FOUNDATIONS OF REAL-WORLD ECONOMICS

What Every Economics Student Needs to Know

Third Edition

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CONTENTS

FIGURES

TABLES

ILLUSTRATIONS

PREFACE TO THE THIRD EDITION

> We must grant to markets what belongs to markets—and retain for people what rightfully belongs to them.
>
> —The author

The motivation for conceiving of the first edition of *Foundations* originated a dozen years ago in the wake of the financial crisis, as it became evident that mainstream economists, who dominated the profession, were caught utterly unprepared for it. They had to improvise to avoid a Chernobyl-like meltdown of the economy.[1] Like millions of others, Queen Elizabeth famously wondered in amazement "Why did nobody notice," the coming of such a stupendous catastrophe?[2] It became obvious that we were witnessing the failure of "zombie neoliberalism"[3] and that a paradigm shift was desperately needed to face the challenges of the new century. The text focused "on the neglected issue of the discrepancy between current economic scholarship and the simplistic, methodologically flawed, outdated, and irrelevant economics we too often teach undergraduates."[4] The aim was to reveal the mistaken theories, covert assumptions, overlooked facts, trivialized exceptions, and the accumulating evidence contradicting the mainstream canon.[5] The new paradigm proposed was "humanistic economics" or "capitalism with a human face," a hybrid of the Nordic Model and of the social market economy.[6]

The message was well received. One reviewer pointed out that "this book is a must-read for anyone interested in reforming the discipline of economics to create a more just society and to promote human development."[7] Another said that "everyone who teaches undergraduate economics should read *Foundations of Real-World Economics*."[8] Another reviewer thought that: "it is trained mainstream economists, not introductory-level students, who should take the time to read, and reflect upon, this book."[9]

Several translations[10] and scores of positive reviews later a new edition was necessitated by the turbulence of the intervening years. These brought into ever sharper focus that the neoclassical paradigm, based on Milton Freedman's and Friedrich Hayek's[11] ideology of market fundamentalism had led to policy failures of historic proportions.[12] The second edition included the topics usually covered in introductory economics courses plus an expanded discussion of globalization and the financial crisis.

The continual deterioration of the social and political order made three additional chapters necessary in this edition. Economics students should know about the economic causes of the unimaginable rise in populism; they should know how false economic theories led to fallacious economic policies, thereby fostering a disillusionment among a large group of men left behind. Feeling mistreated, they revolted against entrenched elites and overthrew the establishment in 2016, a process that culminated in the ferocious Bastille-like uprising on January 6, 2021 (see Chapter 15).[13]

Moreover the Black Lives Matter movement made it difficult to ignore the plight of minorities usually overlooked in mainstream economic courses. In fact, Blacks and Hispanics practically never appear in Econ-101 courses. Students should also know that economics treats discrimination with kid gloves and learn about the appalling disadvantages of those born on the wrong side of the tracks. So, Chapter 16 examines the racist subtext hidden deep within the mainstream's canon.

Then came the Covid-19 pandemic and economists had to scramble again to meet the challenges of a high-impact low-probability event that challenged the very existence of millions of people. The lessons learned from the pandemic is that basic needs are much more important than economists were willing to acknowledge and that fail-safe strategies such as in airplane design should be incorporated into the economic canon so that the very existence of the economic system is not threatened periodically (see Chapter 17). With these three new chapters the student should be able to comprehend the current state of the economy and how we got to this point.

Some of the reviewers suggested that I mention who the intended audience is. I wrote the book for *anyone* who wants to gain essential understanding of how a *real* market economy works and how it can be transformed so that it becomes inclusive. Humanistic economics puts the human element at center stage rather than inanimate abstract concepts like gross domestic product. How do people feel in the economy becomes the key issue rather than how much people earn in the economy. So obviously this should be interesting for students taking introductory courses but also includes their professors who are open-minded enough to notice that mainstream economic theory does not work well in the real world and are looking for alternative ways to approach the subject. The audience also includes graduate students who are looking for new topics and ideas to explore. They will find the extended footnote references useful. This could be helpful at the start of a research project. As several reviewers mentioned, this is an "honest" rendering of the economy without equivocating or trying to whitewash the dual nature of the real-existing economy. It does not focus on theoretical markets but on real-existing ones. Although several reviewers criticized the hundred-dollar words I use, I was able to use the textbook successfully in introductory courses.

The thesis of this volume is that the only way out of the West's current dilemma is through a paradigm shift toward a Capitalism with a Human Face.[14] Humanism means that the economy should work for everyone and not only for the select few. This can be accomplished only if we discard the failed assumptions of mainstream economics and instead of analyzing imaginary markets, we base our theories on evidence gleaned from the real world. Consequently, the book has been used also as a counterweight to conventional economics textbooks so that students gain pluralist insights about the actual economy.

Such a comprehensive paradigm shift will not be easy since there is a political world-view behind the mainstream's interpretation of the discipline and vested interests with deep pockets supporting the status quo. Nonetheless, we must discard a failed ideology,[15] because as long as our minds are trapped in the dogma of neoclassical economics, sketched eloquently on academic blackboards, we will be unable to attain a society in which everyone is flourishing.

Notes

1 John Cassidy, "After the Blowup. Laissez-Faire Economists Do Some Soul-Searching—and Finger-Pointing," *The New Yorker*, January 11, 2010.

2 Dimitris Chorafas, "Queen Elizabeth II and the Economists," in *The Changing Role of Central Banks* (Palgrave Macmillan, 2013), pp. 15–36.

3 Neoliberalism advocates for free-market capitalism, deregulation, and small government. Felicia Wong, "Build Back Better Meets the Spooky Season: Zombie Neoliberalism Creeps into the Negotiations," Roosevelt Institute, October 21, 2021; Thomas Palley, *Neoliberalism and the Road to Inequality and Stagnation: A Chronicle Foretold* (Edward Elgar, 2021).

4 Benjamin Balak, "Book Review" of the second edition, *Political Studies Review* 19 (2021), 3: NP3–NP4.

5 Tony Lawson, *Essays on the Nature and State of Modern Economics* (Routledge, 2015).

6 Julie Nelson, *Economics for Humans*, 2nd edn. (University of Chicago Press, 2018); Torben Andersen et al., *The Nordic Model: Embracing Globalization and Sharing Risks* (The Research Institute of the Finnish Economy, 2007).

7 Rhys Manley, "Book Review," *Journal of Human Development and Capabilities* 21 (2020), 2: 209–210.

8 Michael Ash, "Book Review," *Basic Income Studies* 15 (2020), 2.

9 John Foster, "Book Review," *Economic Record* 95 (2019), 311: 514–516.

10 Translated into Chinese, German, Hungarian, Romanian, and Russian.

11 Milton Friedman, *Capitalism and Freedom* (University of Chicago Press, 1962); Milton Friedman and Rose Friedman, *Free to Choose* (Harcourt Brace, 1979); Friedrich Hayek, *The Road to Serfdom* (University of Chicago Press, 1944).

12 Adair Turner, *Economics After the Crisis: Objectives and Means* (MIT Press, 2012); Assaf Razin, *Understanding Global Crises* (MIT Press, 2014), p. 5, suggests that most theorists consider the pre-crisis consensus a mistake.

13 Donald Trump's inciting pre-insurrection speech: https://www.rev.com/blog/transcripts/donald-trump-speech-save-america-rally-transcript-january-6.

14 Samuel Bowles and Wendy Carlin, "What Students Learn in Economics 101: Time for a Change," *Journal of Economic Literature* 58 (2020), 1: 176–214.

15 Anonymous, "Efforts to Modernise Economics Teaching Are Gathering Steam," *The Economist*, March 20, 2021.

1 Welcome to Real-World Economics

Earth provides enough to satisfy every man's need, but not every man's greed.
—Mahatma Gandhi[1]

The financial crisis and the Covid-19 pandemic illustrated vividly how markets often go haywire; yet, mainstream textbooks remain unchanged, failing to convey the fundamental flaws and Achilles' heels of the free-market system.[2] These limitations resulted in so much accumulated frustration with a system that skewed its benefits to a select few and left too many people far behind, scrambling to eke out a bare existence, that it culminated in the rise of far-right populism and a threat to democracy itself. 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 extravagant government bailouts the whole capitalist system would have collapsed. In a panic, only central banks could print trillions of dollars or euros to avoid utter calamity.

The doctrinaire approach to the teaching of economics is illustrated by the arrogant assertion that, "we know that markets work." That was hardly evident in 2008 or in 2020. In reality, they only do so within an appropriate *institutional framework*, with appropriate government *oversight*, and they not only work inefficiently frequently but tend to tip the stream of benefits toward a few insiders.[3] Hence, we should explore and delineate clearly the circumstances that prevent real markets from working as well as their theoretical counterparts and suggest remedies for their failings.[4] The ideological commitment to "*market fundamentalism*," which led to the excessive reliance on markets in public policy, has brought us to our current precarious political and social polarization. I hope the present volume will rectify this misconception and improve the understanding of real-existing economies by presenting a real-world perspective as opposed to the fantasy world of mainstream textbooks.[5]

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. Congressman Waxman asked if he had been wrong; Greenspan responded:

> 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.[6]

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History is replete with people caught unaware by such ideological blinders. Greenspan made two *inexcusable* mistakes in that short statement: (1) inanimate abstractions like firms cannot have self-interest. They have employees who have their own self-interest in mind and the interest of those employees and the interest of the owners of the firm are often not well aligned (see Section 8.2). (2) Moreover, a banks' management cannot assess the impact of their activities on the rest of the financial system, since they only see their own balance sheet, not those of other banks. The oversight of the whole system was Greenspan's responsibility. Only he could assess the *systemic risks*: how the bankruptcy of one bank and the default on its obligations create a cascade of defaults throughout the financial system (see Section 14.1).[7] Systemic risk arises because the banks are interlinked.[8] So, Greenspan was negligent in abrogating this responsibility.

Congressman Waxman continued: "You had an ideology .... 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's answer was not very convincing: "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."[9]

Greenspan should not have been shocked. One did not need a PhD to realize that housing prices were off the charts and that it made no economic sense because incomes were not increasing (see Figure 14.2). It would not have been difficult to realize that increasing demand was not logical without an increase in incomes. Yet, Greenspan and Benjamin Bernanke, his successor in 2006, chose to ignore this critical evidence, since they were blinded by their ideology that markets were infallible. *Ideology immune to empirical evidence becomes dogma*. So, they were trapped by their own ideology.

1.1 My Credo: It's Not the Economy—It's How People Feel in the Economy![10]

My worldview is progressive, democratic, and *humanistic*.[11] Instead of focusing on production and consumption, I concentrate *on how flesh-and-blood people feel in the real-existing economy*.[12] That is a crucial difference because mainstream economics equates consumption with well-being, which is easily refuted (see Chapter 2). Instead, humanistic economics aims to improve the *quality of life* and to restructure the economy to increase *life satisfaction* for everyone because there are better ways to measure well-being than in terms of money. The goal should be to catch up to Finland in educational attainment, to Switzerland in happiness, to Norway in longevity, and to Denmark in equality, rather than growing the economy.[13] These countries have demonstrated how to improve human flourishing, so they can provide guidance. All students (graduate and undergraduate) must know this.

Economic analysis should begin with empirical evidence, as the natural sciences, rather than with assumptions.[14] Evidence should be at the core of the discipline since "economics is supposed to be an inquiry into the world, not pure thinking."[15] Hence, it should not rely on axioms and derive theorems based on them using deductive logic. Instead, it should start with data, and build theories based on that evidence using inductive logic. It should also be open to *falsification*,[16] but it holds these axioms with such religious faith that they become doctrine and are therefore insensitive to evidence contradicting them.[17] Yet, human beings are not inanimate objects whose trajectory can be described accurately by mathematical formulas. Unlike planets, they can and do change direction. Isaac Newton, one of the greatest scientists, admitted as much in 1720: "I can calculate the movement of the stars, but not the madness of men."[18]

We need theories that are valid not only on academic blackboards[19] but also in concentrated areas of poverty like Cleveland's 44115 zip code area (with a median household income of $15,034).[20] Mainstream economic theory does not work so well there as it does on Park Avenue in New York City (10282 zip code) (with a median household income of $250,000)—four times the national median.[21]

Instead of revering income, humanistic economics stresses values that enhance human dignity and promote *mass flourishing*.[22] "Flourishing can be understood as a state of living in which all aspects of a person's life are good, including, ... happiness and life satisfaction, physical and mental health, meaning and purpose, character and virtue, and close social relationships."[23] Flourishing can be promoted by universal healthcare, universal educational opportunities from kindergarten through college, guaranteed basic needs, minimal stress, and a widespread safety net. Those are the basic ingredients of a *thriving society*.

Humanistic economics also advocates the minimization of pain and anxiety. *Homo oeconomicus*, the idealized construct of mainstream economics, feels no pain or stress or anxiety. Conventional economics assumes that utility cannot become negative. Hence, the current economic system treats the anguish of disadvantaged groups with an indifference that borders on negligence. These include children attending dysfunctional schools in dysfunctional neighborhoods growing up in dysfunctional families, the working poor who are unable to find their bearings in the new economy transformed by the IT revolution and globalization, those trapped in a culture of poverty, or displaced union workers experiencing downward social mobility. They are sentient beings and ought not be treated like inanimate objects without feelings.

The quest for the good life is as old as philosophy itself. Aristotle argued 2350 years ago that the essence of a good life was understanding the world around us. This book is about understanding the fundamental nature of today's economy as it actually works rather than the way it is *imagined* in academic classrooms. Change should start with understanding. My focus is on how real human beings actually live and feel. An abstract concept like the Gross Domestic Product, the total output of an economy, is a number that does not reveal how people feel in that economy. Hence, *GDP should not be equated with welfare* (see Section 7.13).

Moreover, we should be aware of the tyranny of averages, because average income or average GDP per capita are not the same as life satisfaction actually experienced by human beings living in that economy. Those statistics conceal how the income or GDP is distributed in the society which is crucial to understanding how much welfare is being generated. The increasingly uneven distribution of income is crucial, since it created much disaffection and consequently has become a potent political force ripe for manipulation (see Chapter 15).[24]

The pre-Covid-19 common wisdom was that "the economy is in good shape."[25] However, this was a major mistake because (1) it is a misuse of averages and completely disregards the distribution of benefits; and (2) what really matters is if the people living in the economy are in good shape. Gallup polls indicate that this is not the case in the US (see Chapter 2).[26]

Furthermore, I believe that our starting point should not be Adam Smith's *Wealth of Nations* (1776), but his *Theory of Moral Sentiments* (1759), in which Smith asserted forcefully that we possess an innate empathy toward our fellow human beings.[27] Moreover, *ethical principles of fairness* are part of our nature.[28] We ought not expunge these notions from the economics canon. Hence, I believe that mass flourishing can be achieved only in a *just society*, one in which compassion is more important than efficiency (see Section 5.7).[29] Even arch-conservative Republican Alan Greenspan, an ardent advocate of free markets, realized that the perception that the economy is *just* is an essential prerequisite of sustaining Capitalism:

> [y]ou cannot have the benefits of capitalist market growth without the support of … virtually all of the people; and if you have an increasing sense that the rewards of capitalism are being distributed unjustly, the system will not stand.[30]

Well, he was right, it was not standing very firmly on January 6, 2021.

1.2 Humanistic Economics, the New Paradigm

Humanistic economics is not an oxymoron. It implies that a more just capitalism is possible, embedded in a truly democratic society that enables people to live their daily lives with less anxiety, less conflict, less inequality, less insecurity, less manipulation, less pain, less poverty, less stress, less uncertainty, no unemployment, and less fear that their lives could spiral out of control in the next recession. This *Capitalism with a Human Face* would also increase ethical behavior, increase educational attainment, increase the health of the population, increase intellectual satisfaction, allow more leisure time, enable people to love and respect one another, improve social relationships, and enable the attainment of a moral life easier.[31] This is not utopian theorizing. It has been largely achieved in Switzerland, in Scandinavia, and is close to the social-market economy of Germany and Austria, and to the welfare states of other Western European countries.[32] These countries have the highest quality of life in the world.[33] My constructive agenda is to demonstrate that humanistic economics should be the new paradigm for organizing our economic thinking. By emphasizing that consumption ought not to be the goal of a meaningful life, humanistic economics differs fundamentally from the mainstream (Table 1.1). Human beings are *not* "economic agents." The mainstream's emphasis on income often conflicts with human values. "Capitalism with a human face" would enable everyone to live fulfilled lives. John Maynard Keynes said as much:

Table 1.1 The differences between humanistic and mainstream economics

		Humanistic economics	Mainstream economics
1	Start of analysis	Evidence	Axioms
2	Begins with	Children	Adults
3	Logic used	Inductive	Deductive
4	Sister disciplines	Included	Excluded
5	Human Psychology	Behavioral	Rational
6	Mathematics	Minimal	Extensive
7	Markets	Just	Free
8	Government's role	Substantial	Minimal
9	Pain/stress	Minimize	Omitted
10	Utility function	Interdependent	Independent
11	Goal	Quality of life	Consumption
12	Distribution	Important	Unimportant
13	Basic needs	Paramount	Omitted
14	Relative income	Important	Omitted
15	Opportunity	De facto	De Jure
16	Power	Important	Omitted
17	Species	Homo sapiens	Homo oeconomicus

> 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.[34]

The common wisdom erroneously equates economic growth with rising living standards (see Section 7.13). However, surveys categorically contradict this proposition. The growth fetishism disregards not only the pollution it causes but also other negative externalities associated with growth, such as stress and insecurity. Furthermore, focusing on growth disregards the distribution of its benefits: economic growth has not benefited the destitute, the uneducated underclass, or the underemployed. *Despite 250 years of economic growth since the Industrial Revolution, discontent is more widespread than ever* because income has concentrated at the top 1 percent. It is amazing how much dissatisfaction the $23 trillion US economy produces (see Chapters 2 and 15).[35] In 2019, merely 55 percent of US adults considered themselves "thriving" while the rest were "struggling" (41 percent) or "suffering" (4 percent).[36] This economy is inefficient at producing contentment for some 150 million of its citizens. Consequently, by disregarding the distribution of income and the stress generated by the economic system, free-market aficionados have led us astray.

Another important issue is that humanistic economics considers *de jure* equal opportunity insufficient for a *just economy* without *de facto* equal opportunity. Wealth is a privilege because it provides opportunities to those who possess it. Babies born into poor families have less chance of living a fulfilled life than those born into wealthy ones. Hence, their future development diverges, depending on their initial endowment. Such random allocation at the start of life cannot possibly be the basis of a good society. Our goal ought to be to create a just society in which children have *de facto* equal opportunity, not just in theory, and those who are born at a disadvantage can be compensated by society for their initial bad luck (see Section 5.7).[37]

The aim of this volume is to provide a critical framework that helps us understand the actually existing economy—and how the mistakes of the conventional canon have landed us in our current divisive predicament (see Chapter 15). The book also provides a guide to a humanistic economy to which we should aspire and serves as a counterweight to conventional textbooks which instill in students full confidence in the benefits of the free-market system. Such confidence is unwarranted. After all, markets are human inventions; they do not deserve our blind faith. So, this book advocates a new paradigm: *Capitalism with a Human Face*.

1.3 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 Nobelists are typically omitted from mainstream textbooks or relegated to obscure footnotes. Instead of emphasizing their critical ideas, these textbooks hype a free-market nirvana whose validity does not extend beyond the classroom.

Hence, millions of students taking Econ-101 fail to grasp essential aspects of *real-existing* markets in the hyper-globalized world of the twenty-first century. Rather, they learn a caricature of the economy at a level of abstraction that creates a fantasy world and distorts their vision: how inefficient! These textbooks perpetuate a stereotype that markets are efficient, thereby automatically leading to a blissful life. The students fail to grasp that these are abstract hypothetical markets in Alice-in-Wonderland economies, not in the real world. Conventional textbooks sing praises to the immense achievements of the market system, disregarding inconvenient evidence contradicting their claims like the skyrocketing "*deaths of despair*" by the underprivileged, the millions in jail who were rejected by the legal labor market, or the inequality-fueled rise of populism against the entrenched elites who control the system.

Super rationality reigns in this utopian kingdom inhabited by *homo oeconomicus* with sufficient brain power to know every detail of the economy and are therefore not satisfied with anything less than *maximizing their welfare*. These consumers possess perfect understanding of the nuances in contracts in small print; they have perfect foresight from the beginning of their lives onward and are not inhibited by the challenges of information overload because information is available freely, instantaneously, and a cinch to understand. They are neither manipulated nor tempted, so they have complete control over their desires. They avoid bouts of irrational exuberance. Welcome to the *pseudo-science* of mainstream economics.[38]

Theirs is a caricature of human nature and of real-existing markets. The mainstream overlooks emotions and that habit and the unconscious mind play a substantial role in our decisions (see Chapter 4). Thus, it overlooks the path-breaking work of Sigmund Freud on the unconscious mind which is not only a source of many of our desires, but frequently comes into conflict with our rational thoughts.[39] Overlooking this leads economic policy makers astray. After all, if people are rational, there is no need for *consumer protection* from predatory mortgages. Yet, much of our reasoning is rationalizing our unconscious thoughts. By putting an enormous faith in the power of reason, mainstream economics reveals its *pre-Freudian* essence.

Moreover, in the mainstream's fantasy world there are no brands, so goods have no quality dimension, and product choice becomes a no-brainer: two slices of generic pizza, or three? There are no traps, no false promises, no stress, so buyers need not be on their guard in this idyllic economy. There are no regrets, 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 lower class, no power, hence no power imbalances, and neither space nor race, and hardly any time dimension. In this imaginary world consumers are not swayed by advertisements or by other people's consumption.

Producers also inhabit this make-believe economy. They also know everything about consumers' wants and their demand for the firms' products, so they can maximize their profits with ease. Actually, the textbook firms are Mom-and-Pop operations, not modern multinational corporations. They are so small and there are so many of them that they are *price takers*; they must accept the market price, unable to influence it at all (see Chapter 6). This "*perfect competition*"[40] is still the default model although obviously "most industries are now dominated by a small number of large firms."[41] There are no shareholders in these models or board of directors, no CEOs who maximize their own income rather than that of distant shareholders (see Chapter 8). These firms do not advertise to persuade consumers to buy their products, much less collude with others, deceive, or game the system.[42] Lobbyists are an extinct species, so there is no political process that can serve the interests of the high and mighty.[43] Problems are posed in terms of a single decision without antecedents and without fundamental uncertainty and without further implications in subsequent periods. In fact, time hardly plays a role in this static world since sequential decisions are neglected.[44]

Laws are in place, so we can disregard how they came into being or what advantages they provide to those already influential. Laws are not broken, and people do not take advantage of their counterparty's lack of information and hence there are no enforcement costs for contracts. So, oversight would be a waste of effort. Everything runs smoothly—there are no opportunities 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, the mainstream fails to note that this is also a value judgment implying that efficiency is more valuable than sustainability, justice, reducing stress, or eliminating poverty.[45] Hence, questions of fairness are supposedly superfluous.

Moreover, the system is in perpetual *equilibrium*, meaning that supply equals demand in all markets; so, there is no need to worry about bubbles or crisis. Well-being is measured in terms of money, but there are no rich or poor so there is no hunger, therefore the system is democratic: one dollar, one vote. The fact that some consumers own more dollars than others is their birthright, so there is no need to waste time discussing that in reality some do have many more votes. These are the basic elements of *positive neoclassical economics*, at least on the blackboard. But there is nothing positive about the axioms upon which these propositions are based and the inconvenient truth is that they are based on value judgments and have little to do with the actual economy as it exists today full of too-big-to-fail banks and supranational mega-corporations with global reach who operate mostly above democratic oversight. Actually, the canon hides the fact that free markets have never ever existed in the real world because they cannot possibly exist in a social vacuum.[46]

The mentality of conventional economists is rooted in the much simpler Smithian world of the eighteenth century without its moral sensibilities.[47] That is like trying to understand atomic physics with Newton's laws instead of quantum mechanics. Hence, the dominant *neoliberal economic theory is anachronistic*—inadequate to meet the challenges of the crisis-ridden world of the twenty-first century. "Ivory tower" economists are experiencing a paradigm paralysis that blocks their ability to evaluate their canon critically.[48] They are inflexible, unable to think outside of the abstract framework they have created because alternative perspectives are inconceivable to them. They refuse to give up the simplistic assumptions of an imagined economy inhabited by implausible super-rational agents—*Übermenschen*—Supermen—devoid of emotion, without any sense of community, whose only identity is that of being consumers, or producers with hardly any interaction among them.[49] In contrast, humanistic economics is about flesh-and-blood people.

1.4 A Paradigm Shift Is Long Overdue

Our long-range goal should be to provide a thorough empirical foundation for the discipline, while our proximate goal is to demonstrate that the mainstream canon is woefully misleading and therefore a paradigm shift is absolutely necessary away from the current dominance of neoclassical economics and toward humanistic economics.[50] For economics to be relevant, it must become more realistic and work for the benefit of Everyman and not only for the top 1 percent.[51]

Today, economic policy is of paramount importance. The White House has the Council of Economic Advisers and 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 economic data and employs 5,600 people. So, lots of effort is expended on understanding the economy. Hence, it behooves us to discard false theories.

Mainstream economics has been unable to create an inclusive economy in which most people felt good about their life.[52] Mainstream economics steered us straight into the biggest economic crisis in 75 years, and the political crisis was not far behind (see Chapters 14 and 15).[53] Mainstream economics misjudged the severe impact of globalization on the lives of low-skilled workers (see Chapter 13). Mainstream economics misunderstood the impact of inequality on the social and political systems. These errors add up to an extraordinary set of policy blunders.[54] Hence, a paradigm shift is long overdue.[55] That is the proximate reason for writing this book. Without these blatant blunders I would certainly not have done so.

Instead of chasing the elusive "American Dream" in a "treadmill" economy with a few winners and many losers, we should focus on creating a more *harmonious economy* with a creative, decent, dignified, enjoyable, satisfactory, secure, sustainable, and peaceful life, one that is not based on excessive consumption, instant gratification, and cutthroat competition—one that is less materialistic.[56] For the first time ever, we have the possibility of achieving a quality of life that eluded our predecessors without struggling to achieve ever more material goods.[57] That is the essence of *humanistic economics*.

The emphasis on competition in economics is based on *Social Darwinism*—the survival of the fittest. Supposedly, competition brings forth more of the best products and best performance. But we already have enough material goods. We no longer need to strive for more. What we need more of is contentment. We could all live comfortably, given our level of productivity. Materialism is insatiable and therefore ultimately cannot satisfy because it just 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 status and be able to enjoy more of what we already possess.[58] Instead of growing the economy, we need psychological, spiritual, and moral growth. However, for that, we need a new economic paradigm appropriate for the twenty-first century. The Canadian Institute of Wellbeing defines well-being thus:

> The presence of the highest possible quality of life ..., focused on ... 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.[59]

In short, well-being is not identical with GDP or income (see Section 10.10).[60] A good life in Capitalism with a Human Face should include the *minimizing* of anxiety, inequality, insecurity, pain, poverty, stress, unemployment, and *maximizing* ethics, intellectual satisfaction, health, leisure time, social relationships, love, respect, and a moral life.[61] President Jimmy Carter implied as much:

> [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 do not satisfy our longing for meaning.[62]

However, his warning fell on deaf ears: "[Carter] totally ignored the fact that the country's dominant institutions—corporations, advertising, popular culture—were instrumental in promoting and sustaining the hedonistic ethic."[63]

The reader should not misunderstand. I am not advocating abolishing markets or creating an immense leviathan and am resolute about protecting freedoms enunciated in the Universal Declaration of Human Rights. However, I have a wider conception of liberty than libertarians.

Freedom is more than the absence of legal restraint to act. Crucially, it has to encompass Amartya Sen's notion of *capability*: the *ability* to act.[64] It includes the "freedom from want" and the "freedom from fear" emphasized by President Franklin Roosevelt: "Liberty requires opportunity to make a living—a living decent according to the standard of the time, a living which gives man not only enough to live by, but something to live for."[65] That includes, furthermore, the ability to live without the anxiety generated by a high-stress economy, so we should not have to worry about our job or pension disappearing, being defrauded, or paying medical bills or college tuition. The UN's Declaration of Human Rights includes these freedoms:

> Everyone has the right to a standard of living adequate for the health and well-being of himself and of his family, including food, clothing, housing and medical care and necessary social services, and the right to security in the event of unemployment, sickness, disability, widowhood, old age or other lack of livelihood in circumstances beyond his control.[66]

My conception of a good life also includes the freedom to live without 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 autonomously rather than having it imposed by media magnates and influencers. In addition, developing one's character without the interference of the profit motive of multinationals is an essential aspect of true freedom.[67] We would then not be inculcated from the get-go 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 *no market works well for long without adequate oversight*. This is a crucial insight. So, we must verify if specific markets at a specific time really accomplish what is expected of them and, if not, we should improve their performance so that we can function better in them. I am an enthusiastic supporter of those markets that enable individuals to exercise their creativity, autonomy, and individuality without psychological manipulation or coercion and without interference from influencers peddling conformity, and predatory lenders fishing for gullible people, but my support is contingent on *empirical verification*. We should not ignore evidence contradicting the orthodox canon. If markets are suboptimal or even harmful, we must retain the right to reform them. This is also the essence of humanistic economics. Crucially, we, the people, should remain the masters of markets, and not vice versa.[68] Moreover, their benefits should be widely dispersed. So, markets are not above moral judgment.

Actually, there is a continuum of socio-economic systems, ranging from market fundamentalism to socialism. I advocate finding that constellation of institutional arrangements at the golden mean between the two extremes that can provide a fulfilled life for all. However, I do not believe that we need to "grow the economy" to achieve this. Rather, we should create a fairer economy that can sustain future generations, eliminate discontent, and minimize insecurity and *minimize suffering*, mental and physical.

Ernst Schumacher, a pioneer environmental economist, had a similar vision: "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."[69] By being "inefficient," he meant that the economy generates so little life satisfaction despite high average income and despite using so much resources. He continued: "the aim should be to obtain the maximum of well-being with the minimum of consumption." Thus, our goal should be to improve our sensibilities and *consumption skills* so that we can improve our lives by obtaining more gratification with less consumption.[70] That is, become smarter, more autonomous consumers immune to instant gratification.

1.5 Real-World Economics Is Superior

The recognition is increasing that "the progress of economic science has been seriously damaged,"[71] because "[m]odern economics is sick. Economics has increasingly become an intellectual game played for its own sake and not for its practical consequences for understating the economic world."[72] Consequently, there is a widespread effort to reform the discipline. This includes "Rethinking Economics,"[73] an international movement committed to "building a better economics."[74] On the 500-year anniversary of Martin Luther's *95 Theses*, it posted "33 Theses for an Economics Reformation" on the entrance of the London School of Economics, arguing that "within economics, an unhealthy intellectual monopoly has developed."[75] The manifesto is practically identical to humanistic economics.[76]

Similarly, the editors of the journal *Capitalism and Society* are explicit in their criticism of the "otherworldly neoclassical school ... using mathematics to model unrealistic assumptions":[77]

> 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 ... it limits and distorts our view.[78]

However, the groundswell of rejection of mainstream models has not been adequately represented in academic classrooms or in policy.[79] There is a veritable iron curtain protecting the power centers of neoliberal ideology that maintain its dominance in all top journals crucial for promotion and admittance into departments that shape the future of the discipline.[80] Even today most research papers published in prestigious journals begin with unrealistic assumptions.

No less an authority than Nobelist, Joseph Stiglitz, declared—prematurely in 2009—that "neoliberalism as a doctrine, market fundamentalism is dead:"[81]

> 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, which was fundamentally flawed, incoherent, was intellectually bankrupt from the beginning, that has been shown not to work.[82]

Nonetheless, the popular textbooks remain unchanged. This is hardly a benign oversight. It has immense consequences, since it influences the media, political discourse, and the mindset of the voting citizenry. No wonder that many believe, "much of what economists do nowadays is a waste of time."[83]

1.6 Simple Is for the Simple-Minded

The argument that a simple overview suffices to lay the foundations in Econ-101 before students learn more sophisticated aspects of the discipline, is blatantly false. It sells the students far too short. Oversimplification leads to the distortion of reality beyond recognition, deceives students, and blends into indoctrination. If the straight-talking Nobel Prize-winning physicist, Richard Feynman (1918–1988) were still with us, he would concur that such caricatures should not persist in academia. In his 1974 commencement address at the California Institute of Technology, he beseeched students to practice "scientific integrity," "utter honesty," and to "lean over backwards" so as not to "fool ourselves."[84] I believe this holds also for teachers of economics. Economists should be held to the same ethical standards as other professionals.[85] From the start, students must learn about the limitations of real markets as opposed to theoretical ones for four reasons:

1. Half-truths do not belong in academia: not in the beginning or at the end of a program; omitting crucial aspects like Herbert Simon's theory of satisficing or behavioral economics is not living up to Feynman's standard of being "utterly honest."[86]
2. It is much more efficient to learn economics properly the first time than to have to 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 real-world limitations. The human mind is not so flexible: once the neural networks are in place, they are tedious to rewire.[87]
3. The more "sophisticated" ideas of imperfect markets are not so complicated and can be taught successfully at the introductory level. Neglecting them, dubbed "imperfections" or "*frictions*," and focusing instead on perfectly competitive markets distorts economic theory to such an extent that students leave the course "convinced of the righteousness of neoclassical economics and the necessity of deregulation and the reduction of taxes," i.e., with a fundamentally misleading caricature of the real existing economy.[88]
4. Most students of Econ-101 do not continue to study economics; so, they never learn the more nuanced models and are therefore convinced for the rest of their lives that markets work perfectly well without government interference. This influence played a substantial role in political developments by supporting an ideology tilted toward the free-market worldview. Thus, students should not be deceived and the distinction between theoretical and actual markets clarified from the start. Admittedly, instructors are expected to cover a considerable amount of material in Econ-101. Nonetheless, quality ought not be sacrificed for quantity: it is more important that students are not deceived and get a balanced view of the real-existing economy.

1.7 "It's Only a Model!" Is Deceiving

The reliance on mathematics in economic models does not make economics into a rigorous science because the methodology has many drawbacks.[89] These include "sins of omission": complex social and political processes cannot be captured accurately in a few equations. Consequently, many relevant issues are omitted, which leads to "narrow methodological biases," and "epistemological insularity," the isolation from other social sciences.[90] Simple models are unrealistic conceptualization of a complex economy with thousands of variables and interacting components. So, simplification renders many models harmful, as became obvious during the 2008 crisis.

Consider also that some critical issues can only be approximated. Obviously, extreme inequality can destabilize a democratic political system, but the precise relationship between the two variables cannot be described mathematically. Yet, if economists omit political destabilization from their thinking about inequality, they are committing a critical error. Thinking about such issues requires approximation based on intuitive judgment. Teachers are doing their students a disservice if they allow them to leave their classroom without understanding that the political implications of such issues as inequality.

Because of such systematic oversight, simplified blackboard models are applied casually to real-world situations erroneously and lead to *disastrous* policies. The perfectly competitive model, the workhorse of mainstream economics, is invariably misapplied because it is irrelevant in today's economy (see Chapter 9). This is an immense flaw because it led to destructive policies. For example, Greenspan's and Bernanke's application of simple Econ-101 textbook models to the complex financial sector, while ignoring the warning signs before 2008, had catastrophic consequences (see Chapter 14). Similarly, economists omitted in their mathematical equations the ominous political forces that were unleashed by globalization, with similarly disastrous results (see Chapter 15).

Hence, the economics profession is responsible, in the main, for how ill-informed the public, the media, and politicians are about real-world economics. Economists have failed miserably to "bend over backwards" by clearly explaining the limitations of blackboard models. It is insufficient to mention the assumptions at the beginning of the semester and assume that the students remember them years later when they assume responsible positions by becoming newspaper editors, radio commentators, small-town mayors, or political activists, and choose among political candidates based partly on dubious economic models, remembering that free markets are supposedly efficient.[91] This failure has immense deleterious implications for society and its political system. Hence, we must clarify when *blackboard models are not applicable to real-world phenomena*. Without such emphasis most textbooks fail to provide adequate guidance to understanding the real-existing economy.

Thus, the deficiencies of Econ-101 have become a powerful political force as citizens become vulnerable to simplistic sound bites: "competition will lead to growth," "the free market is efficient," "lowering taxes will create jobs," "government is not the solution to our problems, government is the problem,"[92] "we are adults, we do not need consumer protection." To avoid such stereotypical political slogans becoming common wisdom, academics must avoid half-truths before the students are indoctrinated into thinking that competitive free markets miraculously provide the answers to all real-world economic problems.

Yet, economists often argue that unrealistic models are acceptable if their predictions are useful. However, mainstream economics fails miserably in this respect. For instance, typical models predicted that our life satisfaction would increase as real per capita gross national product rose by a factor of 3.5 in the US since 1950. Yet, that prediction is falsified by the inconvenient truth that the share of adults who are happy remained unchanged in the intervening half-century.[93] If anything, it has declined. Hence, the importance of money is obviously overvalued by economists.

Yet another example is Greenspan's prediction that deregulation would increase the efficiency of the financial sector, but that prediction was falsified when financial markets imploded in 2008. Similarly, Bernanke predicted that the subprime mortgage problem would not "drive the economy too far from its full employment path."[94] Yet, this Princeton star macroeconomist was dead wrong: two years later the official unemployment rate reached 10 percent, and the actual unemployment rate was closer to 17 percent.[95] Economists also predicted that globalization would increase prosperity. Instead, it increased the number of have-nots and provided fodder for populism. Economists blundered by predicting that a financial crisis would not occur although there were enough warnings that people in authority disregarded.[96] Despite these mistakes there is no rush to scrap falsified theories in order to put economics on the right track in order to avoid such blunders in the future.

In sum, the failure of economic theory to provide reasonable predictions to the major challenges of our time is essentially a travesty. The argument has been falsified innumerable times that economists can predict accurately even with unrealistic models. Thus, the conclusion is warranted that:

> mainstream economists nowadays might not be particularly good at predicting financial crashes, facilitating general prosperity, or coming up with models for abating climate change, but when it comes to establishing themselves in positions of intellectual authority, unaffected by such failings, their success is unparalleled. One would have to look at the history of religions to find anything like it.[97]

Why this is the case is the subject of this volume.

1.8 Takeaways

The financial crisis of 2008 and the subsequent rise of populism demonstrated the failure of economic theories to grasp the full implications of their policies in the real world. In mainstream classrooms, markets are described as self-regulating institutions that work efficiently without government oversight. However, the devastation of the crisis, together with the upswell of discontent associated with a level of inequality not seen since the Robber Barons of a bygone era demonstrated convincingly how economists were blindsided by events. Theirs was not a minor error but a failure of historic proportions.

Trumpism captured the frustration of the electorate with free-market principles that dominated policies since the trickle-down theories of Reaganomics. Two hundred counties flipped from Obama to Trump in the 2016 election because of the anxiety linked to *downward social mobility* and the devastation that mismanaged globalization brought to the Rust Belt, to small towns, and to rural America.

Yet, textbooks remain unchanged, failing to convey the fundamental shortcomings of the free-market system as well as the ways in which social, political, and economic processes are intertwined. This chapter points to the weaknesses of the current economy and argues that only "Capitalism with a Human Face" can lead to a flourishing society.

Questions for Discussion

1 Do you agree with Alan Greenspan that everyone has an ideology?
2 What is your ideology and how does it compare to the ideology of a typical American?
3 Do you think that the assumptions made in economics textbooks about the behavior of individuals and firms are sufficiently realistic to be appropriate and useful in their application to the real world, or do you think that they are oversimplifications?
4 Do you think that a value-free economics is possible?
5 Do you think it is useful to distinguish between basic needs, wants, and conspicuous consumption?

6 Do advertisements or fashion trends influence your consumption habits?
7 Do you think that ethical considerations are as important as economic efficiency?
8 Do you think that consumerism should be the dominant culture? What about instant gratification, keeping up with the Joneses, conspicuous consumption?
9 Do markets always function well and increase our quality of life or do they frustrate many and exclude some?
10 Can you think of instances when you were disappointed by a salesperson, or deceived, or defrauded, or someone took advantage of your lack of knowledge or experience?
11 Does society have the right to control market activity?
12 Do you expect professors to follow Feynman's admonition to be "utterly honest"?
13 Are you more satisfied with your life than were your parents or grandparents?
14 Do you think that reducing the conspicuous consumption of the rich through higher taxes would improve the supply of public goods such as schools and infrastructure in the United States?
15 Do you know someone who voted for Donald Trump? Why did he/she vote for him?

Notes

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