

Slight Crisis of Mainstream Economics?

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Abstract

Is the neoclassical economic paradigm obsolete? For the past two decades huge number of new ideas and concepts in economic theory have emerged, so it seems that economics have reached a methodological turning point. The need for close interdisciplinary cooperation in researching subjects that have always been in the centre of interest by economists becomes evident.

It seems to me, although it is my subjective opinion – that today's economics is at a methodological turning point. Over the last 15–20 years, a great number of new conceptions, ideas and concepts have appeared and seem to me to be slowly undermining the neoclassical economic paradigm. We are not yet at the stage when a new synthesis is made, for it is a little too early for that. It is not clearly visible either, because a change of textbooks at the first years of college is the vivid and symbolic expression of a new approach. When these textbooks start reflecting new conceptions, it means an actual breakthrough has taken place. It is still a long way. As part of this new methodological change, economics is starting to voice its increasing need and demand for cooperation of other social disciplines. From anthropology, psychology, political science through sociology reaching outside social sciences to such as biology, medicine or physics.

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At what point are we today? The idea of equilibrium seems to be the main concept that organizes our, economists', thinking about micro- and macroeconomics.

My attitude to this idea is ambivalent. Whether we study macroeconomic or microeconomic problems, the approach that makes equilibrium the axis of analysis reveals its weaknesses. By introducing the concept of equilibrium, L. Walras showed that the economy is a system of connected vessels with a certain interdependence between sectors, branches and markets. Various sections of the economy are connected with one another, affect each other and cannot be treated as isolated islands. Even if they initially affect only some branches of the economy, every significant change in economy or its environment, or great demand and supply shocks, they trigger a whole avalanche, a whole cascade of adaptation processes in cooperating or related sectors, on product markets and markets for production factors. All this helped to understand, why despite the fact that the economy is inhabited by entities steered by private egoistic interest it is not torn apart by these egoisms, but is dominated by centralizing factors. It was a great achievement at that time, and that is how it is assessed today.

On the other hand, the concept of equilibrium has somewhat tunnelled economists' vision, for which reason I approach this idea with certain scepticism. The acceptance of the equilibrium approach moved the centre of gravity of economic deliberations to purely static and short-term problems. The dominating point of view is that equilibrium is a state when that acting forces neutralize each other. In this sense equilibrium is actually understood as a certain state of balance of powers. This leads to stagnation, economic standstill and lack of change. This static state repeats itself unchanged in time until some disturbance or perturbation occurs. But then, if the system is stable at least on local level it comes back to equilibrium, unless the shock is too big. In the case of heavy shocks, the system knocked out of the state of one balance can move on to a new static state. In any case, there are only short-term fluctuations around the state(s) of balance. The supporters of the concept of equilibrium rather strongly protest against the allegation that equilibrium is in principle a static idea implicating stagnation and torpor. They adduce the fact that economy is analyzed using both static and dynamic models of equilibrium. The dynamic models can describe the ways of development of economic variables and thus indeed show dynamic features. But this dynamics has a stationary solution where certain parameters of the model recur unchanged in time. The problem of balanced-growth can serve as an example where, in the state of long-term equilibrium, key relations and dynamics are stabilized in time. The fact that the obtained results for static states are insignificant is obviously not the problem. The key issue is that

attention is not focused on disequilibrium states responsible for changes, but on the states of balanced economic powers that signify lack of impulse for change.

These questions are important because we often wonder what finally led us as human beings to leave the world of caves and end up at the moment where we find ourselves today, i.e. refined level of technology, high production and consumption, great productivity, etc. It definitely did not happen because of our operation at the level of balance, but because of our activity at the level of changes. It was not the duplication and repetition of behaviour of various actors of economic life or social groups even on a growing scale that was decisive but the innovations, new ideas, concepts and conceptions or, to put it in macroeconomic terms, these were the growth, development and dynamics of change. The fascination with the concept of equilibrium led to the fact that, at least until recently, in my assessment, maybe 90% of economists devoted their studies to the problems of equilibrium, and only the rest was involved in any problems of dynamics that in my opinion are key in the long-term.

The second, rather deeply rooted stereotype in which many economists believe is the concept that solely competition and rivalry between economic agents are the key motor for change. Positive changes are born on the field of constantly conflicting interests of various entities, consumers and producers. It is a rivalry between egoistic, but rational, wise and calculating players. Every new opportunity for increasing their own profits triggers the agents' activity to secure this profit for themselves. It is the private, material interests and motives that stimulate activity. Conflicts of economic interests, competitive fight and rivalry between people suggest that there are only zero-sum games played in the economic world and within social processes. It is completely untrue, because we simultaneously claim here that competition is advantageous not only for winners and vanquishers of competition, but also for the community and leads to social prosperity. It even seems that the more there is competition, the more socially effective the system is.

Therefore while appreciating the role of competition, as it indeed is an impulse for change and triggers new processes, it is worth to adopt a different perspective. Not rivalry and competition but cooperation between people are the key to understand what determines the growth of the effectiveness and efficiency of the processes of management. To play zero-sum games requires people to cooperate. Modern technologies are characterized by the economies of scale. Production on a large scale gives an advantage over a company that produces on a small scale, because mass production is characterized by lower unit production costs and is more competitive. There are multiple reasons for such a producer's advantage and chiefly result from

the indivisibility of technology, high fixed production costs or high set-up costs. The problem is that large production is not possible in small, family or one-man companies, and division of duties and specializations is necessary and sensible.

It makes you think of the case of Robinson Crusoe on the desert island, who has determined material resources at his disposal and allocates them to meet his needs so as to maximize their usefulness to him. Technologies are at the same time a function of Robinson's knowledge, competence and practical skills and are firmly defined. In this world, there is no doubt where lie the limits of production, or, to put it differently, what is the production possibility frontier. Let us imagine, however, that Friday shows up on the island. This very much complicates the situation. The new actor would not bring in anything to our deliberations, had **no economies of scale existed** in economics. In this case one could talk only of not more than a doubled production capacity of the economy once Friday appeared on the stage and collective activity would be a simple sum of behaviour of individuals. However, in the case of the increasing returns, cooperation does increase effectiveness, efficiency and production, and production limits move. In the language of science, this is called positive feedback and it helps to understand why cumulative development processes occur in economy.

Robinson's and Friday's cooperation cannot be taken for granted and is only one of the possible scenarios. However, if there is no cooperation, the economic system works below its production capacity. The thing is that the second scenario is much more probable than the first. In a world where Robinsons are very rare, the phenomenon of human cooperation and collaboration must be the key element of economic analysis. This moves the centre of gravity of deliberations from the optimization of single actor (which is the matter of interest of microeconomic studies) to the way in which the activity of single agents intertwine. It is here precisely that runs the line separating a strictly microeconomic analysis (a single actor) and a macroeconomic description. Macroeconomics is not a sum of behaviours of microunits. The frequent demand to base macroeconomics on strong microeconomic foundations is therefore admissible to a certain point. To date, this expectation was actually understood as a postulate to have macroeconomic events be inferable from the motives for the actions of single microentities. In practice, the assumption of the representative agent was used as the basic methodological tool. This, however, introduces, as if through the back door, the assumption that there are no increasing returns. The representative agent construction when used, naturally ignores the issues of cooperation between the subjects and imposes the handling of macro-events as a sum of microeconomic events.

There is a problem of risk related to cooperation. Let us go back for a moment to Robinson. He controls the whole process of production because he is the only one to manufacture on the island. Obviously, the control is limited by vicissitudes of nature such as climate, weather conditions, natural disasters, etc. Nonetheless, the production process is under his control. Robinson's efficiency is admittedly low, but he operates in a very low risk situation. However, when Friday comes in, and he is followed by his friends and people start cooperating, divide duties, specialize, etc. problems appear. These problems are brought about by the growing behavioural risk, which is a high risk that is the result of other agents' behaviour.

Risk is generally the result of the fact that people operate in a world with strong information asymmetry combined with large transaction costs. And contracts or agreements made with others are often incomplete contracts or agreements. The incompleteness of a contract is the incapacity to specify all terms of contract and/or to impose very high contract execution costs to one of the parties. A simple example of such an incomplete contract is when you go shopping to a grocery store: I pay and put good money on the counter and receive a promise from the other party that the goods put into my basket are of good quality. The buyers have no effective way to verify this promise *ex-ante*. It is not earlier than during consumption that they can find out if the promise was kept. You cannot check in the shop if the cream cheese or eggs are fresh, beauty products, toothpaste, cold cuts or white are of desirable quality. At the same time I do not know anyone who would go to court with a bad egg or cheese to fight for their consumer rights. Simply because it's not worth it. Transaction costs are too high and in this sense the contract is incomplete.

If the employer hires a worker and pays good money, the employer gets from the other party not more than a commitment of good work. It is only a promise because good work cannot be precisely defined. The payment contract cannot specify in detail all conditions and situations that make up efficient and effective work. Sometimes employers go to court to put in a claim against their employees. In principle this takes place in the case of criminal offences committed by employees (such as theft), and not manifestations of bad work. A similar situation characterizes the relations between the moneylender (bank) and borrower. Here we only have the borrower's promise to pay the future liability to the bank.

What am I aiming at? If we are indeed living in a world of incomplete, open contracts, whose execution by a third party (arbitration, court) is difficult, costly, or even impossible, then why are contracts executed at all? The answer must come as a surprise to both supporters and apologists of equilibrium. Such contracts are executed because there is no equilibrium on nearly any market. And it is precisely

because of the lack of equilibrium that these contracts can be implemented. The lack of equilibrium means a power factor will appear on the side of the economic relation that is initially weaker because it has no full contractual security.

Unemployment is the symptom of lack of equilibrium on the labour market and it is a disciplinary factor that helps exact a determined minimal quality of the job service. On the consumer goods market, or on any products market, this role is played by the offer that exceeds demand. When we study any goods or services market, in principle there are stocks that the supplier could sell at any moment if there is a new buyer. And in the case of markets where the production is not warehoused (such as the energy turbines market, tanks, ships, etc.) it is typical for the producers to keep free reserve production capacity. All these are cases of the state of imbalance with oversupply. This gives a big advantage to the buyer for they can refuse to continue buying from suppliers who offer bad products. This sanction is effective because it is economically severe to producers by reducing their income. What would happen if the seller had the advantage and there were many more agents wishing to buy than products supplied – the supplier could then with impunity ignore the buyers' demand of high quality. Refusal to buy would be ineffective since the place would be filled by others deprived from possibility to satisfy their needs otherwise.

The situation on the loan market is similar. The key instrument here is the threat to refuse a loan again. On loan markets there is the imbalance of constantly higher demand for loans than credits offered. In this sense the economic power is on the side of the bank, which can only sign incomplete contracts with its clients and thus does not have a completely effective way of executing its debtors' liabilities except for the refusal to continue granting loans.

Aside economic power there is the second factor that determines effective execution of incomplete contracts. The second factor is an interesting element that links economics to sociology. Social norm or rather the system of values is the second element. Many employees do not work well and effectively because of fear of sanctions and yields to the pressure of employers' economic power, but because they have their work ethos. Entrepreneurs manufacture good products not because of the fear of the negative reaction of the buyers that the dissatisfied customer will not buy their products, but for many it results from their code of good work. The economic force and social norm partly substitute themselves as factors for execution of incomplete contracts. The weaker the role can be played by social rules that regulate behaviour, the stronger the economic power must be manifested.

The mechanisms that shape social norms and the mechanism that shapes systems of values are the task for research for economists to a certain extent only. In particular

in the extent to which their key role in ensuring effective cooperation between people can be observed. At the same it is also or mainly the area of interest for the sociologist, psychologist, anthropologist or even biologist. It seems to be an optimistic forecast for cooperation of various branches of social sciences.

