

John Komlos

# Foundations of Real-World Economics

Second Edition

What Every Economics  
Student Needs to Know



# FOUNDATIONS OF REAL-WORLD ECONOMICS

The 2008 financial crisis, the rise of Trumpism and the other populist movements which have followed in their wake have grown out of the frustrations of those hurt by the economic policies advocated by conventional economists for generations. Despite this, textbooks continue to praise conventional policies such as deregulation and hyperglobalization.

This textbook demonstrates how misleading it can be to apply oversimplified models of perfect competition to the real world. The math works well on college blackboards but not so well on the Main Streets of America. This volume explores the realities of oligopolies, the real impact of the minimum wage, the double-edged sword of free trade, and other ways in which powerful institutions cause distortions in the mainstream models. Bringing together the work of key scholars, such as Kahneman, Minsky, and Schumpeter, this book demonstrates how we should take into account the inefficiencies that arise due to asymmetric information, mental biases, unequal distribution of wealth and power, and the manipulation of demand. This textbook offers students a valuable introductory text with insights into the workings of real markets not just imaginary ones formulated by blackboard economists.

A must-have for students studying the principles of economics as well as micro- and macroeconomics, this textbook redresses the existing imbalance in economic teaching. Instead of clinging to an ideology that only enriched the 1%, Komlos sketches the outline of a capitalism with a human face, an economy in which people live contented lives with dignity instead of focusing on GNP.

**John Komlos** is Professor Emeritus of Economics and of Economic History at the University of Munich, Germany. He has also taught at universities such as Harvard, Duke, UNC-Chapel Hill, University of Vienna, and Vienna School of Economics and Business. In 2003 Komlos founded the field of *Economics & Human Biology* with the journal of the same name, and through his research he has come to realize the limitations of conventional economic theory and has been an ardent advocate of humanistic economics.



**Taylor & Francis**

Taylor & Francis Group

<http://taylorandfrancis.com>

# FOUNDATIONS OF REAL-WORLD ECONOMICS

What Every Economics Student  
Needs to Know

SECOND EDITION

John Komlos

Second edition published 2019  
by Routledge  
52 Vanderbilt Avenue, New York, NY 10017

and by Routledge  
2 Park Square, Milton Park, Abingdon, Oxon, OX14 4RN

*Routledge is an imprint of the Taylor & Francis Group, an informa business*

© 2019 Taylor & Francis

The right of John Komlos to be identified as author of this work has been asserted by him in accordance with sections 77 and 78 of the Copyright, Designs and Patents Act 1988.

All rights reserved. No part of this book may be reprinted or reproduced or utilised in any form or by any electronic, mechanical, or other means, now known or hereafter invented, including photocopying and recording, or in any information storage or retrieval system, without permission in writing from the publishers.

*Trademark notice:* Product or corporate names may be trademarks or registered trademarks, and are used only for identification and explanation without intent to infringe.

First edition published by M.E. Sharpe 2014  
First edition published by Routledge 2015

*Library of Congress Cataloging-in-Publication Data*  
A catalog record has been requested for this book

ISBN: 978-1-138-29652-7 (hbk)  
ISBN: 978-1-138-29654-1 (pbk)  
ISBN: 978-1-315-09997-2 (ebk)

Typeset in Interstate  
by Swales & Willis Ltd, Exeter, Devon, UK

# CONTENTS

<i>List of Figures</i>	<i>ix</i>
<i>List of Tables</i>	<i>xii</i>
<i>List of Illustrations</i>	<i>xiii</i>
<b>1 Welcome to Real-World Economics</b>	<b>1</b>
My Credo	3
Humanistic Economics	5
A Primer on Blackboard Economics	6
Toward a Paradigm Shift in Economics	8
Real-World Economics Is Preferable	10
Simple Is for Simple Minded	11
“It’s Only a Model!”	13
<b>2 Markets Are Neither Omniscient Nor Omnipotent</b>	<b>19</b>
Markets Are Not Created by Divine Power	19
The Downside of Free Markets	19
Government Is an Essential Component of the Economy	26
Markets Have Limitations	28
The “Achilles Heel” of Markets	31
Morality Should Take Precedence over Markets	31
Economics Is a Social Science and Not a Natural Science	32
Ideology Is Unavoidable	33
<b>3 The Nature of Demand</b>	<b>39</b>
What Is Scarce?	39
Consumer Sovereignty and Endogenous Tastes	40
Wants and Basic Needs	45
The Metaphor of the Invisible Hand	49
The Magic of Competition	50
Consumerism	51

<b>4</b>	<b>Homo Oeconomicus Is Extinct: The Foundations of Behavioral Economics</b>	<b>57</b>
	Utility Maximization	57
	Optimization Is Impossible for Finite Minds	58
	Our Brain Is Imperfect	59
	Neuroeconomics	60
	Bounded Rationality	61
	Satisficing Instead of Optimizing	62
	Biases and Wonders of Intuition	64
	Heuristics	65
	Framing, Accessibility, and Anchoring	66
	Prospect Theory	68
	Behavioral Economics	74
	Cognitive Endowment	76
	Genetic Endowment	77
<b>5</b>	<b>Taste Makers and Consumption</b>	<b>81</b>
	The Influence of Corporate Power	81
	Interdependent Utility Functions	83
	Society	85
	Culture	86
	Fairness	88
	Efficiency vs. Equity	88
	Self-Interest and Altruism	90
	Positive and Normative Economics	91
	Expected vs. Realized Utility	92
	Imperfect Information	93
	Signaling	94
<b>6</b>	<b>Firms and Imperfect Competition</b>	<b>99</b>
	Firms	99
	The Illusion of Perfect Competition	101
	Imperfect Competition: Oligopolies and Monopolies	101
	Prices	104
	Equilibrium and Disequilibrium	106
	Adverse Selection	107
<b>7</b>	<b>Returns to the Factors of Production</b>	<b>109</b>
	Marginal Theory	109
	Wages	110
	The Returns on Capital	119
	Profits	120
	Institutions as Capital	121
	Intangible Forms of Capital	121
	Natural Resources	122

Income Distribution	122
The Second Gilded Age	125
Growth in Welfare	132
Ethics and the Skewed Distribution of Income	133
<b>8 The Case for Oversight, Regulation, and Control of Markets</b>	<b>142</b>
Principal-Agent Problem	142
Moral Hazard	144
Transaction Costs	144
Opportunistic Behavior	145
Regulation in the Public Interest	147
Regulatory Capture	148
Moral Constraints	149
Market Failures	150
Exploitation	151
Time and Space	152
Path Dependence	152
Limits and Standards	155
<b>9 Microeconomic Applications on and off the Blackboard</b>	<b>159</b>
Minimum Wage Is Good Economics	159
Price Controls Can Be Good	161
Unions and Countervailing Power	162
The American Medical Association Is a Cartel	166
Discrimination Is Pernicious	167
Redistribution Would Help	168
<b>10 What Is Macroeconomics?</b>	<b>172</b>
Keynes the Savior	172
Keynesian Fiscal Policy	175
Monetary Policy	176
The Liquidity Trap	177
Neoclassical Synthesis	178
The Monetarist Counterrevolution	180
A Macroeconomic Policy Void	181
GNP Is an Estimate of Production and Not of Welfare	183
Production Possibilities Frontier	184
<b>11 Macroeconomics Part II</b>	<b>189</b>
Unemployment and Underemployment	189
The Natural Rate of Unemployment	193
Economic Growth	194
Economic Growth Does Not Increase Life Satisfaction	194
Technological Change Is a Two-Edged Sword	196

viii	<i>Contents</i>	
	Missing Markets	198
	Environment	200
<b>12</b>	<b>Macroeconomics Part III</b>	<b>205</b>
	The Government Is Part of the Solution	205
	The Challenges of Keynesian Fiscal Policy	205
	Crowding Out	206
	The Threat of a Mushrooming National Debt	207
	Taxes Are Good for Us	208
	Savings or the Lack Thereof	213
	Inflation and Deflation	214
	Nominal vs. Real Wages	215
	The Obama Stimulus	215
<b>13</b>	<b>International Trade: Open Economy Macroeconomics</b>	<b>219</b>
	The Theory of Comparative Advantage	219
	The Effects of Tariffs on Welfare Are Complicated by Underemployment	220
	Free Trade Is Not an Engine of Growth	223
	The Protection of Infant Industries	224
	Unbalanced Trade Creates Underemployment	224
	Import Certificates Are the Only Safe Way to Eliminate the Trade Deficit	226
	New Trade Theory	227
<b>14</b>	<b>The Financial Crisis of 2008</b>	<b>231</b>
	Preliminaries	232
	Financial Innovations	234
	Double Trouble: Greenspan's Bubbles	236
	Early Warnings Fell on Deaf Ears	238
	The Minsky Moment: The Meltdown of 2008	241
	Thirty-One Factors That Contributed to the Crisis	243
	The Bailout: A Crisis Obama Wasted	253
	Nationalization of the Banks as Pre-privatization	256
<b>15</b>	<b>Conclusion: The Foundations of Real-World Economics</b>	<b>265</b>
	Imaginary vs. Real Markets	265
	The Inconvenient Truth about the Current State of the U.S. Economy	266
	The U.S. Economy Is Facing 14 Headwinds, None of Which Is Fixable in the Foreseeable Future	269
	<i>Index</i>	273

# FIGURES

2.1	Poverty Rate among Children below Age 18	21
2.2	Cumulative Distribution of After Tax Income, U.S., 2014	24
2.3	Ratio of the Top 90% of the Disposable Income Distribution to the Bottom 10%, 2014	25
2.4	Health Care Expenditures, 2016	29
2.5	Life Expectancy at Birth	30
3.1	Conventional View of Consumer Sovereignty	40
3.2	In Reality Tastes Are Determined within the Economic System	41
4.1	Medicare Part D Options Confuse	63
4.2	What Is the Average Length of These Lines?	67
4.3a and b	Context Matters a Lot in Case of Ambiguity	67
4.4	Concave Utility Function Implies Risk Aversion	69
4.5	Convex Utility Function Implies Risk Seeking	69
4.6	Changes in Utility and Wealth of Two Investors According to the Conventional Model	70
4.7	The Value Function Defined on Gains and Losses in Prospect Theory of Behavioral Economics	71
4.8	Comparison of Cathy's and Susan's Utility According to Prospect Theory	72
4.9	Conventional Comparison of Two Options	73
4.10	Experimental Results Conform to Prospect Theory: The Case of Two Options	74
4.11	Conventional Demand and Supply Analysis with Negative Feedback	75
4.12	Positive Feedback Loop Causes Asset Price Bubbles	76
6.1	Profit of a Monopolist (Without Fixed Costs)	104
7.1	Index of the Productivity-Wage Gap in the U.S.	111
7.2	Median Income by Gender in 2016 Dollars, 1955-2016	114
7.3	Share of Labor Income in GDP (%)	115
7.4	Distribution of Household Income by Ethnicity, U.S., 2009	123
7.5a and b	Distribution of Household Income by Quintiles, U.S., 2016	126
7.6	Distribution of Earnings in 2016 Compared to Ford Workers of 1914	127

x *Figures*

7.7	Trends in the Share of Total Income by Households, 1967-2016	127
7.8	Changes in the Share of Total Income in Three Epochs, by Quintiles	128
7.9	Growth of Income by Quintiles and Percentiles, 1979-2011	130
7.10	Ratio of Group's Income to That of the Poor	131
7.11	Growth of Welfare by Quintiles, 1979-2011	133
7.12	Inequality Is Inversely Related to Happiness	137
8.1	The Optimum Level of Freedom in an Economy	147
8.2	Corporations Invest Heavily in Order to Tilt the Playing Field in Their Direction	149
8.3	Investment Decision with Perfect Foresight Two Periods Ahead Is Easy	153
8.4	Investment Decision with Perfect Foresight One Period Ahead Is Also Easy	154
8.5	With Sequential Decision, Optimum Technology "A" Is No Longer Feasible	154
9.1	Profit of a Quasi-Monopolist Without Fixed Costs	160
9.2	The Effect of a Price Ceiling on a Monopolist Without Fixed Costs	162
9.3	Profit of an Oligopolist Employing Seven Workers	163
9.4	Median Household Income by Education, 2016 Dollars	164
9.5	Physicians per 1,000 Population, 2016	166
9.6	The Supply and Demand for Doctors with Supply Constraint Brought About by the American Medical Association	167
9.7	Redistribution Increases Total Utility and Social Welfare	169
10.1	U.S. Consumer Confidence Index, 1996=100	173
10.2	Fluctuating Demand During the Great Depression	174
10.3	Automobile Production in the U.S., 1900-1970	174
10.4	Velocity of Circulation of M1	177
10.5	The Interest Rate Charged by the Federal Reserve	178
10.6	Quantitative Easing and GNP Per Capita	179
10.7	Capacity Utilization All Industries	185
10.8	Production Possibilities Frontier with Institutional Constraint	186
11.1	The <i>Official</i> Unemployment Rate and the Official Underemployment Rate	190
11.2	Official Underemployment Rate (U6) by Ethnicity	191
11.3	The "Natural" Rate of Unemployment Compared to the Official Unemployment Rate	193
11.4	Global Warming	199
12.1	U.S. National Debt as a Percentage of Gross Domestic Product	206
12.2	U.S. Personal Saving as a Percentage of Disposable Income	213
13.1	The Effect of Tariffs on Domestic Production and Consumption	221
13.2	Men's Hourly Wages by Education	223
13.3	U.S. Trade Balance in Goods and Services	225
13.4	U.S. Cumulative Balance of Payments Deficit Is \$15 Trillion in 2017 Prices	226

14.1	Price to Earnings Ratio of S&P 500 Stocks	233
14.2	Ratio of U.S. House Prices to Rents and to Nominal Income, Index 1995=100	237
14.3	National Home Price Index, January 2000=100	239
14.4	Fed's Interest Rates and GDP Growth	245
14.5	Real Median Household Income in the U.S.	255
14.6	Median Household Income by Ethnicity, 2016 Dollars	256
15.1	Average Annual Growth Rates of Real GDP Per Capita	266
15.2	Real GDP and Potential GDP, 2009 Prices	267
15.3	Women's Hourly Wages by Education	268

# TABLES

1.1	Electoral Votes Needed to Tip the 2016 Presidential Election in Favor of Hillary Clinton	13
2.1	The U.S. Homicide Rate Per Capita as a Multiple of Those in These Countries	20
2.2	Drug-Related Deaths Per Million Persons Aged 15-64	21
2.3	Share of Income and Wealth Distribution in the U.S., 2013	26
7.1	Growth in Productivity and Real Wages, U.S., 1947-2011	111
7.2	The Tax Returns of the Superrich	124
7.3	Racial Gaps in Median Household Incomes in 2014, Dollars	125
7.4	Share of U.S. Aggregate Income by Quintiles, 1967-2016	129
7.5	Real Disposable Income, 1979-2011, Thousands of 2011 Dollars	130
7.6	International Comparison of CEO Compensation, 2015	135
7.7	International Comparison of Inequality, 2014	136
9.1	Change in Household Income Since the Year 2000 in 2016 Dollars	164
10.1	Increase in Disposable Income of U.S. Households by Quintiles, 1979-2011	184
11.1	The Official and Real Unemployment Rate in the U.S., January 2018	190
11.2	Ranking of Happiness, 2012-2014	195
12.1	Happiness Rank and Average Tax Rates	208
12.2	There Is No Relationship Between Economic Growth and the Top Tax Rates	210
13.1	U.S. Average Annual Current Account Balance (Billions of 2017 Dollars)	224

# ILLUSTRATIONS

2.1	The Market Treats Some Children Cruelly	23
2.2	The Market Did Not Give Rosa Parks the Option to Ride the Bus	32
3.1	Virginia Slims' Successful Marketing	42
3.2	Consumerism Overwhelms	43
3.3	Drink to Contentment	47
3.4	The Marlboro Man	48
5.1	What Is One Without a Mansion and a Yacht?	95
7.1	United, Labor Would Have Countervailing Power and Obtain a Bigger Share of the Pie	113
7.2	Life Would Just Not Be the Same If I Had to Travel on a Commercial Airline	124
8.1	Doctors for Camel Exploit the Gullibility of Consumers	151
11.1	You Did Not Bleed on Omaha Beach on June 6, 1944	199
14.1	Brooksley Born	238
14.2	No Less Than Eight Million Families Lost Their Homes as a Consequence of the Financial Crisis	254



**Taylor & Francis**

Taylor & Francis Group

<http://taylorandfrancis.com>

# 1 Welcome to Real-World Economics

*We must grant to markets what belongs to markets—and retain for people what rightfully belongs to them.*

The author

The financial crisis of 2008 illustrated vividly how markets often do go haywire, yet textbooks remain unchanged, failing to convey the fundamental flaws and systematic weaknesses of the free-market system. The recent election of Donald Trump was fueled by the frustrations that have been accumulating due to an economic system that skews its benefits to a select few and leaves too many people behind scrambling to eke out a bare existence. Yet, academics and politicians continue to sing the praises of abstract markets as if they had descended straight from heaven while maintaining a conspiracy of silence about the fact that without government help countless giant corporations would have landed in the dustbin of history.<sup>1</sup> When the chips were down, only the Fed could print the trillions of dollars to prop up markets and save them from extinction.

The doctrinaire approach to the teaching of economics is well illustrated by the oft repeated but rather arrogant assertion, “We know that markets work.” Instead, teachers of economics should admit at the outset that while markets do work well in some circumstances they only do so within an appropriate institutional framework, and they not only work inefficiently in others but often tip the stream of benefits toward a few insiders. Hence, our job is also to explore and delineate clearly the circumstances that prevent real markets from working as well as their theoretical counterparts and suggest remedies for their failings. The ideological commitment to “market fundamentalism,” which led to the excessive reliance on markets in the making of public policy, has brought us to our current, precarious situation. I hope the present volume can help rectify this misconception and improve the teaching of economics by presenting a real-world perspective as opposed to the fantasy world of mainstream textbooks.

Alan Greenspan’s post-meltdown confession that he made a ghastly error in believing in—and aggressively preaching—market deregulation demonstrates vividly the miscalculations of the fundamentalist approach to economics. When asked by Congressman Henry Waxman, “You have been a staunch advocate of letting markets regulate themselves . . . Were you wrong?” Greenspan responded:

## 2 *Welcome to Real-World Economics*

I made a mistake in presuming that the self-interest of organizations, specifically banks . . . were such that they were best capable of protecting their own shareholders and equity in the firms . . . The problem here is [that] something which looked to be a very solid edifice and indeed a critical pillar to market competition and free markets did break down and . . . that . . . shocked me. I still do not fully understand why it happened.

History is, of course, replete with people wearing similar ideological blinders. Greenspan makes a number of serious mistakes in that short statement: banks are incapable of assessing the impact of their policies on the rest of the financial system. That is the role of the oversight authority. This is known as systemic effects. They just see their own balance sheets and not those of their rivals. The Fed is supposed to have the overview. Other problems with his statement were noted by the Nobel Prize winning founder of behavioural economics, Daniel Kahneman. Referring to the above statement as “Greenspan’s confession,” he was surprised by:

[Greenspan’s] assumption that agents are fully rational, and there is a lot of evidence clearly that they’re not. The other is the idea that firms are actors; that firms are rational agents. But firms are really not actors . . . there are executives making decisions; the interest of those executives and the interest of that abstract idea that we call the firm are clearly not aligned and if we want to understand why firms are suicidal it is in part because the agents are . . . quite frequently not committing suicide. So, there is a mismatch between firms and the actors who act in their behalf.<sup>2</sup>

Waxman continued his query of Greenspan by asking, “You had an ideology . . . and this is your statement: ‘I do have an ideology, my judgment is that free competitive markets are by far the unrivaled way to organize economies.’” Greenspan answered by offering the congressman a philosophical lesson: “Remember . . . what an ideology is . . . [it] is a conceptual framework with the way people deal with reality. Everyone has one . . . Yes, I found a flaw . . . in the model that I perceived . . . how the world works.” Waxman: “In other words, you found that your view of the world, your ideology was not right.” Greenspan: “Precisely. That’s precisely the reason I was shocked.”<sup>3</sup> Greenspan was right in this case: ideology is unavoidable in economics because one approaches it with some values and an organizing system of thought, that is, some preconceived notions of how the world works.<sup>4</sup> This is unavoidable.

Greenspan should not have been so shocked. There were plenty of warnings: Brooksley Born, Edward Gramlich, Paul Krugman, Raghuram Rajan, Nouriel Roubini, Peter Schiff, Robert Shiller, Joseph Stiglitz, Nassim Taleb, and John Taylor, to name but a few eminent proponents of opposing views. They were no strangers to Greenspan or to the establishment. They were not outsiders. They are mostly scholars who have held professorships at major universities or have distinguished themselves in other ways. All he would have had to do was to listen with care to their well-reasoned warnings with an open mind. Instead, Greenspan dismissed their ideas out of hand and cold-bloodedly thwarted Brooksley Born’s valiant efforts to regulate derivatives a decade before the meltdown.<sup>5</sup>

One did not need a PhD to recognize that housing prices were off the charts. Yet, Greenspan and Benjamin Bernanke, his successor in 2006, ignored all the evidence because they were blinded by their ideology of the infallibility of markets. They were prisoners of their own ideology. If one does not subject that ideology to empirical evidence, the ideology becomes dogma.

The notion that ideology plays a major role in the social sciences has a long history. Observers of human societies cannot be free of their preconceived notions “because the understanding of a ‘social’ experience itself is always fashioned by ideas that are in the researchers themselves.”<sup>6</sup> One of the many limitations of mainstream economists is their reluctance to address the problem of ideology adequately and to acknowledge the need to understand its role in economic policy. Textbooks simply ignore the issue. Yet, as Greenspan suggested, we cannot help but begin to organize our thoughts without making some fundamental assumptions, and these assumptions are a function of our own mindset, worldview, and intellectual and emotional commitments and therefore influence greatly the rest of the ideas developed in the discipline.

Hence, economics cannot be purged of ideology; our political, moral, and philosophical likes and dislikes—conscious and unconscious—are reflected in our assumptions and thus in how we structure our economic thinking and our understanding of the world around us. Much of that ideology is colored by our political philosophy. In other words, contrary to received wisdom, economics—despite the extensive use of mathematics—will not be a rigorous discipline until it is based essentially on verifiable empirical evidence. Our long-range goal should be to provide such an empirical foundation to the discipline. Our more immediate goal here is to present evidence to support the notion that the mainstream view is misleading. Our aim is to introduce the student to alternative perspectives, thereby providing a complement to standard presentations of the subject and widening the student’s understanding.

## **My Credo**

Perhaps I should first clarify my own credo—the assumptions that underlie my own worldview of economic matters. I consider my views to be progressive, democratic, and humanitarian.<sup>7</sup> These values imply that I believe that we could restructure the economy so as to improve our lives by focusing on increasing our life satisfaction instead of on income growth. I am also convinced that we should begin our economic analysis with empirical evidence rather than on ivory-tower theorizing. Experiential evidence should be at the core of the discipline rather than assumptions. In the words of Deirdre McCloskey, a U.S. economics professor, “economics is supposed to be an inquiry into the world, not pure thinking.”<sup>8</sup>

In other words, I believe that economics should reduce its reliance on deductive logic and mathematics and become more of an inductive discipline.<sup>9</sup> Human beings are not inanimate objects whose trajectory can be described accurately by a mathematical function of a handful of variables. Unlike planets, they can and do change direction. Economics should not attempt to be an axiomatic discipline like geometry. Sir Isaac Newton said as much: “I can calculate the movement of the stars, but not the madness of men.”<sup>10</sup>

To understand the world around us we need an economic theory based on empirical evidence, one that can hold its own when transferred from the blackboard<sup>11</sup> to, say, the slums,

#### 4 Welcome to Real-World Economics

areas with a concentration of poverty in our big cities. The pieces of the economic puzzle do not fit together as smoothly in Bronx's 10454 zip code area with a median household income of \$20,210 as they do in Loudoun County, Virginia's 20129 zip code district, with a median household income of \$250,000—four times the national average.<sup>12</sup> Moreover, we need a theory of economics that is not isolated from other social sciences but integrates insights derived from sociology, psychology, political science, and philosophy. Economists who focus on mathematics at the expense of these disciplines tend to neglect those issues that are not easily tractable mathematically and end up with a mechanistic view of the world.

In addition, my economic principles are humanistic in that they focus on values that enhance the human experience and lead to mass flourishing. Pain also plays a major role in my thinking. I advocate its minimization. In contrast, the mainstream does not give pain much thought. But the current economic system treats some groups with an indifference that borders on cruelty. The groups include those children who are attending dysfunctional schools in dysfunctional neighborhoods, people who are unable to catch their bearings in the new economy created by the IT revolution and globalization, the working poor, or those who are trapped in a culture of poverty. They ought not be treated like machines without feelings.

The quest for the good life is as old as philosophy itself. Aristotle was among the first to think about it systematically around 350 BC by arguing that the good life was about understanding the world around us.<sup>13</sup> Much of this book is about just that: understanding the nature of today's economy as it exists in reality rather than on academic blackboards. Change must start with understanding. My focus is on real human beings and how they actually live and feel, rather than inanimate objects such as money or abstract concepts such as output or gross national product, which economists often substitute for the human dimension. I do not believe that the level of money income translates automatically into life satisfaction. This is particularly the case for statistical averages, because these hide what is going on in the lower tail of the income distribution. This distribution is increasingly important insofar as it has become much more skewed and consequently its potent political force has been manipulated by the rise of Trumpism.

Many economists are heard saying that “the economy is in good shape.”<sup>14</sup> OK, but what about the people in it? Are most people doing well or are there segments of the population which are excluded from the good life? Hence, it seems to me that average growth of consumption, money income, or gross domestic product (GDP) should not be the exclusive focus of economics. As constituted, the current U.S. economic system has so many challenges and fault lines that it is incapable of providing a satisfactory life to about 44% of the population.<sup>15</sup> That implies that 56% were doing just fine, but is that good enough for a \$20 trillion economy that is supposedly the richest in the world?

Furthermore, I believe that our starting point should not be Adam Smith's *Wealth of Nations*, but his *Theory of Moral Sentiments* (1759), in which he asserted quite forcefully that we possess an innate empathy toward our fellow human beings.<sup>16</sup> Morality and ethical principles of fairness are part of our nature. We ought not expunge these notions from the economics canon. Hence, I begin with the notion that economics ought to aspire to creating a just society and one in which compassion is as important as efficiency, if not more so. Admittedly, the meaning of justice is arguable, but that does not give us the license to disregard it completely. I think that an important aspect of it should be that the economy

should minimize suffering, while enhancing human dignity and self-worth. I seek a common-sense Aristotelian “golden mean” which is situated between two extremes of advocating excessive changes at the one end and complacency at the other.

## Humanistic Economics

Humanistic economics need not be an oxymoron. It implies the vision that a kinder and more just economic system is possible, one that is embedded in a truly democratic society that not only empowers people but enables them to live their daily lives with less uncertainty, less manipulation, less taking advantage of people’s weaknesses, and less fear that their lives could collapse like a house of cards. This capitalism with a human face envisions an economy with zero unemployment, zero inflation, zero trade deficits, and zero government deficit over the business cycle.

Humanistic approach to economics highlights that a meaningful life goes well beyond consumption and production. Since human beings are not simply “economic agents”—the values promulgated by the mainstream—the emphasis on money often conflicts with human values. Instead of advocating growth at any price, “Capitalism with a Human Face” would enable more people to live fulfilled, less harried, and ultimately more satisfied lives. John Maynard Keynes said as much:

I think that capitalism, wisely managed, can probably be made more efficient for attaining economic ends than any alternative system yet in sight, but that in itself it is in many ways extremely objectionable. Our problem is to work out a social organization which shall be as efficient as possible without offending our notions of a satisfactory way of life.<sup>17</sup>

So, in contrast to the mainstream, in my view, the purpose of any economic system ought not be “growth” for its own sake, but the efficient allocation of resources. Foremost, it should be the provision of a decent life in which output is distributed equitably, people do not need to struggle to meet their basic needs, can avoid the rat race of fierce competition just to be able to stand still, and can realize their human potential. This means having sufficient leisure time to participate in the community’s social, cultural, and political life.

People mistakenly equate economic growth with rising living standards. They harmonize with the politicians’ and economists’ pro-growth chorus. However, surveys contradict this perspective. In spite of all the growth in our lifetime, satisfaction eludes us in a big way. The growth-at-any-price perspective does not consider the decisive problem of distribution: economic growth will not help the destitute, the uneducated underclass, or the majority of those who are underemployed. In spite of all the growth since the Industrial Revolution a quarter millennium ago, there is much discontent with the economy as well as with the political system. Consider that in July 2017 in the country with aspirations to be the greatest in the world, 40% of the population evaluated their life as “struggling” and another 3% consider themselves “suffering.”<sup>18</sup> That adds up to no less than 140 million people with dependents adding an extra 40 million. It seems like we ought to be able to generate more satisfaction with \$20 trillion. The economy seems to be quite inefficient in producing well-being. The problem is that most of the discontented have yet to understand how the “free marketeers”—radicals who advocate free markets at any price—have led us astray.

## 6 Welcome to Real-World Economics

*De jure* equal opportunity is insufficient for a just economy without *de facto* equal opportunity. Wealth is a privilege because it provides opportunities. Babies born into poor families have less chance of living a fulfilled life than those born into wealthy ones. Their future development will be on divergent paths determined by their initial endowments. Such random allocation at the start of life cannot possibly be the basis of a good society. Our goal ought to be to create an environment in which children have more equal opportunities, and those who are born at a disadvantage can be compensated by society for their initial bad luck.<sup>19</sup>

My aim in writing this book is to provide a critical framework that helps students understand the real economy—the actually existing one—and how the mistakes of conventional theorizing have landed us in our current predicament with rampant divisiveness and dissatisfaction. The book should also serve as a guidepost of the kind of economy to which we should aspire, and serve as a counterweight to conventional textbooks which claim to be above morality but conveniently disregard the untenable level of inequality the economy helped to create.

As we have seen hundreds of times since the Industrial Revolution, and most vividly in 2008, free markets, being a human invention, often become dysfunctional; they do not deserve our blind faith. Furthermore, there are better ways to measure progress than in terms of money. One need not be a naive utopian to be appalled by a society in which one bumps—sometimes literally—into scenes of gross inequity around the corner. And there must be something wrong with an economics that fosters a system which leaves so many people stranded that they strike back at the establishment by voting for a leader such as Donald Trump. In this spirit, this book is dedicated to a new kind of economics that promotes Capitalism with a Human Face.

### **A Primer on Blackboard Economics**

“What do George Akerlof, Kenneth Arrow, Daniel Kahneman, Paul Krugman, Thomas Schelling, Herbert Simon, Robert Shiller, Joseph Stiglitz, Richard Thaler, and Oliver Williamson have in common?” would make a great Econ 101 question except for the fact that the contributions of these Nobel Prize winning economists to the Dismal Science are usually excluded from mainstream Econ 101 textbooks or relegated to obscure footnotes. Instead of including their critical ideas, introductory textbooks hype a free-market utopia which does not extend much beyond the edges of the blackboard. Hence, most textbooks do not help to understand the essentials of the *real existing* market economies in the hyper-globalized world of the twenty-first century. Rather, they present a caricature of the economy at a level of abstraction that creates a fantasy world and distorts the student’s vision: how inefficient! They perpetuate a stereotype that markets are efficient, thereby somehow automatically leading to a blissful life, and they continue to sing the praises of the immense achievements of the free-market system, keeping any demurrals muted.

Super rationality reigns in this utopian kingdom inhabited by consumers with sufficient brain power to know every detail of the economy and are therefore not satisfied with anything less than doing the very best they can. They possess perfect understanding of all the nuances in small print, perfect foresight from the beginning to the end of their lives,

and are not inhibited by the challenges of information overload insofar as information is free, available instantaneously, and a cinch to understand. They are neither manipulated nor tempted, so they have perfect control over their desires. They are not subject to bouts of irrational exuberance. Actually, this is a misguided view of human nature. Emotion and the unconscious mind play a big role in our decisions. In Freud's view, the unconscious is not only the ultimate source of many of our desires, but they frequently come into conflict with our rational thoughts.<sup>20</sup> Overlooking this leads economic policy makers astray. After all, if people are rational, there is no need to worry about banks giving predatory risky mortgages. Everyone knows what they're doing.

Moreover, in the mainstream's fantasy world there are no brands, and goods have no quality dimension, so product choice is a no-brainer: two boxes of generic cereal, or three? There is no small print in contracts, no traps, no false promises, so buyers need not be on their guard. There are no regrets in this idyllic economy, no need for human judgment or intuition, no emotion, no real uncertainty hence no mistakes, and no need to worry about lawyers' fees or other enforcement or transaction costs. Indeed, there is no society at all, no children, no gender, no glass ceilings, no class hence no underclass, no power hence no power imbalances, and neither space nor race, and hardly any time dimension. In this fictional world consumers are not influenced by advertisements or by other people's consumption.

Producers also inhabit this imaginary economy; they also know everything there is to know about consumers' wants as well as their own firms, so they can maximize their profits with perfect ease. Actually, there are no firms at all in this economy, in the sense of a modern corporation, just simple entities like a Ma-And-Pa operation. There are no shareholders or boards of directors, no CEO who might maximize her own income rather than that of the far-away shareholders. This pseudo-firm does not need to advertise to persuade consumers to buy its products, much less collude with others, deceive, or game the system.<sup>21</sup> Lobbyists are an extinct species, so there is no political process that can tilt the playing field in favor of the wealthy and influential.<sup>22</sup> Problems are posed in terms of a single decision without antecedents and without uncertainty and without further implications in subsequent periods. In fact, time hardly plays a role in this static world: the past is passé and the future is obvious. So, there is only the right now, and no sequential decisions need to be pondered.

Laws are in place so we do not need to discuss how they came to be or what advantages they provide to the powerful and the extent to which they disregard the dispossessed. If laws go unmentioned it is because they go unbroken, that is, people do not take advantage of each other's lack of information or inaptitude and hence there are no enforcement costs. So, oversight would be a waste of effort and of brainpower. Everything runs smoothly—there are no chances to finagle, no conflicts, let alone wars. Basic needs have given way to benign wants. Free markets are efficient, hence above morality, so questioning their *laissez-faire* premise would be a waste of ethical scruples. (However, this is also a value judgment implying that efficiency is valuable rather than, say, sufficiency, or sustainability, or fairness, or minimizing risk, poverty, or pain.) Hence, it is alleged that *laissez-faire* does not need a moral basis, and ethics and aesthetics are superfluous. However, this overlooks the inconvenient fact that this in itself is also a value judgment. Well-being is measured by income in monetary terms, but there are no rich or poor so there is neither power nor hunger, therefore

the system is democratic: one dollar, one vote. The fact that some hold more dollars than others is their birthright, so there is no need to waste time discussing that de facto, they do have more votes. These are the basic elements of what is called positive economics, at least on the blackboard—that is to say, the way economics is taught at the undergraduate and especially at the introductory level.

Furthermore, the conventional wisdom invariably emphasizes the perfectly competitive model, although a negligible segment of the economy can still be conceptualized as such in an economy full of too-big-to-fail banks and supranational corporations with global vision who operate above political oversight. The psychological world of the ultra-rational consumer is essentially pre-Freudian and pre-Pavlovian, that is to say, it lacks a sound psychological basis. It is rooted in the much simpler Smithian world of the eighteenth century without the moral fiber of that world. That is like trying to understand molecular motion using Newton's laws instead of those of quantum mechanics; hence, the current state of the economics discipline is essentially inadequate for the post-meltdown world of the twenty-first century.

However, an increasing number of economists believe that the above "ivory tower" economy, rooted in simplistic assumptions, is merely a product of our imagination.<sup>23</sup> It is inhabited by implausible super-rational individuals, a race of *Übermenschen*, or supermen and superwomen devoid of emotion, living alone hence without any sense of community, whose only identity is that of being consumers, or producers with hardly any interaction with others.<sup>24</sup>

### **Toward a Paradigm Shift in Economics**

However, economics is far too important to be left to blackboard economics. In order for it to be useful it must bear some semblance to reality and it must work for the benefit of Every Man on Main Street not only for the few. Because it impacts our lives to such a great extent, it is arguably the most important academic discipline; no other has such direct and immediate impact on our daily lives in terms of employment, income, consumption, and investment as does economics. That is why the media is full of data, information, and reporting. That is why the government has institutionalized the role of economics in effective governing. The White House has the Council of Economic Advisers as well as the National Economic Council; the legislative branch's Congressional Budget Office has 235 employees, the Department of Commerce has the Bureau of Economic Analysis with 500 employees; the Bureau of Labor Statistics employs 2,500; the Bureau of the Census also collects and analyzes some economic data and employs 5,600 people. So, lots of effort is expended on getting the data right. It behoves us to get the theory right as well and not to delude ourselves with abstractions. The discipline should be about flesh and blood beings and not economic agents. This text is dedicated to this point of view.

Mainstream economics steered us straight into the biggest economic crisis in 75 years, and political crisis was not far behind. Mainstream economics was also unable to create an inclusive economy in which most people felt good. Hence, it is time for a paradigm shift in economic theory. Instead of chasing the elusive "American Dream" in a "rat-race" economy with a few winners and many losers,<sup>25</sup> we should focus on creating a more harmonious

economy with a decent, sustainable, dignified, creative, secure, peaceful, satisfactory, and enjoyable life, one that is not based on excessive consumption and instant gratification—in short, one that is less materialistic.<sup>26</sup> For the first time in history we have the possibility to achieve a quality of life that eluded our predecessors. However, in order to live comfortably, we do not need an ever-increasing quantity of goods. Materialism is insatiable and therefore cannot satisfy, because it always makes us want more. Rather, we need to rein in our appetite, our greed, and have a mindset that is less concerned with success measured by money and more concerned about the spiritual and social aspects of life.<sup>27</sup> Instead of growing the economy, we need psychological, spiritual, and moral growth. However, for that we also need to rethink economic principles. That is what this book aims to foster.

The Canadian Institute of Wellbeing defines well-being thus:

The presence of the highest possible quality of life in its full breadth of expression, focused on but not necessarily exclusive to: good living standards, robust health, a sustainable environment, vital communities, an educated populace, balanced time use, high levels of civic participation, and access to and participation in dynamic arts, culture and recreation.<sup>28</sup>

In short, well-being is by no means identical with GDP or output or income.<sup>29</sup> A satisfactory life in a capitalism with a human face should include the minimizing of poverty, pain, inequality, unemployment, stress, anxiety, and insecurity, and an increase in health, leisure time, social relationships, love, respect, ethics, intellectual satisfaction, and a moral life. President Jimmy Carter understood this when he said in 1979:

[T]oo many of us now tend to worship self-indulgence and consumption. Human identity is no longer defined by what one does, but by what one owns. But we have discovered that owning things and consuming things does not satisfy our longing for meaning . . . It is the truth and it is a warning.<sup>30</sup>

However, his warning was not heeded any more than Eisenhower's warning of the "grave implications" of the military-industrial complex.<sup>31</sup>

The reader should not misunderstand. I am not supporting abolishing markets or creating a leviathan of immense proportions, and I am resolute about protecting freedoms enunciated in the Universal Declaration of Human Rights. However, I have a wider conception of liberty than Milton Friedman or Ronald Reagan did. My conception is closer to Amartya Sen's notion of capability. It includes the freedom from anxiety of an unrestrained form of capitalism that my pensions will disappear, free from the anxiety associated with our lives today: threat of crime, or becoming unemployed, or not knowing what happens if I become sick or unable to pay for my college tuition, as well as the freedom from seeing the suffering of the underclass, the unemployed, and homeless. This is congruent with the classical conception of liberty also echoed by Edmund Burke.<sup>32</sup> My conception also includes the freedom to live without the hard-press sales pitches of intrusive advertisements, or being free from the feeling of relative deprivation from seeing the lifestyles of the profligate rich and famous. One should also be free to develop one's personality from within rather than having

it imposed through the media. Developing one's character autonomously without the interference of the profit motive of big business is an essential aspect of true freedom. We would then not be inculcated with the fundamental elements of consumerism.

Furthermore, I also believe that many markets work well some of the time and a few markets work well most of the time, but we should verify if particular markets do what we expect from them. We need to think about improving their functioning so that we ourselves can function better in them. I am an enthusiastic supporter of those markets that enable people to exercise their creativity, autonomy, and individuality without being manipulated and without interference from trend setters and predatory lenders, but my support is contingent on empirical evidence. I refuse to disregard evidence that is contrary to the orthodox canon.<sup>33</sup> If markets obviously do some of us harm, then we must retain the ultimate right to make alternative arrangements and take collective action to relieve the discomfort. This is the humanistic approach to economics: we should minimize suffering, mental and physical. Crucially, we should remain the masters of markets, and not vice versa. Furthermore, the benefits of markets should not accrue to a few members of the society, because that would be unfair and because that brings about relative deprivation. This was also at the root of the "Occupy Wall Street" movement. This is not a quixotic perspective. This is the approach of the Nordic countries, which usually are on top of all lists that measure the quality of life.

Actually, there is a continuum of socioeconomic systems, ranging from market fundamentalism to socialism. I advocate finding that constellation of institutional arrangements at the golden mean between the two polar extremes that can provide most of us, as well as future generations, with a reasonably fulfilled life. I do not believe that we need to "grow the economy" to achieve this. Rather, we need to create a fairer economy that can sustain future generations and that produces less discontent and less insecurity than the current version does.

As E.F. Schumacher put it, "The most striking thing about modern industry is that it requires so much and accomplishes so little. Modern industry seems to be inefficient to a degree that surpasses one's ordinary powers of imagination."<sup>34</sup> By "accomplishing so little," he meant that the economy provides so little life satisfaction despite high average incomes. In other words, we should not set ourselves the goal of producing as much as possible but to improve our sensibilities so that we can obtain more gratification with less: "the aim should be to obtain the maximum of well-being with the minimum of consumption." Schumacher also insisted that work itself would yield much more satisfaction if the scale of enterprise were smaller so that workers would retain more of their autonomy. Thus, the politicians' and economists' admonition to "grow the economy" will not get us further.

## **Real-World Economics Is Preferable**

There is an increasing recognition that mainstream economics is in need of a paradigm change. There are many efforts underway to bring change to the discipline including "Rethinking Economics," an international movement committed to "building a better economics in society and the classroom."<sup>35</sup> On the recent 500-year anniversary of Martin Luther's *The 95 Theses*, it posted "33 Theses for an Economics Reformation" to the entrance of the London School of Economics, which starts with the assertion that "within economics,

an unhealthy intellectual monopoly has developed."<sup>36</sup> The 33 theses include all of the points discussed in this book. The Institute for New Economic Thinking, The International Confederation of Associations for Pluralism in Economics, have similar aims.<sup>37</sup> The latter is made up of some 38 separate organizations. In short there are many efforts underway to reform the discipline.

Thus, although many economists and students have rejected the simple mainstream models, their views have not been adequately represented in mainstream textbooks. For instance, W. Brian Arthur, a noted authority in complexity theory, explains:

[c]omplexity economics . . . assumes that the economy is not a perfectly balanced machine, but an evolving complex system. Actors in the economy do not necessarily face well-defined problems or use super-human rationality in making their decisions. They explore, try to make sense, and react and re-react to the outcomes they together create. Viewed this way, the economy is not in stasis, but always forming, always evolving . . . Bubbles and crashes happen, markets can be "gamed" or exploited, and history and institutions matter. The result is a rigorous but realistic picture of the economy.<sup>38</sup>

Moreover, under the heading "Aims and Scope," the editors of the journal *Capitalism and Society* are explicit in their criticism of the mainstream:

Today's established economics—the economics dominant in classrooms, banks, and governments—misconceives the modern economy. This disconnect has consequences for how we understand history, how we make policy, and how we view capitalism. Its explanations fail and mislead at important junctures in modern history. Until economics is grounded on the basic character of modern economies—the ignorance, the uncertainty, and the new ideas for speculation and innovation—it limits and distorts our view.<sup>39</sup>

In short, we need to take a fresh look at the realities around us instead of accepting at face value dubious illusory notions conceived in the ivory tower, no matter how brilliant the theorems and how impressively sophisticated the mathematics seem to be.

No less an authority than Nobel Prize winning economist, Joseph Stiglitz, declared—as it turns out prematurely—that "neoliberalism as a doctrine; market fundamentalism is dead."<sup>40</sup> Yet, you would not know it by reading the popular textbooks in the field, which influence a million students every single year. This is not a benign oversight. It has immense consequences insofar as it influences the media, political discourse, and the mindset of the voting public. No wonder, then, that many ask, "why economics is on the wrong track."<sup>41, 42</sup>

## Simple Is for Simple Minded

The argument that a simple overview of the discipline suffices in Econ 101, because one must lay the foundations before students can learn more sophisticated aspects of the discipline, is utterly misguided.<sup>43</sup> It sells the students far too short. The foundations ought

not to be such a caricature that distorts reality beyond recognition. I dare say that if the straight-talking Nobel Prize winning physicist, Richard Feynman (1918–88), were still with us, he would concur with me. In his famous 1974 commencement address at the California Institute of Technology, he beseeched the graduating class to practice “scientific integrity,” “utter honesty,” and to “lean over backwards” so as not to “fool ourselves” (and of course others).<sup>44</sup> I believe that this holds for us—teachers of economics as well. Economists should be held to professional ethics, like other professionals.<sup>45</sup> From the very beginning, students must be made keenly aware of the limitations of real markets as opposed to theoretical ones for at least four crucial reasons:

- 1 Half-truths hardly belong in academia at any time, not any more in the beginning of one’s studies than at the end; omitting important aspects and new developments such as Herbert Simon’s theory of satisficing or Kahneman and Tversky’s prospect theory is hardly being “utterly honest.”<sup>46</sup>
- 2 It is much more efficient to learn a discipline correctly the first time than to have to unlearn it and correct it subsequently. It is extremely difficult to unlearn something once one is socialized into accepting the main tenets of the discipline without learning about their limitations in the real world. The human mind is not so flexible: once the neural networks are in place, they are extremely challenging to rewire.<sup>47</sup>
- 3 The more “sophisticated” ideas of imperfect markets are not so complicated and can be explained easily at the 101 level. Neglecting them and focusing on perfectly competitive markets distorts economic theory to such a degree that students leave the course with a fundamentally misleading caricature of the real existing economy.
- 4 Most students of Econ 101 do not continue to study economics, so they are never even exposed to the more nuanced version of the discipline and are therefore indoctrinated for the rest of their lives with the idea that markets work perfectly well. This indoctrination played a substantial role in the political developments of the last half-century in forming an intellectual climate tilted heavily toward the free-market worldview that came to prevail. Thus, every statement one makes in the classroom ought to be true and the distinction between theoretical and actual markets clarified and stressed. This is the case although the instructor is expected to cover a lot of material in the introductory course. Nonetheless, unless the various perspectives on economics are presented in a balanced way, the student can only gain a biased perspective on the reliability of market processes. Quality ought not be sacrificed for quantity.

Many principles’ texts make the argument that one must simplify in order to begin to understand this complex system. However, finding the right balance between simplification and realism is crucial: oversimplification leads to distortion and to a fundamental misunderstanding of the application of economic principles to the real world.

An example of the misapplication of economic principles is economists’ unconditional support of free trade without regard to those who are devastated by the foreign competition (Chapter 13). The benign neglect of the displaced workers especially in the Rust Belt, led to a level of frustration that helped elect a candidate who promised to bring those jobs back even if the promise was based on bait and switch tactics and will not lead to an

Table 1.1 Electoral Votes Needed to Tip the 2016 Presidential Election in Favor of Hillary Clinton

	<i>Trump Plurality</i>	<i>Electoral Votes</i>
PA	44,292	20
MI	10,704	16
WI	22,748	10
Total	77,744	46

Source: U.S. Electoral College. "Historical Election Results, Election for the Fifty-Eight Term, 2017-2021." [www.archives.gov/federal-register/electoral-college/votes/2000\\_2005.html#2016](http://www.archives.gov/federal-register/electoral-college/votes/2000_2005.html#2016).

improvement in their lives. Consequently, Dani Rodrik, an economist in Harvard's Kennedy School, answered his question, "Are economists partly responsible for Donald Trump's shocking victory in the US Presidential election?" in the affirmative.<sup>48</sup> Hillary Clinton's loss of three of the Rust Belt states—distressed by globalization—tipped the election in favor of Donald Trump (Table 1.1). His plurality in Pennsylvania, Michigan, and Wisconsin was just 77,744. Thus, if just 39,000 voters had switched their votes (0.6% of the votes cast in these states for Donald Trump), Hillary would have had a majority in the Electoral College.

Yet, some economists argue that the models can be unrealistic as long as their predictions are correct. But mainstream economics comes up especially short on this account. On the basis of mainstream models, one would predict that our life satisfaction or happiness would have increased substantially since World War II. After all, per capita gross national product (GNP) in real terms increased in the U.S. in the meanwhile by a factor of 3.5. But that prediction is falsified by the fact that the share of people who report that they are either happy or very happy has not changed at all in the intervening half-century.<sup>49</sup> If anything, it has fallen. Hence, obviously, the importance of money is overvalued by economists.

Yet, another example in which predictions were completely false is that no mainstream economists predicted the crisis of 2008. Fed chairman Ben Bernanke expected the subprime mortgages not to destabilize the financial system.<sup>50</sup> Geologists are better at predicting earthquakes than Ben Bernanke was in predicting the Meltdown of 2008. In other words, when it comes to the major challenges of our time, economic theory has misguided us. So the argument that economists can predict accurately even with unrealistic models has been falsified by the evidence.

### **"It's Only a Model!"**

Economists think in terms of theoretical models expressed in equations or in geometric diagrams. Blackboard economics is based on assumptions and on conceptualizations of how the variables of the model interact. Although these appear rigorous, given the obvious limitations of the human mind, the number of variables must be restricted to a handful in order for the mathematics to be manageable. While these simple logical constructs can be quite useful, they are just as likely to be misleading and at times extremely so. And there is lots of evidence that simple models cannot possibly capture the true nature of our complex economy with thousands of variables and millions of interacting components, which

themselves are embedded in an even larger global framework. So, simplification can render models destructive, as we saw during the 2008 financial crisis and during the 2016 presidential election. Unfortunately, much too often the distinction between the world of the model and reality is not stressed sufficiently so that students and practitioners confuse the two. Teachers are doing their students a great disservice if they allow them to leave their classrooms with the differences between the two worlds blurred in their minds.

The reason is that all too frequently, oversimplified blackboard models are applied to real-world situations erroneously so that instead of enhancing our understanding, they obscure, lead us astray, and ultimately become a powerful destructive force. Greenspan and Bernanke's overlooking powerful systemic effects—negative externalities—in the financial sector prior to the run-up to the Great Meltdown is a recent vivid example of the damage of models applied inappropriately to actual circumstances that exist at street level.<sup>51</sup>

Similarly, economic models and policy makers overlooked completely the political storms that were unleashed by the hurricane-size forces of globalization. Politics was not part of their models and that was supposed to somehow take care of itself. How? Well, that was not part of the economists' purview.

Another example is the recurrent misguided application of models of perfect competition to unions, and to the minimum wage to markets that are far from perfectly competitive (Chapter 9); after all, today's insignificant share of economic activity takes place in a perfectly competitive environment. Thus, an enormous intellectual problem arises in our culture because the theoretical models are misused every day and especially so in political discourse.

This is hardly a minor phenomenon. Instead, it is at the root of the current economic, social, and political malaise—a watershed in U.S. history. Hence, the economics profession bears the responsibility that the public, the media, and politicians are ill informed about real-world economics. It has not followed the spirit of Feynman's admonition, and did not bend over backwards to explain with sufficient clarity and ample emphasis the qualifications that accompany the blackboard models. It is insufficient to mention the assumptions at the beginning of the semester and assume that the students will remember them throughout the course. We have to be much more careful to delineate the circumstances under which the models are appropriate to apply to the real world. Without such clarification most textbooks fail to provide a nuanced understanding of flesh-and-blood economic processes.

The failure to emphasize real-world economics has immense implications for the body politic and civil society. The fact that millions of students go on with their lives and years later choose among political candidates based partly on their economic policies, or become newspaper editors, radio commentators, small-town mayors, congressional aides, or political activists—in other words, their careers take them to responsible positions within the society—mistakenly think that they have understood the basics of economic theory, that markets are efficient if left alone. Thus, the deficiencies of Econ 101 become a powerful damaging force—students become vulnerable to, or perpetrators of, simplistic slogans particularly vitriolic in the current political climate: "Competition will lead to growth;" "the free market is efficient;" "lowering taxes will create jobs;" "government is not the solution to

our problem, government is the problem;<sup>52</sup> “no consumer protection is needed as we all know what we are doing.” To avoid such stereotypical pitfalls, it is incumbent upon us in the academia to “lean over backwards” in the first course in economics to avoid half-truths at all costs before the students are socialized into thinking that competitive markets have the magic formula to provide the answer to all or even most of our actual economic problems.

Examples abound, as most economic models are applied inappropriately. For instance, one finds such gobbledygook in a leading textbook as: “Health care is an economic commodity like shoes and gasoline.”<sup>53</sup> This invidious contention disregards the essential differences between these markets. It has been known at least since a seminal article on the subject in 1963 that the standard economic model of perfect competition does not apply to health markets. This is because of the crucial role of asymmetric information between doctor and patient, because of the conflict of interest between the various counterparties in which very complicated decisions have to be made with a great deal of uncertainty, and because price competition is non-existent.<sup>54</sup> These factors make the health market completely different from the shoe market. One does not usually purchase insurance for one’s shoes, for example. Moreover, doctors know much more biology than we do, and there is no practical way for us to ascertain the most prudent treatment. I have not heard of anyone wanting to get an MRI when it was unnecessary, but I have experienced doctors wanting to prescribe one to increase the profits of their employers. Another difference is that health is a necessity whereas shoes are often considered a luxury. “If a designer shoe goes up from \$800 to \$860, who notices?”<sup>55</sup> Moreover, the quality of a shoe is much easier to ascertain than the quality of a health insurance contract. Gasoline is also entirely different from the other two products. It is produced from an exhaustible resource, pollutes, and therefore has major environmental effects. Thus, the essence of the three markets could not differ by more. To conflate them is to willfully defy common sense and confuse the student.

Another example from the current political discourse is the oft-cited allegation that “taxing the rich is bad for economic growth,” which overlooks the inconvenient evidence that economic growth was quite robust in the 1950s and 1960s, when the tax rates were notably higher on top income earners than they are today. The proponents of the view also overlook empirical evidence that other countries—such as Germany, Switzerland, and Japan, to name just a few of the many—manage to invest just fine without having a U.S.-like abyss between rich and poor. Lowering tax rates on the rich is supposed to increase investments, again overlooking the obvious fact that a goodly share of their income is spent on conspicuous consumption or on overseas investments and does not help create U.S. jobs.<sup>56</sup> Practically nothing trickled down below the 1% of income earners from the Reagan tax cuts.<sup>57</sup> As Nobel Prize winning economist, Joseph Stiglitz, writes: “Lower [tax] rates have done nothing for growth”.<sup>58</sup> Still the hype remains in the media and public consciousness that lower tax rates are good for growth. All they did, according to Stiglitz, is to fuel inequality.

The question surely arises whether John Travolta really needed two jet airplanes sitting in his back yard for us to have a growing economy. Does Mitt Romney really need an elevator for his car at his La Jolla beach house in order to put people back to work?<sup>59</sup> If the wealthy had to pay higher taxes, they would not be able to afford such frivolous

expenditures, and perhaps there would be more money available for mental health facilities so that the number of mass shootings might be reduced.<sup>60</sup>

## Notes

- 1 Joseph Stiglitz observed that there is not much variation in the perspectives conveyed in introductory textbooks. See Stiglitz, "On the Market for Principles of Economics Textbooks: Innovation and Product Differentiation," *Journal of Economic Education* 19 (1988) 2: 171-182; here, p. 172.
- 2 Fora.tv, Nassim Taleb and Daniel Kahneman, "Reflection on a Crisis," @ 18 minutes. [http://library.fora.tv/2009/01/27/Nassim\\_Taleb\\_and\\_Daniel\\_Kahneman\\_Reflection\\_on\\_a\\_Crisis](http://library.fora.tv/2009/01/27/Nassim_Taleb_and_Daniel_Kahneman_Reflection_on_a_Crisis)
- 3 "Waxman to Greenspan: Were You Wrong?" YouTube video, 5:05, posted by "NancyPelosi," October 23, 2008. [www.youtube.com/watch?v=txw4GvEFGWs](http://www.youtube.com/watch?v=txw4GvEFGWs).
- 4 An ideology is a belief system without empirical foundation that justifies social, economic, or political aspirations and policy. As a consequence, it is not open to empirical refutation.
- 5 On Brooksley Born, see the outstanding PBS documentary, *Frontline: The Warning*. [www.pbs.org/wgbh/frontline/film/warning/](http://www.pbs.org/wgbh/frontline/film/warning/) She received the John F. Kennedy Profiles in Courage Award in 2009 for her valiant efforts to regulate derivatives.
- 6 Wikipedia contributors, "Frankfurt School," *Wikipedia: The Free Encyclopedia*.
- 7 Mark A. Lutz and Kenneth Lux, *Humanistic Economics: The New Challenge* (New York: Bootstrap Press, 1988); George P. Brockway, *The End of Economic Man: An Introduction to Humanistic Economics* (New York: W.W. Norton, 1991).
- 8 Deirdre McCloskey, *The Secret Sins of Economics* (Chicago, IL: Prickly Paradigm Press, 2002).
- 9 Donald N. McCloskey, "The Rhetoric of Economics," *Journal of Economic Literature* 31 (1983) 2: 482-504.
- 10 Wikipedia contributors, "South Sea Company," *Wikipedia: The Free Encyclopedia*.
- 11 The Nobel-Prize winning economist Ronald Coase first referred to theorizing models as "blackboard economics." *The Firm, The Market, and the Law* (Chicago, IL: The University of Chicago Press, 1988), p. 19.
- 12 [www.incomebyzipcode.com/](http://www.incomebyzipcode.com/) Loudoun County, VA is the richest county in the U.S. Most of the richest counties lie on the outskirts of Washington, DC, for obvious reasons.
- 13 Edmund Phelps, *Mass Flourishing: How Grassroots Innovation Created Jobs, Challenge, and Change* (Princeton, NJ: Princeton University Press, 2013), p. 273.
- 14 Martin Feldstein, "The U.S. Economy is in Good Shape," *The Wall Street Journal*, February 21, 2016.
- 15 40% think that they are "struggling" and 4% feel that they are "suffering." [www.gallup.com/poll/151157/life-evaluation-weekly.aspx](http://www.gallup.com/poll/151157/life-evaluation-weekly.aspx).
- 16 "How selfish . . . man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it except the pleasure of seeing it." Adam Smith, *The Theory of Moral Sentiments* I.I.1 (London: A. Millar, 1790 [first published in 1759], available at Library of Economics and Liberty).
- 17 John Maynard Keynes, *The End of Laissez-faire: The Economic Consequences of the Peace* (London: Hogarth Press, 1926).
- 18 Gallup, Inc., "U.S. Life Evaluation." [www.gallup.com/poll/151157/life-evaluation-weekly.aspx](http://www.gallup.com/poll/151157/life-evaluation-weekly.aspx).
- 19 Some people are luckier in the choice of their parents than others. John Komlos, "Income Inequality Begins at Birth and These Are the Stats that Prove It," *PBS Newshour*. [www.pbs.org/newshour/making-sense/plight-african-americans-u-s-2015/](http://www.pbs.org/newshour/making-sense/plight-african-americans-u-s-2015/).
- 20 Sigmund Freud, *The Unconscious* (London: Penguin Classics 2005); First published as *Das Unbewusste* in 1915.
- 21 David Cay Johnston, *Free Lunch: How the Wealthiest Americans Enrich Themselves at Government Expense and Stick You with the Bill* (New York: Portfolio Books, 2007); David Cay Johnston, *The Fine Print: How Big Companies Use "Plain English" to Rob You Blind* (New York: Portfolio Books, 2012).
- 22 David Cay Johnston, *Perfectly Legal: The Covert Campaign to Rig Our Tax System to Benefit the Super-Rich—and Cheat Everybody Else* (New York: Portfolio Books, 2003).
- 23 See the journal *Real-World Economics Review*.
- 24 Stephen A. Marglin, *The Dismal Science: How Thinking Like an Economist Undermines Community* (Cambridge, MA: Harvard University Press, 2010).
- 25 Robert H. Frank and Philip J. Cook, *Winner-Take-All Society* (New York: Free Press, 1995).

- 26 B.F. Skinner's answer to "What is the Good Life?" in his *Walden Two* was: It is "a life of friendship, health, art, a healthy balance between work and leisure, a minimum of unpleasantness, and a feeling that one has made worthwhile contributions to one's society." Wikipedia contributors, "B.F. Skinner," *Wikipedia: The Free Encyclopedia*.
- 27 In Pope John Paul II's socioeconomic encyclical *Centesimus annus* (1991) both private property and the organization of labor unions are included among a variety of fundamental human rights.
- 28 "What Is Wellbeing?" Canadian Index of Wellbeing, available at <https://uwaterloo.ca/canadian-index-wellbeing/wellbeing-canada/what-wellbeing>.
- 29 Shortcomings of GNP accounting is in Joseph E. Stiglitz, Amartya Sen, and Jean-Paul Fitoussi, *Mismeasuring Our Lives. Why the GDP Doesn't Add Up* (New York: New Books, 2010).
- 30 David Shi asserts that "[Carter] totally ignored the fact that the country's dominant institutions—corporations, advertising, popular culture—were instrumental in promoting and sustaining the hedonistic ethic." David Shi, *The Simple Life: Plain Living and High Thinking in American Culture* (Athens, GA: University of Georgia Press, 2007), p. 272.
- 31 "We must guard against the acquisition of unwarranted influence . . . by the military-industrial complex. The potential for the disastrous rise of misplaced power exists, and will persist. We must never let the weight of this combination endanger our liberties, our democratic processes." "Eisenhower Warns Us of the Military Industrial Complex," YouTube video, 2:31, posted by "RobUniv," August 4, 2006.
- 32 "Society cannot exist, unless a controlling power upon will and appetite be placed somewhere; and the less of it there is within, the more there must be without. It is ordained in the eternal constitution of things, that men of intemperate minds cannot be free. Their passions forge their fetters." Edmund Burke, *Letter to a Member of the National Assembly* (London: J. Dodsley, Pall-Mall, 1791), pp. 68-69.
- 33 George Akerlof and Robert Shiller, *Phishing for Phools. The Economics of Manipulation and Deception* (Princeton, NJ: Princeton University Press 2015).
- 34 Ernst F. Schumacher, *Small Is Beautiful: Economics as If People Mattered* (New York: Harper Torchbook, 1973).
- 35 [www.rethinkeconomics.org/](http://www.rethinkeconomics.org/).
- 36 [www.newweather.org/wp-content/uploads/2017/12/33-Theses-for-an-Economics-Reformation.pdf](http://www.newweather.org/wp-content/uploads/2017/12/33-Theses-for-an-Economics-Reformation.pdf); [www.newweather.org/category/projects/the-economics-reformation/](http://www.newweather.org/category/projects/the-economics-reformation/); [www.rethinkeconomics.org/](http://www.rethinkeconomics.org/).
- 37 [www.ineteconomics.org/](http://www.ineteconomics.org/); <https://icape.org/>.
- 38 W. Brian Arthur, external professor, Santa Fe Institute, <http://tuvalu.santafe.edu/~wbarthur/>.
- 39 "Aims and Scope," *Capitalism and Society*, A Journal of the Center on Capitalism and Society. [www.degruyter.com/view/j/cas](http://www.degruyter.com/view/j/cas).
- 40 In a lecture in November 2008, Stiglitz declared, "This September has been to market fundamentalism what the fall of the Berlin Wall was to communism. We all knew that those ideas were flawed, that free market ideology didn't work; we all knew that communism didn't work, but these were defining moments that made it clear that it didn't work . . . America really has a system . . . of corporatism corporate welfarism . . . under the guise of free market economics. And it is that mixture that was fundamentally flawed, incoherent, was intellectually bankrupt from the beginning, that has been shown not to work." Joseph Stiglitz, "Market Fundamentalism Is Dead," YouTube video, posted by "ForaTV," November 10, 2008. [www.youtube.com/watch?v=x\\_2-Tv2GPs0](http://www.youtube.com/watch?v=x_2-Tv2GPs0).
- 41 McCloskey charges the mainstream with "cultural barbarism," and "historical ignorance." McCloskey, *Secret Sins*.
- 42 Deirdre McCloskey, *The Secret Sins of Economics* (Chicago, IL: Prickly Paradigm Press, 2002).
- 43 Jeffrey Madrick, *Seven Bad Ideas: How Mainstream Economists Have Damaged America and the World* (New York: Knopf, 2014).
- 44 Richard Feynman, "Cargo Cult Science," *Engineering and Science* 37 (1974) 7: 10-13.
- 45 George De Martino, *The Economist's Oath. On the Need for and Content of Professional Economic Ethics* (Oxford, UK: Oxford University Press, 2011).
- 46 Herbert Simon, "Rationality in Psychology and Economics," in *Rational Choice: The Contrast Between Economics and Psychology*, ed. Robin M. Hogarth and Melvin W. Reder (Chicago, IL: University of Chicago Press, 1986); Amos Tversky and Daniel Kahneman, "Judgment under Uncertainty: Heuristics and Biases," *Science*, New Series 185 (1974) 4157: 1124-1131.
- 47 B.F. Skinner showed that it takes much more time to unlearn something than to learn it in the first place. See his *Science and Human Behavior* (New York: Free Press, 1965), pp. 62-71.
- 48 Dani Rodrik, "Straight Talk on Trade," Project Syndicate, November 15, 2016. [www.project-syndicate.org/commentary/trump-win-economists-responsible-by-dani-rodrik-2016-11?barrier=accessreg](http://www.project-syndicate.org/commentary/trump-win-economists-responsible-by-dani-rodrik-2016-11?barrier=accessreg).

## 18 Welcome to Real-World Economics

- 49 Richard Easterlin, "The Economics of Happiness," *Daedalus* 133 (2004) 2: 26-33.
- 50 YouTube Video, "Bernanke was Wrong." [www.youtube.com/watch?v=INmqvibv4UU&t=2s](http://www.youtube.com/watch?v=INmqvibv4UU&t=2s).
- 51 The role of economists in the financial crisis is highlighted in the Academy Award winning documentary *Inside Job*.
- 52 Ronald Reagan, Inaugural Address, January 20, 1981, The American Presidency Project. [www.presidency.ucsb.edu/ws/?pid=43130](http://www.presidency.ucsb.edu/ws/?pid=43130).
- 53 Paul Samuelson and William Nordhaus, *Economics*, 19th ed. (New York: McGraw-Hill/Irwin, 2009), p. 221.
- 54 Kenneth Arrow, "Uncertainty and the Welfare Economics of Medical Care," *American Economic Review* 53 (1963) 5: 141-149.
- 55 Stephanie Clifford, "Even Marked Up, Luxury Goods Fly Off Shelves," *The New York Times*, August 3, 2011.
- 56 Danny Yagan, "Capital Tax Reform and the Real Economy: The Effects of the 2003 Dividend Tax Cut," *American Economic Review*, 105 (2015) 12: 3531-3563.
- 57 John Komlos, "Growth of Income and Welfare in the U.S., 1979-2011," NBER working paper, 2016, no. 22211. [www.nber.org/papers/w22211](http://www.nber.org/papers/w22211).
- 58 Joseph Stiglitz, *Rewriting the Rules of the American Economy: An Agenda for Growth and Shared Prosperity* (New York: W.W. Norton 2015).
- 59 Ashley Parker, "For Romney, a Four-Car Garage with Its Own Elevator," *The New York Times*, March 27, 2012.
- 60 John Komlos, "How Raising Taxes on the Rich Could Prevent Mass Shootings," *PBS Newshour*, September 2, 2015. [www.pbs.org/newshour/making-sense/face-mass-murders-case-universal-mental-health-insurance/](http://www.pbs.org/newshour/making-sense/face-mass-murders-case-universal-mental-health-insurance/).