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Global Economic Turmoil: An Inclusive Economic Perspective

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There is broad agreement that the world economy has performed badly since the global financial crisis erupted September 2008. The articles contained in this volume of the JCES on varieties of capitalism and work motivation provide some important microeconomic details. All rest in part or whole on standard neoclassical assumptions. This forward places them in a larger theoretical framework and adds a macroeconomic dimension.

The particulars of the economic turmoil besetting the global economy today vary from country to country, but the American experience as Lawrence Summers and Paul Krugman describe it is representative[1]. Surveying the recent past, and envisioning the future they foresee substandard economic growth and secular stagnation, exacerbated by abnormally high unemployment and underemployment, widening income and wealth disparities between corporate executives and workers (including the middle class), and deteriorating conditions for Black and Hispanic retirees[2].

Data provided by the Economic Policy Institute support Summers's and Krugman's contention that the US is now in a period of "secular stagnation"[3]. Given the anticipated stimulatory effects of "internal devaluations" (reduced costs of labor), huge government deficit spending (in absolute and relative terms), monetary expansion, cheap money and external currency devaluations; economic growth and the rebound in employment should have been more vigorous.

Summers and Krugman believe they know how to cure these ills. They recommend accelerating the pace of government spending (current rates of which they call "austerity"); embracing perpetual high deficit spending, easy money and doubling the minimum wage[4]; a broad prescription endorsed by the Obama administration[5].

The hidden assumption of the Summer-Krugman model is that America's overregulated economic system is superior to democratic free enterprise (unfettered markets with prudent public programs, complemented with strong minority property rights protections)[6], even though Summers and Krugman recognize and that regulation and social transfers are inefficient. More federal governance for the two economists always is beneficial, and accordingly is the cure, not a cause of secular stagnation. More and better government, bigger deficits, higher debts, heavier corporate and middle class taxation[7], smarter regulation and sterner business discipline are seen as the surest path to "socially responsible" rejuvenation. The only caveat imposed is that "demand-side" measures must be given pride of place because "supply-side" reforms take too long and could perversely intensify "deflation"[8]. The approach which has affinities with Abenomics cannot be falsified because it lacks a rigorous theoretical structure[9]. Whatever the government does, and whatever the results, leaders always can claim that their actions were best.

Summers's and Krugman's outlook is important because it serves as a blueprint for political action supporting more rather than less government stimulus. The opposition's platform is the reverse. The Republican Party also champions substantial government stimulus, but only at lower levels. The dichotomy here isn't between social democracy and democratic free enterprise. The welfare state is taken as a given by both sides. The dividing line is between Summers's and Krugman's support for aggressive macroeconomic stimulation purportedly targeted in favor of "deserving minorities" with little concern for mounting national debt, and the Republican Party's preference is for less macroeconomic stimulation coupled with Laffer Curve-style business tax incentives and deregulation[10], and a slightly lower tolerance for excessive national debt.

This broad consensus on the value of big government, deficit spending, huge national debts and easy money masks many important microeconomic, macroeconomic and financial issues. What are optimal levels of deficit spending, national debt and credit creation? To what extent can government improve the performance of competitive markets in terms of efficiency, growth and income distribution? What is the optimal size of government? The comparative merit of Summers's and Krugman's policy prescriptions cannot be judged without thoroughly investigating their theoretical constructs and those of their Republican rivals.

This can be accomplished for both camps issue by issue, but for the purposes at hand, the big picture can be glimpsed by scrutinizing tacit assumptions. Neither camp is Marxist. Both accept mathematical optimizing neoclassical axiomatics derived from Paul Samuelson's *Foundations of Economic Analysis*[11], which assume that individuals are rational, competent, and abide by a basic Lockean social contract[12]. Specifically, every individual can and does comprehensively utility and profit maximize, with the corollary that government representatives are also rational and morally upright. They are said to be the people's servants, and only participate in the economic process to the extent that they can improve market outcomes. These premises are microeconomic, but can be extended to macroeconomics by variously assuming that competitive processes are fully determinative, except in the labor market when wages are sticky or investment is thwarted by liquidity traps.

All these assumptions have their charms and facilitate economic discourse, but it is important to remember that they aren't comprehensively true, either on the consumption or supply side of the ledger:

1) Consumers don't possess well-defined continuous preferences,
2) Consumer preferences are not interpersonally independent,
3) Consumers do not comprehensively rationally select,

4) Consumers do not exhaustively utility search (optimizing rather than satisficing),

5) Consumers do not autonomously choose (individuals and households),

6) Consumers do not universally act ethically (competitively) within the framework of a Lockean social contract,

7) Wellbeing is not solely determined by successive rational marginal choices,

8) Consumer preferences are not entirely formed rationally,

9) Production and cost functions are not continuous, twice differentiable and monotonic,

10) Suppliers do not have complete knowledge of demand and intermediate input acquisition possibilities,

11) Suppliers do not possess well-defined continuous preferences that enable them to optimize with discrete production and cost functions, as well as restricted information on intermediate input supplies and demand,

12) Supplier (manager) preferences are not interpersonally independent,

13) Managers do not comprehensively rationally select,

14) Managers do not exhaustively search profit and cost minimization possibilities (optimizing rather than satisficing),

15) Managers do not autonomously choose (CEOs and collective corporate decision makers),

16) Managers do not always act ethically (competitively) within the framework of a Lockean social contract,

17) Managers' preferences are not comprehensively formed rationally.

It follows directly that the causes Summers, Krugman and the Republican Party ascribe to contemporary economic disorders may be incomplete because their axioms are flawed. Consumers, producers and government authorities may behave dysfunctionally from the ideal neoclassical perspective for two broad reasons. First, as Herbert Simon showed long ago[13], individuals and firms confronted with bounded rationality may satisfice in ways that preclude individual utility optimizing and firm profit maximizing[14]. Secular stagnation and income inequality accordingly may have more to do with bounded rationality and government incompetence than deficit spending, national debt accumulation, credit creation and minimum wages, but these possibilities are seldom considered in today's public policy discourse. Government and business are implicitly assumed to be doing the right things, when they are actually causing serious inefficiencies and stoking the fires of speculation. As a consequence, preference for the Summer's and Krugman's programs or Republican alternatives often boil down to acts of faith rather than analytic science.

This tendency to reduce the resolution of microeconomic and macroeconomic issues to matters of belief is aggravated by the double fallacy of claiming that people's behavior is dependably rational and scrupulous. Consumers, producers, government rulers, insiders and officials seldom are wholly dispassionate and incorruptible. Crimes of all kinds happen, and cannot be adequately explained by neoclassical optimal or satisficing principles. The relevance of the observation is self-apparent as soon as politicians' motives are called into question. Rulers like Viktor Yanukovych may be more interested in their own wealth and power than the people's welfare[15]. Some may use their governments to deficit spend, accumulate national debt and adopt QE infinity for motives that lie outside the neoclassical framework.

This comes as no surprise to students of politics, sociology, anthropology, law, political economy, or even neoclassical theorists themselves when they are thinking out of the box, but the insights aren't incorporated into a unified theoretical framework that allows analysts to diagnosis specific maladies across axiomatic systems and formulate integrated policy prescriptions. The task is manageable. The behavior of unscrupulous and corrupt power-seekers often mimics the conduct of rational actors and can be embedded into an expanded theoretical framework that realistically captures causes and consequences. All that is required is a commitment to distinguish neoclassical optimizing and satisficing from misguided, unscrupulous and power-seeking behaviour, using the insights to design unified theoretical solutions to today's policy challenges.

There is a cost to this inclusive economic theory[16]. It leaves open possibilities that welfare state advocates prefer left closed. Politicians appear comfortable with the status quo. They don't want to accept responsibility for the adverse consequences of their actions. The benefits to their various constituencies however may justify pushing policy makers beyond their comfort zone. At the very least, inclusive economic theory offers the prospect of improved scientific understanding, and could substantially enhance the effectiveness of contemporary public policy making. Discarding self-imposed blinders could make a significant contribution to improving all aspects of microeconomic, macroeconomic and financial behavior across the globe in capitalist and socialist countries alike[17].

Notes

[1] Paul Krugman, *The Return of Depression Economics and the Crisis of 2008*, New York: W. W. Norton Company, 2009. Lawrence Summers, "Washington Must Not Settle for Secular Stagnation," *Financial Times*, December 5, 2013. http://www.ft.com/cms/s/2/ba0f1386-7169-11e3-8f92-00144feabdc0.html#ixzz2pi6xfiEe James Pethokoukis, "The Slump That New Ends: Does the US Face 'Secular Stagnation'?" AEI, November 19, 2013. Henry Blodget, "Has the US Entered a 'Permanent Slump'?" *Daily Ticker*, November 18, 2013, http://finance.yahoo.com/blogs/daily-ticker/u-economy-entered-permanent-slump-165120719.html "Summers speculates that the natural interest rate "consistent with full employment" fell "to negative 2% or negative 3% sometime in the middle of the last decade." But conventional monetary policy can't push rates that low because of the dreaded zero low bound. Thus, Summers concludes, "We may well need, in the years ahead, to think about how we manage an

economy in which the zero nominal interest rate is a chronic and systemic inhibitor of economic activity, holding our economies back, below their potential." Alan Greenspan, "Never Saw it Coming," *Foreign Affairs*, November/December 2013, http://www.foreignaffairs.com/articles/140161/alan-greenspan/never-saw-it-coming Jenny Cosgrave, "Summers: US faces a 'Downton Abbey' economy," CNBC, February 17,2014. http://www.cnbc.com/id/101421153

[2] John Taylor has dismissed the Summers-Krugman secular stagnation crisis as hokum because he believes that free markets assure a robust American economic recovery. However, while he is justified in challenging Krugman's liquidity trap framework, his own critique of abusive American government points to a plausible alternative explanation for the United States' economic dyspepsia. See John Taylor, "Economic Hokum of 'Secular Stagnation': Blaming the Market for the Failure of Bad Government policies is no more persuasive now than it was in the 1930s," Wall Street Journal, January 1, 2014. http://online.wsj.com/news/article_email/SB10001424052702304858104579263953449606842-lMyQjAxMTA0MDAwMjEwNDIyWj

[3] www.stateofworkingamerica.org The Economic Policy Institute is a Washington DC think tank founded in 1986 by left-liberal economists Jeff Faux, Lester Thurow, Ray Marshall, Barry Bluestone, Robert Reich, and Robert Kuttner. Thurow for example is a longtime advocate of a political and economic system of the Japanese and European type, in which governmental involvement in the direction of the economy is far more extensive than is presently the case in the United States – a model that has come to be known as "Third Way." See Lester Thurow, *Zero Sum Society*, New York: Basic Books, 1980.

[4] Summers has moved away from advocating "easy money" and now stresses intensified deficit spending. "The third approach – and the one that holds most promise – is a commitment to raising the level of demand at any given level of interest rates, through policies that restore a situation where reasonable growth and reasonable interest rates can coincide. This means ending the disastrous trend towards ever less government spending and employment each year – and taking advantage of the current period of economic slack to renew and build up our infrastructure. If the government had invested more over the past five years, our debt burden relative to our incomes would be lower: allowing slackening in the economy has hurt its potential in the long run." Lawrence Summers, "Washington Must Not Settle for Secular Stagnation," *Financial Times*, December 5, 2013. http://www.ft.com/cms/s/2/ba0f1386-7169-11e3-8f92-00144feabdc0.html#ixzz2pi6xfiEe

[5] "Obama's 2014 State of the Union address: Full text," January 28, 2014. http://www.cbsnews.com/news/obamas-2014-state-of-the-union-address-full-text/

[6] Steven Rosefielde and Quinn Mills, *Democracy and its Elected Enemies*, Cambridge: Cambridge University Press, 2013.

[7] Phil Gramm And Mike Solon, "Gramm and Solon: Suddenly, an Opening for Tax Reform," *Wall Street Journal*, February 24, 2014. Gramm and Solon contend that Congress has had a

change of heart and will authorize pro-growth tax cuts with requiring tax increases elsewhere because the CBO reports that the American government has failed to realize 4.9 trillion dollars since 2008 due to shortfalls in expected economic growth. It seems having forgotten, the administration is now rediscovering the Laffer Curve. http://online.wsj.com/news/article_email/SB10001424052702303426304579402850803113112-lMyQjAxMTA0MDIwNTEyNDUyWj

[8] Supply-side fundamentals include "labour force skills, companies' capacity for innovation, structural tax reform and assuring the long-run sustainability of entitlement programmes." "Indeed, measures that raise supply could have the perverse effect of magnifying deflationary pressure." Lawrence Summers, "Washington Must Not Settle for Secular Stagnation," *Financial Times*, December 5, 2013. http://www.ft.com/cms/s/2/ba0f1386-7169-11e3-8f92-00144feabdc0.html#ixzz2pi6xfiEe

[9] "Abe's Master Plan," *The Economist*, May 18, 2013.

[10] Arthur Laffer, "The Laffer Curve: Past, Present, and Future, Heritage Foundation," June 1, 2004. http://www.heritage.org/research/reports/2004/06/the-laffer-curve-past-present-and-future

[11] Paul Sameulson, *Foundations of Economic Analysis*, Cambridge MA: Harvard University Press, 1947. Cf. Kenneth Boulding, "Samuelson's Foundatins: The Role of Mathematics in Economics," *Journal of Political Economy*, Vol.56, No.3, 1948, pp.187-199.

[12] John Locke, "An Essay Concerning the True Original Extent and End of Civil Government" 1689.

[13] This matter is addressed more formally in chapter 10. Cf. Herbert Simon, *Models of Bounded Rationality*, Cambridge MA: Harvard University Press, 1982. Reinhard Selten, "What is Bounded Rationality?" in *Bounded Rationality The Adaptive Toolbox*, Gerd Gigerenzer,and Reinhard Selten eds., Cambridge MA: MIT Press, 2002. Daniel Kahneman, *Thinking, Fast and Slow*, New York, Macmillan, 2011.

[14] This is a very complex matter. Both government officials and private businessmen operate in bounded rational environments with multiple objective functions. For example, William Baumol has shown that many firms with market power may prefer to maximize sales subject to a minimally acceptable profit, rather than simply profit maximizing. Firms of this sort operate in an "attractor" space that allows them latitude, but still assures positive profits. Governments by contrast don't have to make profits in their service businesses. Consequently their attractor domains are wider and include a broad range of adverse outcomes. See Steven Rosefielde and Ralph W. Pfouts, *Inclusive Economic Theory*, Singapore: World Scientific Publishers, 2014.

[15] "Inside ousted Ukrainian president Viktor Yanukovych's palace – video," *The Guardian*, February 25, 2014. http://www.theguardian.com/world/video/2014/feb/24/ukraine-president-viktor-yanukovych-palace-video

[16] Steven Rosefielde and Ralph W. Pfouts, *Inclusive Economic Theory*, Singapore: World

Scientific Publishers, 2014.

[17] Steven Rosefielde and Quinn Mills, *Global Economic Turbulence*, Singapore: World Scientific Publishers, 2014.