit but rather the method itself, *the method used in their day by physics*. Adopting this approach to methodology means that instead of being led by ontological enquiry, one defines *a priori* the ontology to fit the method. Nothing could be more against the procedures and mindset that have dominated the natural sciences from Copernicus on. In applying a system of analysis, mathematical or otherwise, to an empirical domain, the key question for the real scientist is always whether or not the structures described by the former are isomorphic to those found in the latter. For the scientist, although not for the mathematician, the mathematics is supposed to illuminate empirical reality rather than the other way around. This means that *ultimately* the choice of method, like the question of whether or not Mill's Composition of Causes pertains to a particular domain, is a question of ontology. In real science an ontology, however imperfect, decides the method, not the opposite. The birth of classical mechanics is a paragon case. Rather than pretend that the mechanical universe had properties isomorphic to an existing math, Newton invented one, calculus, which did. Instead of bending his ontology to fit the mathematics, he created mathematics, a method, to fit his ontology. A similar sequence of events has characterized the development of 20th century physics, especially the theory of general relativity. In the twentieth

century the natural sciences, not just physics but also biology, underwent radical and more or less continuous ontological revision. The elementary entities and fundamental properties that populate the minds of physicists today are light-years removed from those of Newton's time or even of Maxwell's.

The 20th century, especially its second half, witnessed a gradual intensification of economics' obsession with dressing up in the methodological clothes of physics. Some economists, so carried away by their masquerade, even developed a taste for pretending that their achievements merited comparison with those of the great names of physics. The science historian Yves Gingras [2002] has described one such case:

> Paul Samuelson (1970 winner) wrote about his 'Nobel coronation' – not his 'Bank of Sweden Coronation' – and filled his talk with references to Einstein (4 times) Bohr (2 times) and eight other winners of the (real) physics Nobel prize (not to mention, of course, Newton) plus a few other names as if he were part of this family.

But some more recent winners of the Swedish prize have not, at least with hindsight, been so taken in. Milton Friedman [1999, p. 137] has acknowledged that "economics has become increasingly an arcane branch of mathematics rather than dealing with real economic problems", and similarly Ronald Coase [1999, p. 2] has written "Existing economics is a theoretical [meaning mathematical] system which floats in the air and which bears little relation to what happens in the real world". Method counts for virtually everything, substance for little or nothing, and disconnection from "real economic problems" and "the real world" is general in scope. In the typical research seminar, observes Bruce Caldwell in this volume, "No claims are ever defended with anything like the vigor with which one defends one's choice of econometric techniques." [p. 16]

Ontologies

By unveiling the mainstream's ontology entailed by its methodology and by calling attention to economics'' scientism, Lawson seeks to win the minds of the young and thereby bring about a reversal of the discipline's traditional order of priority between method and substance. Above all Lawson's project is one of persuading economists to do as physicists have always done: to take cognizance as best they can of the basic characteristics of their domain of inquiry and then proceed to develop and choose their methods accordingly.

Lawson builds his prescriptive analysis on the ontological platform of the social-philosophical school of thought called Critical Realism. This movement, a predominately Anglo-American affair, can through Continental eyes appear rather hackneyed. Lawson lists five key properties which, "according to the (philosophical) ontological account" that underwrites his project, social phenomena possess. [Reply to Davidsen, 15]

1. They are produced in *open systems*.
2. They possess *emergent* powers or properties.
3. They are *structured*.
4. They are *internally-related*.
5. They are *processual*.

These core ontological ideas of Lawson's project include nothing that at the time of Critical Realism's inception in the 1970s was not already part of the woodwork of Continental

philosophy and social theory. One example well illustrates the case. In Simone de Beauvoir's *The Second Sex* (1949), one of the last century's most influential books, the concept of gender and the ontological framework that supports it incorporate all five of the properties of social phenomena that Lawson embraces.

1. *open systems:*
   "humanity is something more that a mere species: it is a historical development;" [Beauvior, p. 725]
2. *emergent:*
   "Woman is not a completed reality, but rather a becoming," [p. 66]
   "One is not born, but rather becomes, a woman." [p. 295]
3. *structured*:
   "For us woman is defined as a human being in quest of values in a world of values, a world of which it is indispensable to know the economic and social structure. We shall study woman in existential perspective with due regard to her total situation." [p. 83]
4. *internally-related*:
   "Otherness is a fundamental category of human thought." [p. 17]
   "The Other is posed as such by the One in defining himself as the One." [p. 18]
5. *processual*:
   "An existent *is* nothing other than what he does;" [p. 287]

And of course above all Beauvoir was an existentialist so that, in Lawson's words, "there is no one-to-one mapping from social structure to individual pathways, experience or personal identities [p. 65, this volume]," and in Beauvoir's words, "she acquires this consciousness under circumstance dependent upon the society of which she is a member. . . . But a life is a relation to the world, and the individual defines himself by making his own choices through the world about him." SS, 80-1][6]

Pointing out the historical pedigree of Lawson's core ontological ideas is not a criticism but, on the contrary, an endorsement. It is the unoriginality that so suits Critical Realism for the task of critiquing mainstream economics. The legitimacy and fecundity of the ontological ideas that it pushes are so well-tested and so widely embraced outside of economics that it makes an ideal replacement for the ontology implicitly assumed by mainstream formalist methods. To my knowledge no one of repute in economics has dared to come forward to argue, against Lawson, that the economy is a closed system, that it is not characterized by the property of emergence, that it is not structured, that in it internal relations do not play a pivotal role and that it does not consist of an inter-related series of unending processes. Only a fool would publicly take up these arguments. And most economists, but not all, are also too sensible to suggest that economics should not take cognizance of the fundamental properties of its object of enquiry. In consequence, defenders of the status-quo find it difficult to frontally attack Lawson's ideas. They tend to settle instead for indirect approaches. Easiest and in the short

[6] For more on Beauvoir's ontology see Edward Fullbrook and Kate Fullbrook*, Simone de Beauvoir: A Critical Introduction*, Cambridge, UK: Polity Press, 1998, or Edward Fullbrook and Margaret A Simons, "Simone de Beauvoir and Jean-Paul Sartre" *Gendering Western Philosophy: Pairs of Men and Women Philosophies from the 4th century B.C.E. to the Present*, New York: Rowman and Littlefield, 2008, or "Chapter 14: Gender and Ethics" and "Chapter 15: The Second Sex" in Edward Fullbrook and Kate Fullbrook, *Sex and Philosophy*, London: Continuum, 2008, or the many papers in "Première Partie: La Philosophie du Deuxième Sexe" in *Cinquaternaire du Deuxième Sexe*, editors Christine Delphy, Sylvie Chaperon, Kate Fullbrook and Edward Fullbrook, Paris: Éditions Syllepse, 2002, pp. 19-190.

run probably strategically the wisest is just to ignore him. Another has been to hurl personal abuse at him, as in Herbert Gintis's amazon.com review of *Reorienting Economics*. Another and increasingly common tactic has been to misrepresent the current situation in economics. There can be a big payoff for this approach when addressing a non-economist public, including economics students, or when addressing oneself in bad-faith. Out of the tens of thousands of papers published in mainstream economics journals over the past half century, one can easily find some, which having slipped past the gate keepers, embody one or more of the five properties. Wave these papers about vigorously enough and some people will be convinced that economics is already as Lawson would like it to be. Alternatively, one can misrepresent the formal properties of various methodologies, as when it is suggested that standard game theory describes an open system.

Thirteen years on

Thirteen years on, Backhouse's collection belongs not just to another century but also to a different era. Although many economists, especially older ones, still entertain kissing-cousin fantasies about their relation to physicists, inhibitions have developed about acting them out in public. It is hard to imagine anyone accepting the Swedish prize today behaving as Samuelson did. Among methodologists the shift has been especially pronounced and quick. The majority may still in their heart of hearts prefer to view economic method through the physical science prism. But in the main they have, even if begrudgingly, taken on board the fact than any methodological commitment is also an ontological one. Questions concerning the fundamental nature of economic phenomena are not yet basic to the practice of economics, as the corresponding questions are in physics, but neither are they still treated as totally beneath attention. Today nearly all methodologists are either conversing with Lawson or heckling him from the edges of the room.

Many people, including all of the contributors to this collection (several in particular), have played a part in bringing about this shift, this *new new* direction in economic methodology. But more than anyone, I believe, Tony Lawson deserves credit for the swing away from judging method in economics as an end in itself to judging it as a means to substantive knowledge and hence its ontological fit. It will be a long struggle to reverse the wrong turn that Mill made for economics in 1843. But Lawson's *Economics and Reality* in 1997 and *Reorienting Economics* in 2003 together with his many papers have provided the growing number of reformists in the profession with a formidable and expandable arsenal, and with the likes of which dissenters have not previously been armed.

Lawson's Critics

Over a period of 18 months I commissioned for the *post-autistic economics review* the ten critical essays around which this volume is formed. I chose the critics partly on the basis of the particular approach I anticipated that they would take to Lawson's work and partly because in each case I held their critical powers in special regard. None of them disappointed me. Very briefly I will run through the arguments of the critics, whose essays have been ordered alphabetically.

Bruce Caldwell declares his “substantial agreement with Lawson’s fundamental complaint that the economics profession is dominated by a mainstream orthodoxy” [1] that is unhealthy because of its methodological approach. He also finds attractive Lawson’s description of structured social reality. But unlike Lawson, Caldwell retains a strong faith in traditional “basic economic reasoning” as “a powerful tool” that enables us to understand the world, improve our decisions and order human behaviour. [4] He cautions us not to ”worry about establishing causes” [4] in lieu of using the tools we already have, and would like to see research into “why such reasoning works”. [4]

Bjørn-Ivar Davidsen argues that the social ontology upon which the critical realism project in economics bases itself lacks “epistemological credibility beyond a reasonable amount of doubt.” [8] Consequently, he sees it as “ill advised” to rely on critical realism in its present form as the basis for critiquing and reforming “scientific practices” in economics. Davidsen calls instead for a critical realist project that would develop “domain specific ontological theories” and then apply them to “scientific work directed toward analysis of substantive economic questions and issues.” [9] Critical realism would then be judged by its success in offering improved accounts of old and new economic topics. If successful, the epistemological status of the critical realist ontology would be enhanced and acceptance from mainstream economics might follow.

John B. Davis believes that today heterodox economists have a choice between two strategies for reforming economics. They can hope for a “big scientific revolution” or they can gradually chip away at the mainstream core. Lawson’s view of heterodoxy, says Davis, conceals this choice. He sets about establishing its existence by inventing and applying a classification system to economics. This includes three principles shared by heterodox economic approaches, and that “draw the dividing line between orthodox and heterodox economics circa 1980” [p. 6], and four ways by which an approach could become heterodox or vice-a-versa. Davis’s argument also grows out of his recognition of promising new research programs in economics and their characteristics.

Paul Downward and **Andrew Mearman**, while generally backing Lawson’s analysis, argue that there needs to be more emphasis on practical methodology for guiding research projects informed by critical realism. To this end, they advocate a principle that they call *trianglualtion*, a “commitment in research design to investigation and inference via multiple methods which are not placed in any *a priori* hierarchy.” [2] They argue that this approach makes operational Lawson’s principle of *retroduction*, promotes pluralism, co-operation with other social sciences and leaves the door open to quantitative methods that otherwise would be excluded. In this way they see triangulation as a means for realizing Lawson’s project of transforming economics.

Like Lawson, **Bernard Guerrien** was a mathematician before turning to economics. Unlike Lawson, he identifies the type of social structure, not the type of economic agent, implicitly assumed in the models of modern economics as what makes them so irrelevant. When they assume that households and firms are price-takers, they describe not a market but a centralized economy. When they reduce the whole economy to the choice of a “representative” agent, they are indulging in blatant nonsense. Guerrien argues that the real reason why intelligent people can propose and endlessly study “such *stupid* models” is ideology and that to overcome it ontological debates are no or little help.

Geoffrey M. Hodgson agrees with Lawson that modern economics' malaise stems from "the victory of technique over substance," and its dogmatic insistence on the use of formalism. [1] But he largely rejects Lawson's critique of formalism and, more significantly, accuses him of a dogmatism of his own. Hodgson makes the case that Lawson's criterion of local closure for the use of mathematics together with his critical realist ontology, which rules out virtually all such closures, in effect denies almost all possibility for legitimate use of mathematics in economics. Alternatively, Hodgson rejects strict local closure as a criterion for the use of formal modelling, citing biology in support. He then explores two types of situation in economics, heuristics and internal critiques, where applications of formalism, including "using closed models to help understand an open reality", have proved useful.

Bruce R. McFarling makes the case that epistemology, not ontology, should be given the "starring role" when it comes to reorienting economics. Ontological choices, he notes, ought to be founded on epistemology. His argument centres, however, on the mainstream mode of explanation, which he identifies as the root cause "of why sixty years of determined empirical testing has left the mainstream project stalled." [p. 3] The failure stems from the method's unit of analysis, the problem solving isolated individual, which renders this approach "blind to important aspects of the economy". [p. 3] Researchers, wedded to the method, systematically ignore all those features of the economy incompatible with the standard unit of analysis. Degenerately, the method's failure perpetuates its use. Researchers, instead of reconsidering their methodology, reapply it but with a different selection of variables and parameters, hoping that at last success will come.

David Ruccio applauds Lawson's efforts to make economists self-conscious about the conceptual schemes and ontological presuppositions of contemporary economic discourse. But he objects to what he sees as Lawson's attempt to have the critical realist ontology adopted as "the singular reality appropriate for economic science". [p. 6] *the* conception of reality. Ruccio points to the existence of other ontologies, especially Marxism and post-modernism, which have proven useful, both in their own right and as critiques of mainstream economics. He elaborates on the contributions that have come through the application of these ontologies and which emanate from their particular characteristics. He concludes by withholding support for "the project of finding or producing a single ontology that will serve as the shared foundation of the various schools of thought that have come together in the post-autistic economics movement." [p. 8]

Irene van Staveren identifies Lawson as a strong supporter of the feminist cause in economics. Nonetheless, she levels three criticisms regarding feminism against him. In his encouraging feminists to study gender as an ontological category, she sees him as advancing a universalist and essentialist "claim about the nature of human beings, a claim against which the whole project of feminism is set up." [p. 2] Straveren then makes the case that Lawson's rejection of formalistic modelling can work against the aims of feminist economics. Feminists cannot afford to ignore either theoretical or empirical modelling, regardless of their ontological legitimacy, because they influence the way people think of society. She considers the example of modelling work on unpaid labour and the care economy, where the modeller is faced with the choice between constructing a model that permits changing gender relations and one that does not. Finally, she criticizes Lawson for failing to make the learning relations between critical realism and feminism run in both directions.

Jack Vromen takes strong exception to what he characterizes as Lawson's "presumption that adherence to a mathematical-deductivist style of modelling imposes a 'flat', non-layered empiricist ontology." [p. 1] He also argues, against Lawson, that mainstream economists believe both in underlying mechanisms, although different ones, and that a satisfactory economic theory should identify them. But unlike Lawson, mainstream economists do not think that it is necessary to model them. Vromen explains why. He then sets out an argument against using ontology as "a final arbiter in assessing economic theories," [p. 3] especially the presumption that there "are many uncontested generalised observations about social reality." [p. 4] He concludes that ontological considerations should serve as "heuristic principles" for developing new economic theory.

As a year passed and these critical essays accumulated I came to fear their combined effect – that perhaps I was doing Lawson a disfavour. This fear grew when he declined to respond to any of his critics until the series was finished. Then a further silence followed, as he insisted upon writing all ten of his replies before revealing any of them.

Finally, his replies arrived on my desk. The week that followed, with its close back-to-back reading of the critiques and Lawson's replies, proved one of the most satisfying of my professional life. This is a collection of fine minds, stretching to near their limits, interacting with each other and being changed by the process. I was changed by reading it. I hope you will be too.

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The real dirt on happiness economics:

A reply to 'The unhappy thing about happiness economics'[1]

Dan Turton [Victoria University of Wellington, New Zealand]

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Introduction

In their recent article *The Unhappy Thing about Happiness Economics* http://www.paecon.net/PAEReview/issue46/JohnsOrmerod46.pdf Helen Johns and Paul Ormerod make the strong claim that "time series data on happiness tells us nothing".[2] Their argument is based on three main points: that statistically significant correlations between time series happiness data and other important socioeconomic indicators cannot be found, that the nature of happiness scales makes them insensitive and difficult to compare with most other economic data, and that using time series happiness data for policy-making creates several undesirable problems. While some of Johns and Ormerod's concerns about the rigour of studies using time series happiness data should be taken note of, their main conclusion lacks the strong evidence such a claim requires. This article will evaluate all of the main points from Johns and Ormerod's paper and provide considerable evidence that, far from telling us nothing, time series happiness data can actually tell us a great deal.

There is no relationship between happiness and other variables that we would expect to observe a relationship between

Johns and Ormerod begin by criticising the apparently "widely mentioned" argument that there is no correlation between measures of economic growth and measures of well-being. I assume that they are referring to the argument: 'If there is no correlation between economic growth and happiness, then economic growth must not bring happiness'. They then refer to several other major social trends that should have affected average happiness through recent history, but (according to them) have not done so. Johns and Ormerod take these lack-of-relationships very seriously and assert that happiness researchers should admit that either no government's actions since World War Two have ever affected their citizens' happiness or that time series happiness data is completely useless.

Considering that some of the six major concurrent social trends that Johns and Ormerod point out are expected to increase happiness, and the others decrease it, it is hardly surprising that relationships between any of these individual trends and average happiness over time are not obvious in simple correlative analyses! Most economists who study happiness do not make crude arguments like the one above. Rather, unexpected findings are usually posed as questions inviting further investigation (e.g. 'why does it appear that a considerable increase in real income has not made U.S. citizens any happier over the last 50 years?'). These investigations often use multivariate regression analysis and control for certain factors in order to isolate the variables that are being studied. When studies comparing societal trends with

[1] Many thanks to Lucas Kengmana for several particularly insightful comments on this paper.

[2] H Johns and P Ormerod (2008), 'The unhappy thing about happiness studies', *Real-World Economics Review*, 46, 139-146, http://www.paecon.net/PAEReview/issue46/JohnsOrmerod46.pdf

happiness are carried out in this manner, like those discussed below, significant relationships are discovered.

Johns and Ormerod show evidence for a statistically insignificant relationship between income inequality and well-being in the U.S. over the last 30 years, but fail to mention the results that *do* show a significant relationship between income inequality (using the same measure) and happiness in Europe during the same time period. In Europe, rising income inequality significantly explains some of the variation in reported happiness; income inequality generally made Europeans less happy.[3] Why the difference? Economist Bruno Frey puts it down to U.S. citizens' higher belief in social mobility; they don't mind the inequality because they (mostly mistakenly) believe that they will be one of the rich folk in the near future.[4]

Johns and Ormerod believe that the best explanation for the supposed lack of correlation between happiness and these socioeconomic indicators is that, in its current state, the happiness data is simply not worth the paper that it's printed on. The fact of the matter is, however, that significant relationships between reported happiness and many other socio-political factors *are* being discovered in careful studies that properly isolate the variables in question.[5] Nevertheless, Johns and Ormerod's criticisms of the construction of happiness scales (why they think the data is not worth anything) will now be addressed.

Happiness scales are insensitive

The two main criticisms that Johns and Ormerod pin to the construction of happiness scales are that they are insensitive and that the type of data they produce is not easily comparable to most of the data that economists use.

There is some legitimacy to Johns and Ormerod's claim that time series happiness data is insensitive, but much of their argument is misleading on this point. Happiness is usually measured by asking participants to choose the option, from a number of discrete categories, which describes them best (e.g. 1 = Very happy, 2 = Quite happy, 3 = Not very happy, 4 = Not at all happy). Johns and Ormerod give the example of a 3-point scale and then proceed to discuss how insensitive scales with only three options are. First of all, many happiness scales have four or more options, like the example above from the World Values Survey,[6] and many well-being scales have up to ten options.[7]

Secondly, Johns and Ormerod assert that to observe a 10% increase from 2.2 in average happiness on a 3-point scale, 22% (net) of a population would have to place

[3] A Alesina, R Di Tella and R MacCulloch (2004), 'Inequality and happiness: Are Europeans and Americans different?', *Journal of Public Economics*, 88, 2009-2042.

[4] B Frey (2008), *Happiness: A revolution in economics*, MIT Press. See pp57-58.

[5] See for example: B Frey (2008), *Happiness: A revolution in economics*, MIT Press. And, P Dolan, T Peasgood and M White (2008), 'Do we really know what makes us happy? A review of the economic literature on the factors associated with subjective well-being', *Journal of Economic Psychology*, 29, 94-122.

[6] See <http://www.worldvaluessurvey.org/> for more information and access to the full data set.

[7] See, for example, the life satisfaction question from the World Values Survey (question V22).

themselves in a higher category, an increase that they consider "very difficult" to imagine occurring over "a few years".[8] Well, they are not the only ones. An enduring 10% increase in happiness is a lot to ask for in a few years, regardless of the scale used. On a 4-point scale 30% of respondents would have to judge themselves as a category happier and on a 10-point scale 90% would have to go up a category or 22.5% would have to go up four categories. Naturally, the gap between categories gets smaller as the number of them to choose between gets larger, but the proportion of respondents required to report higher happiness increases too. With 3-point scales, researchers simply have to pay more attention to smaller changes in the average value – thank goodness for decimal places!

Despite being hard to imagine, a 10% increase in average reported happiness (on 4-point scales) has actually occurred in some countries over just a few years, such as in Lithuania (1997-1999), Mexico (1996-2000), and Slovenia (1992-1995). Furthermore, since 1980 at least 21 countries have reported a 10% or more increase in happiness over longer periods of time, including Johns and Ormerod's home country of Great Britain (1998-2006).[9] In light of these results, the claim that time-series happiness data is too insensitive to capture trends is totally unfounded.

Having said this, the general consensus in the psychological community is that 3-point scales are not ideal for measuring well-being.[10] Fortunately, happiness studies, and especially well-being studies, are increasingly using much more precise and robust measures, such as the Subjective Well-Being construct used by Inglehart and colleagues, which combines a 4-point happiness scale and a 10-point life satisfaction scale.[11]

Happiness scales are hard to compare with other economic measures

Johns and Ormerod's other criticism of happiness scales is that the type of data they produce is not easily comparable to most of the data that economists use because the scales are discrete and bounded. They are correct that discrete data is not completely easy to compare with non-discrete data because it makes it harder to find statistically significant results. However, this problem is one faced by many different types of data, most of which are widely considered to contain useful information when studied carefully.

On the point of time series happiness data being bounded, Johns and Ormerod admit that short term trends in reported happiness data might exist, but correctly note that no trend in

[8] It should be noted that another way to interpret the data suggests a smaller increase. It would take 22% of a population to change if a 10% increase in happiness meant multiplying the current average of 2.2 by 1.1 (which equals 2.42). But consider that the average comes from a scale limited to values between 1.0 and 3.0. The accessible part of the scale can be split into 10 equal portions of 0.2. This clearly indicates that a 10% movement on the scale would increase the average from 2.2 to 2.4, which would only require 20% of respondents to opt for a higher happiness category.

[9] R Ingleheart, R Foa, C Peterson and C Welzel (2008), 'Development, freedom, and rising happiness: A global perspective (1981-2007)', *Perspectives on Psychological Science*, 3(4), 264-285.

[10] R Cummins and E Gullone (eds.) (2002), *The universality of subjective wellbeing indicators: A multi-disciplinary and multi-national perspective*, Kluwer Academic Publishers.

[11] R Ingleheart, R Foa, C Peterson and C Welzel (2008), 'Development, freedom, and rising happiness: A global perspective (1981-2007)', *Perspectives on Psychological Science*, 3(4), 264-285.

happiness data can *persist* using the present measuring technique. This is because if happiness increased until everyone rated themselves as happy as possible on a discrete scale, then they could not communicate any increase in happiness from that point. Of course, this is true but the chances of everyone reporting maximum happiness on any realistic scale do not seem high enough to warrant this being considered a problem at this stage.

Johns and Ormerod then make the fair point that calculating correlations between trend-exhibiting variables and *non*-trend-exhibiting variables is "fraught with inherent problems". However, they then combine this point with their misleading assertion that time series happiness data cannot show trends to conclude that comparing time series happiness data with trend-exhibiting data is very problematic. The problem here for Johns and Ormerod is that happiness data do in fact exhibit trends in many countries. Inglehart and colleagues' recent study of reported happiness in 52 countries from 1981-2007 revealed that nearly all of them exhibit upwards trends in happiness.[12] They also suggest several reasons for why this trend might have been missed by some researchers. The oldest data on happiness comes from the most developed countries, such as the U.S., all of which had already passed the point of economic growth where gains in happiness could be easily attained through economic development. Furthermore, increases in tolerance and democratisation, which help increase a sense of freedom and happiness, have been relatively recent and do not always have significant effects on other measures of well-being.

Time series happiness data is not useful for policy-making

So far, Johns and Ormerod's allegations of missing relationships have proven to be false and their criticisms of happiness scales relatively inconsequential. However, they also claim that happiness data should not be used in policy-making. Johns and Ormerod justify this claim by arguing that governments will inevitably "influence" the data, which is only possible because it doesn't contain any "real information". Presumably they mean that governments will 'cook' the happiness 'books', as opposed to create policies that make their citizens happier (thereby influencing them to report higher levels of happiness). Naturally, governments will attempt to present happiness data in the best light (for them at that time), just like managing directors *and governments* now do with financial data. Without the actual falsification of the data itself, such unscrupulous behaviour cannot continue for long without being spotted. And, happiness data is just as open to falsification as financial data. However, if every set of happiness data contained as much information as a random set of numbers, then it would be somewhat more difficult to identify happiness 'book cooking' (mainly because no one would care about it).

Is time series happiness data really indistinguishable from a purely random series like Johns and Ormerod allege? They claim that time series happiness data provides a flat autocorrelation and no statistically significant individual values and that this makes it impossible to create accurate forecasts from it. However, they just tested one set of happiness data from one country. Reported happiness in many countries exhibits clear trends over time, as discussed above, so implying that *all* time series happiness data provides a flat autocorrelation

[12] R Ingleheart, R Foa, C Peterson and C Welzel (2008), 'Development, freedom, and rising happiness: A global perspective (1981-2007)', *Perspectives on Psychological Science*, 3(4), 264-285.

is very misleading. Furthermore, our ability to forecast time series happiness data is constantly increasing due to careful comparisons of changes in reported happiness over time between different countries (or distinct groups within countries). By identifying changes in happiness that occur in some countries or groups, but not others experiencing very similar conditions, variables that might explain the variance in happiness can be isolated. The prevailing conditions in some of these comparisons will even allow for the direction of causality to be assessed and thereby begin to provide useful information for predicting the effects on future reported happiness of some upcoming change in circumstances.

Economist David Dorn and colleagues recently showed not only that the more democratic countries in their study had higher average reported happiness values, but also that as the countries in the study became more democratic, their average reported happiness values increased too.[13] By observing how happiness and other variables interact within populations and comparing that with the interactions observed under similar circumstances in other populations we can gain valuable insight as to the direction of causality between the happiness and the other variable.

So, Johns and Ormerod have not yet provided any good reason for us to believe that happiness data contains no information. However, they go on to cite an unpublished mathematical paper, showing that the variation observed in time series happiness data can be completely explained by sampling error. What the paper actually shows is that some of the variation of happiness over time in one set of 3-point time-series happiness data from one country could be explained by sampling error. Johns and Ormerod implicitly generalise this lone result to *all* time series happiness data in their paper. Since many other time series happiness data is based on more sensitive scales, shows clear trends, and shows more variation from year to year, generalising such a finding to *all* time series happiness data in not a valid inference.

Nevertheless, the example that they use is potentially damaging enough for time series happiness data for it to also be investigated. Based on U.S. 3-point time-series happiness data from 1971-2006, Johns shows that only about 22% of the data points fall outside of the 95% confidence interval for sampling error (from the mean of the data set). This means that we cannot be 95% confident that most of the average reported happiness values are different from the mean reported happiness throughout the whole period. Contrary to the claims of Johns and Ormerod, this result far from implies that there is no real information in this data. First of all, even in Johns' analysis we can be very confident that nearly a quarter of the average reported happiness values cannot be explained by sampling error and we can be fairly (90%) confident that nearly half of the average reported happiness values cannot be explained by sampling error. What should we think then of the other half of the values? Johns and Ormerod would have you believe that they are as good as random. However, a better interpretation of them (along with the values that we are more confident about) is that all of them probably carry some sampling bias and some real information *regardless* of their proximity to the mean for the period. Johns' interpretation of the data implies that the values closer to the mean carry less information than those further away. If, as Johns and Ormerod claim, reported happiness really

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[13] D Dorn, J Fischer, G Kirchgässner and A Sousa-Poza (2007), 'Is it culture or democracy? The impact of democracy, income and culture on happiness', *Social Indicators Research*, 82(3), 505-526.

remains flat over time, we should actually be more suspicious of the samples that produce average reported happiness values further from the mean for the period *not* those closer to it.

Considering the average reported happiness values for what they really are, we should not expect to see perfectly smooth trends (such as the flat line Johns and Ormerod propose) because while some of the factors that we expect to affect average happiness change steadily over long periods of time, many others change much more erratically over shorter periods. Therefore, calculating the confidence that we should have in the average reported happiness values (when other happiness-influencing variables are not controlled for) should not be based on comparison to a smooth trend. However, even if time series happiness data were always treated as smooth long-term trends, we could still gain useful information out of the data from countries exhibiting clear long-term trends (which is nearly all of them).

For example, the fact that the recent average reported happiness scores in Iraq and Zimbabwe are currently amongst the lowest in the world should be no surprise.[14] If those countries ever get back on their feet and become free, safe and prosperous societies, then we would predict that their reported happiness would increase generally inline with their redevelopment. However, if Johns and Ormerod are correct that *all* variation in time series happiness data is probably due to sampling error, then we should not bother celebrating that increase in happiness when it comes (and neither should the people who live in those countries) because it's probably just caused by sampling error.

Johns and Ormerod are certainly right to warn against taking the dramatic year-to-year zigzagging of average reported happiness values completely at face value, because some of the variation is inevitably going to be caused by sampling error. However, some of the year-to-year variance is also going to be caused by changes in the average happiness that the population would report. Good happiness researchers should bear this in mind when interpreting their results by looking for highly significant relationships with high explanatory value, as many of them do.

Knowing that not all time series happiness data is as sensitive as it could be and that (as with much social science data) some of its variation is probably due to sampling error, should time series happiness data ever be used for public policy? At most, combining these findings should result in the conclusion that *some* happiness studies should not be used to guide policy because their results should not inspire enough confidence. However, the other time series happiness studies can be useful for policy-making in many ways.[15] For example, by carefully comparing results from several populations in circumstances as similar as possible, and implementing the policy change in only some of those populations, changes in reported happiness can be recorded and compared. If other variables are sufficiently controlled for and the changes in happiness are significant, then useful information can be gained about how the policy might affect other populations in similar circumstances.

[14] R Ingleheart, R Foa, C Peterson and C Welzel (2008), 'Development, freedom, and rising happiness: A global perspective (1981-2007)', *Perspectives on Psychological Science*, 3(4), 264-285.

[15] See Frey (2008, Chap 13) for more on how happiness studies should be used in public policy.

Johns and Ormerod also note that they are not alone in their dislike of time series happiness data, referring to a recent report by economist and well-being expert Paul Dolan and colleagues.[16] Johns and Ormerod quote the following from the report:

> "One very firm conclusion that can be drawn from our review is that the existing evidence base [for well-being] is not quite as strong as some people may have suggested….This, in addition to lack of clear evidence on causality, makes it difficult to make clear policy recommendations at this stage."

While the quote is accurate, it is certainly not all Dolan and colleagues had to say on the matter. Johns and Ormerod's editing of the passage removed this: "… and there are some important avenues for further research that could be explored with the existing panel datasets." And in the conclusion of the report, Dolan and colleagues noted that there are some clear determinants of self-reported well-being (age, separation, unemployment and health) and that they hope policy-makers become aware of these relationships. Furthermore, Dolan himself is a supporter of using measures of subjective well-being (which often include self-reports of happiness) for policy-making, as discussed in his article *In Defense of Subjective Well-Being*.[17]

Closing remarks

Johns and Ormerod's bold claim that time series happiness data does not tell us anything at all has been shown to rest uneasily on the generalisation of just one study of one country to a whole range of different types of studies conducted in dozens of countries around the world. Examination of other happiness studies reveals some very useful information, which policy-makers should take note of. Naturally, policy-makers should not base their decisions wholly on happiness studies. Rather, they should take potential affects on happiness into account in decisions where useful happiness or subjective well-being-related information is available.

Johns and Ormerod's parting shot is to remind us that the flatness of average reported happiness cannot be pinned on economic growth. But not many people ever really thought that increasing GNP caused happiness to remain fairly flat in developed countries. However, many people *have* wondered why average reported happiness does not respond more than it does to large GNP increases in developed countries. This unintuitive result has helped attract interest to the burgeoning field of happiness studies, a field that continues to provide insights into how we might help populations to become happier.

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[16] P Dolan, T Peasgood and M White (2008), 'Do we really know what makes us happy? A review of the economic literature on the factors associated with subjective well-being', *Journal of Economic Psychology*, 29, 94-122.

[17] P Dolan (2008), 'In defence of subjective well-being', *Health Economics, Policy and Law*, 3, 93-95.

Reply to Dan Turton

Helen Johns and Paul Ormerod [Volterra Consulting, UK]

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Our original article http://www.paecon.net/PAEReview/issue46/JohnsOrmerod46.pdf in *Real-World Economics* Review has been downloaded well over 10,000 times. The editor of the journal invited a range of leading happiness researchers to respond to our critique of time-series data on average happiness. The only response, however, has been from Dan Turton, whose contribution is the focus of this short note.

We should make it clear beyond doubt that we are not criticising the entire corpus of happiness economics research. Far from it. We regard the careful, micro-econometric panel data analysis carried out under the banner of happiness research as a part of valuable attempts in behavioural economics to construct better models of boundedly rational agent behaviour.

Indeed, in our original monograph on the topic (Johns and Ormerod, 2007) we devoted the opening chapter to this aspect of happiness research and economic theory, concluding that its findings fit in with a wide range of evidence in the more general field of experimental and behavioural economics that economics needs different postulates on individual behaviour.

The focus of our critique is time series data on average happiness at the national level, and specifically in developed countries. The notorious chart which plots GDP rising over time and average happiness remaining flat has been enormously persuasive, especially in policy circles. Carrying out simple correlations of average happiness with other variables makes clear that the simple lack of correlation between GDP and happiness over time has no meaning.

Turton agrees with this, pointing out quite correctly that multiple regression analysis is needed whenever there may be more than one hypothesised causal factor. But the community of happiness economists is largely silent when it comes to making clear that no credibility can be accorded to the simple GDP/happiness time series plot. Why? We can only pose the question and speculate on the answer.

However, our critique of time series data on average happiness goes much further than this.

Turton's main argument is that the basic premise that happiness levels remain flat in Western societies is incorrect. He cites evidence from Inglehart et al. (2008). But to use this as a counter-argument to our paper is disingenuous. The claim we make is simply replicating those made by some of the very leading researchers on happiness economics, recent examples being Easterlin (2005) and Kahneman and Krueger, (2006).

Clearly there is a difference of opinion within happiness research itself. In Britain, the idea that happiness levels have not increased over several decades has been presented as established fact and used as the basis for influential policy arguments (Layard, 2005) The idea that this flatness is due to the inability of economic growth to generate happiness in already affluent societies has rooted itself in public debate. If some happiness researchers are now

claiming, as the data presented in Inglehart (2008) appears to show, that in fact happiness has been increasing for some time in the USA and most European countries and this simply was not spotted before, this hardly stimulates confidence in the discipline or the quality of the data.

Further, if the average happiness scores presented in the Annexes of Inglehart et al. (2008) are representative and definitive, one wonders why many of the most prominent names in happiness research have been labouring under this misapprehension for so long. Far from clinching the argument, we suggest that this shows that totally different interpretations of happiness evidence have emerged within the discipline, and that this raises serious doubts that the analysis of happiness evidence is reliable and robust enough for policy purposes.

Turton cites evidence from Inglehart et al. (2008) that Lithuania, Mexico, Slovenia and Great Britain have all experienced 10% increases in average happiness over relatively short timescales on a four-point scale. We suggest that to draw such definitive statements from selected pairs of data points at face value without estimating sampling error is poor scientific practice and lacks statistical rigour. In addition, many of the arguments Turton derives from Inglehart et al. (2008), as well as studies such as Alesina et al. (2004), are based on microeconometric analysis. As our arguments relate solely to national-level average happiness time series and not to microeconometric studies, a great deal of Turton's arguments are at total cross-purposes to our own.

Our paper by no means claims to be a comprehensive review of happiness time series sampling error; Turton correctly states that it examines only one three-point time series. However, if it is the case that the estimation of sampling error has not been attempted as a matter of routine during several decades' collation and analysis of nation-level happiness data, we consider this to be the greater omission, . We agree that sampling error *should* be estimated for other time series and scales and would encourage happiness researchers to do so.

We do not recognise Turton's digest of our interpretation of sampling error and confidence intervals. Our paper is not intended as a formal test of the hypothesis that all points in the US happiness 3-point time series are not significantly different from the time series mean, as Turton implies. Nor do we claim that all variation is due to sampling error; that there is no possibility of a trend showing in an aggregate happiness time series (a possibility we explicitly allow for); or make the rather bizarre suggestion that only some data points are affected by sampling error.

For clarity, we argue that over short time periods true variation in average happiness time series (at least on the 3-point scale examined) is of comparable magnitude to sampling error and that this suggests the indicator is unresponsive. Physical scientists question whether true signals in their measurements are at risk of being drowned out by statistical noise, and so should social scientists.

It is self-evident that where random samples are taken, every data point is a composite of a real value and some sampling error. If the error of an indicator is routinely of comparable or greater magnitude to real changes in it – even if it sluggishly lurches a little way beyond a particular confidence interval from time to time - then the ability of the indicator to convey useful

information is thrown into doubt. If, however, it routinely displays movement which far exceeds statistical noise, it is far likelier that it is telling us something about underlying processes.

Turton's detailing of which specific data points are within or without a particular confidence interval is therefore not especially key, because the confidence interval used in our analysis is *approximate*, a best guess. We don't actually *know* the distribution of people in each happiness category in the underlying population for any given year, we only have the samples to guide us.

As it happens, the application of random matrix theory to time-series happiness data suggest that the data is dominated by noise rather than signal[1]. The eigenvalues of the correlation matrix of an appropriate delay matrix formed from UK time series data fall entirely within the theoretical range of the eigenvalues of a purely random matrix. For US data, the leading eigenvalue lies slightly outside this range. These results suggest that the UK data is indistinguishable from noise, whilst the US data contains a small amount of true information but is dominated by noise. These results are available on request.

We further argue that "true variation" is not equivalent to "useful information". We do not doubt that even a three-point scale could register increased happiness in Zimbabwe were daily life there to dramatically improve. But is this useful information?

Just as one might question why it is necessary to prove that bereavement and poor health make people less happy, one might ask what value is added for policy-makers in quantitatively demonstrating that people in a prosperous, free society are happier than those in a tyrannous, disease-ridden nation with no functioning economy.

Who exactly are the political decision-makers whose views on the benefits of democracy and economic prosperity will pivot on this proof? What extraordinarily weak faculties of qualitative reasoning they would need to have. In so many areas of public policy, it is not diagnosis which is the challenge but prescription; how to put decent leaders, institutions and policies in place to achieve a desired outcome.

Inhabitants of any country know that the reality is far more complex than a single quantitative score can convey. Turton states that happiness has been increasing in the UK; but there is a significant strand of British public opinion which considers British society to have grown more aggressive, ill-at-ease and socially fragmented over the period cited. Prominent experts have argued over recent years that Britons are suffering such an epidemic of mental illness that a drastic rethink of our cultural values and/or public policy is required (James, 2007; Layard, 2005), the latter making extensive use of happiness evidence to make his case.

Why are these arguments being made if Britons are demonstrably getting happier? What is the British public to make of the suggestion that happiness experts were just misinterpreting the data and that happiness is, despite everything previously said, actually increasing? They could be forgiven for concluding that expert opinion should be taken with more than a pinch of salt.

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[1] An application of this, with a description of the technique, is given in Ormerod and Mounfield (2000)

If happiness data is of high quality and robust then it should be as clear as crystal whether happiness in Western societies is increasing or not. This is a basic question on which happiness researchers have drawn totally different conclusions.

Social scientists should not expect political decision-makers to base policies on indicators which give such conflicting signals. An omission to routinely estimate sampling error in average happiness time series is a further interpretative flaw which raises questions over whether national-level average happiness scores can be taken at face value.

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