

On Revolution in Economic Theory, Economic Growth and Economic Development

Theses for the Conference “Concerted Strategies to Meet the Environmental and Economic Challenges of the 21st Century” (National Bank of Austria, Vienna, Thursday 16th and Friday 17th April, 2009)

1. Excellent Policy Notes distributed to the participants provide a sound basis for national and international anti-crises actions.
2. Global financial crisis is a big market failure in the sphere of risk assessment by financial institutions. In conditions of globalized economy it brings to the fore the necessity to introduce adequate regulation in financial sphere both on national and international levels. Moreover, it probably requires radical restructuring of this sector.
3. There is no doubt that liberal market produces incentives which can (and do) lead to the deterioration and sometimes even destruction of ecological systems. As far as global climate changes are concerned experts have different opinions whether they are the result of human activity or constitute just a chain in the development of long-term cyclical natural processes, anthropogenic factors playing but a minor role.

In any case such changes along with ecological disturbances, energy and development problems exert huge influence upon economic conditions of mankind and, therefore, require adequate economic responses. It is, therefore, absolutely logical to propose that measures taken to deal with financial and economic crises take into account other global crises we now face. At the same time it is obvious that these crises have different time horizon; overcoming financial and economic crisis is to occur first.

3. The idea that “revolution in economic thinking is needed” deserves complete recognition as well as the critique of Anglo-Saxon paradigm. But what kind of revolution is needed? Should we just throw away the heritage of the mainstream economic theory?
4. In accordance with classical tradition modern microeconomic theory is built on the assumption that human species strive for maximization of the level of satisfaction of their own needs, paying no attention to what happens around them. In other words, utility function of an “economic man” does not include anything but commodities and services he consumes.

This is a helpful assumption because on its basis it is possible to explain very important manifestations of human behavior. In fact, market mechanism is able to “take into account” only these, so to say, “egoistic” needs of people. “Economic man” assumption is, therefore, necessary and sufficient for understanding the way market operates. Mainstream microeconomics can thus pretend to be a theory adequately describing the interaction of market forces.

But there is no doubt that we all, to more or less degree, do care about what happens in the world around us. The very fact that people usually live together with other members of the family, with whom they share common interests, is sufficient to show that our individual utility functions are richer than

that of an “economic man”. Moreover, there is quite a broad field where market fails and allocation of resources should be carried out with the aid of other, non-market institutions.

Conclusions from what was said above are:

- Economic processes go far beyond the processes which occur in the marketplace;
- Mainstream microeconomics should not be equated with economic theory; the latter is of much greater scope.

5. An extremely important and difficult problem is that of how to define the welfare of a group of people?

5.1. The answer from the welfare economics – a specific section of modern microeconomic theory – is that in the economy as a whole it occurs in conditions of general equilibrium when marginal costs equal marginal benefits in all spheres. This is an “ideal state” of the economy because under these conditions no members of society, if they respect the basic market rules of the game, are interested in any change. Two properties of this “optimal social state” are worth mentioning:

- It is not sensitive to the income distribution, which is determined by the initial allocation of resources between members of the society, all of whom possess the qualities of “economic men”;
- It is not sensitive to any circumstances, which, like global climate change, cannot be “taken into account” by the market;
- It is characterized by a particular allocation of resources, which can be adequately expressed in vector (not scalar) form.

5.2. The answer from the macroeconomic theory is different: it affirms that the welfare of the state depends on aggregate income (GDP) of the society. Correspondingly, dynamics of aggregate income is considered as an adequate measure of economic growth. One should take into account that this scalar representation of welfare contradicts one of the basic assumptions of microeconomics according to which interpersonal comparisons of welfare (and, as a result, summation of individual incomes) are forbidden. Macroeconomics gaining in simplicity sacrifices precision of its conclusions. Thus macroeconomics can be considered as a qualitatively different field of economic theory oriented rather on practical applicability than theoretical pureness.

Macroeconomic assessments of welfare and its dynamics ignore all factors but aggregate income. Endeavors to improve aggregate measure of welfare by applying weights to indicators, which characterize different sides of social life, may have only marginal effect: the result will still be nothing more than scalar approximation of a complex vector reality. Besides, it is hardly possible to find objective basis for selecting weights for different indicators.

5.3. It is enticing to apply to the problem of social welfare approach used by microeconomics in analysis of individual preferences. It would be great if we could know how group ranges all its possible states and, as a result, could construct group utility function. But this way has been blocked since K. Arrow proved famous “possibility theorem”, which says that in order to jump from individual preferences of the members of the group to the preferences of the group as a whole dictatorship is needed.

5.4. All this said only one way seems to exist. We have, probably, to look for the specific state of polity, characterized by all its innumerable dimensions, which would be a result of coordinating, under existing resource constraints, of individual interests of its members with the aid of given social choice rule. Individual preferences embrace here not only consumption goods, but attitudes of any person towards different states of society. Under “given social choice rule” one has to understand all decision-making mechanisms – market, political system and civil society institutions, which deal with resource allocation. In a sense, this is an extended welfare economics approach (see 5.1).

No doubt this logical construction possesses elements of tautology: in order to take decisions polity has first to take decision how decisions should be taken. But probably this is not so bad after all, because this “vicious circle” makes it easier to understand why social choice rule evolve with time. If given mechanisms of decision-making produce social results which are not acceptable to a significant part of its members pressure aimed at changing these institutions increases.

6. Of course, this is nothing more than a logical construction. But it seems to be useful one since it helps incorporate in the economic thinking factors, which are important for the society but ignored by market mechanisms. It is based on “vector approach” and is thus incompatible with the scalar economic growth paradigm. Instead it puts an emphasis on the necessity to seek economic development (progress), these notions being of multidimensional character.

7. This is not to say that classical macroeconomics and economic growth models should cease to exist. Not at all! They are very convenient for many practical purposes. It is important, though, to understand approximate and simplified character of conclusions driven on the basis of macroeconomic models and to be ready to supplement the macroeconomic analysis with examination of additional indicators which are beyond its sphere, but may still be very important.