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Review of an excellent book on the weaknesses of neo-classical economics.

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The Naked Emperor of the Social Sciences

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Debunking Economics: The Naked Emperor of the Social Sciences, Steve Keen, Zed Books (ISBN: 1864030704)

To paraphrase Nietzsche, economics is dead we have killed it with our disbelief. To see why, Steve Keen's excellent book is essential reading (as is his webpage: www.debunkingeconomics.com). It is an important work and recommended for any one interesting in finding out about the limitations of mainstream economics.

And what limitations they are! Keen goes into the crazy assumptions, methodology and contradictions of neoclassical economics in some detail, debunking key aspects of the dogma and showing not only when they contradict reality but also when they are logically inconsistent and contradict itself. Keen argues that it is impossible to ignore economics ("to treat it and its practitioners as we these treat astrologers") as it is a social discipline and so what we "believe about economics therefore has an impact upon human society and the way we relate to one another." Despite "the abysmal predictive record of their discipline," economists "are forever recommending ways in which the institutional environment should be altered to make the economy work better," i.e. make the real

economy more like their models (as “the hypothetical pure market performs better than the mixed economy in which we live”). (pp. 6–8)

Given that since the mid-1970s the promotion of the market and the reduction of government interference in the economy have become dominant. The “global economy of the early 21st century looks a lot more like the economic textbook ideal that did the world of the 1950s … All these changes have followed the advance of economists that the unfettered market is the best way to allocate resources, and that well-intentioned interventions which oppose market forces will actually do more harm than good.” As such, “[w]ith the market so much more in control of the global economy now than fifty years ago, then if economists are right, the world **should be** a manifestly better place: it should be growing faster, with more stability, and income should go to those who deserve it.” However, “[u]nfortunately, the world refuses to dance the expected tune. In particularly, the final ten years of the 20th century were marked, not by tranquil growth, but by crises.” (p. 2)

These problems and the general unhappiness with the way society is going is related to various factors, most of which are impossible to reflect in mainstream economic analysis even if economists could be bothered to include them (their assumptions and methodology exclude such concerns by behalf). They flow from the fact that capitalism is a system marked by inequalities of wealth and power and so how it develops is based on them, not the subjective evaluations of atomised individuals that economics starts with.

Anarchists argue that this is unsurprising as economics, rather than being a science is, in fact, little more than an ideology whose main aim is to justify and rationalise the existing system. Keen’s book is a contribution to making economics “less of a religion and more of a science” by tearing up “the foundations of economics” and, as such, it should be essential reading for all. (p. 19) Given how comprehensive his book is, it is difficult to cover all aspects of

it. As such, I will concentrate on some key areas which will indicate why anarchists should read it.

As Keen argues, neoclassical economics is based on a "dynamically irrelevant and factually incorrect instantaneous static snapshot" of the real capitalist economy. (p. 197) Equilibrium analysis simply presents an unreal picture of the real world. Not that the stable unique equilibrium actually exist for, ironically, "mathematicians have shown that, under fairly general conditions, general equilibrium is unstable." (p. 173) Economics treats a dynamic system as a static one, building models rooted in the concept of equilibrium when a non-equilibrium analysis makes obvious sense. It is not only the real world that has suffered, so has economics:

> "This obsession with equilibrium has imposed enormous costs on economics … unreal assumptions are needed to maintain conditions under which there will be a unique, 'optimal' equilibrium … If you believe you can use unreality to model reality, then eventually your grip on reality itself can become tenuous." (p. 177)

Indeed, the neo-classical theory falls flat on its face. Basing itself, in effect, on a snapshot of time its principles for the rational firm are, likewise, based on time standing still. It argues that profit is maximised where marginal cost equals marginal revenue yet this is "correct if the quantity produced never changes" and "by ignoring time in its analysis of the firm, economic theory ignores some of the most important issues facing a firm." Neo-classical economics "ignores time, and is therefore only relevant in a world in which time does no matter." (pp. 80–1)

Economics even has problems with its favoured tool, mathematics. As Keen indicates, economists have "obscured reality using mathematics because they have practised mathematics badly, and because they have not realised the limits of mathematics." Indeed,

there are “numerous theorems in economics that reply upon mathematically fallacious propositions.” (p. 258 and p. 259) As an example, he points to the theory of perfect competition which assumes that while the demand curve for the market as a whole is downward sloping, an individual firm in perfect competition is so small that it cannot affect the market price and, consequently, faces a horizontal demand curve. In other words, economics breaks the laws of mathematics.

A key chapter is Keen’s discussion of the Cambridge Capital Controversy when dissident economists pointed out that the neoclassical justification for profits as the contribution of capital to output was deeply flawed. While leading neoclassical economists admitted that the critique was correct in the 1960s, today “economic theory continues to use exactly the same concepts which Sraffa’s critique showed to be completely invalid” in spite the “definitive capitulation by as significant an economist as Paul Samuelson.” As he concludes: “There is no better sign of the intellectual bankruptcy of economics than this.” (p. 146, p. 129, p. 147) This is important as this theory (theory of marginal productivity) is used to this day to justify the current distribution of income, arguing that the widening gap between rich and poor simply reflects the market efficiently rewarding productiveness.

What is the critique of this mainstay of economic orthodoxy? In essence, capital goods cannot be aggregated together unless you give them a price. However, to give them a price involves assuming a rate of interest equal to the rate of profit. This means that the rate of profit on capital is meaningless as it is based on circular reasoning and so profits cannot equal any contribution to production.

Even if you ignore this problem, marginal productivity theory still runs aground. Keen summarises the arguments, noting that looking at the economy as a whole, “the desired relationship — the rate of profit equals the marginal productivity of capital — will not hold true” as it only applies “when the capital to labour ratio is the same in all industries — which is effectively the same as saying

ideas of a 1920s economist who had the decency to revise his theory when faced with the 1929 crash. His dissection of the Efficient Market Hypothesis is a classic, showing how it assumes that everyone is identical in terms of what they know, what they can get and what they do with knowledge and cash. This results in a theory which argues that investors correctly predict the future. He quotes the developer of the theory being honest enough to state that the “consequence of accommodating” key aspects of reality “are likely to be disastrous in terms of the usefulness of the resulting theory … The theory is in a shambles.” Unsurprisingly, “as time went on, more and more data turned up which was not consistent with” the theory. This is because the model’s world “is clearly not our world.” It “should never have been given any credibility — yet instead it became an article of faith for academics in finance, and a common belief in the commercial world of finance.” (p. 233, p. 246 and p. 234)

This insane theory is at the root of the argument that finance markets should be deregulated and as many funds as possible invested in them. While the theory may benefit the minority of share holders who own the bulk of shares and help them pressurise government policy, it is hard to see how it benefits the rest of society. Keen presents alternative, more realistic theories which argue that finance markets show endogenous instability, result in bad investment as well as reducing the overall level of investment as investors will not fund investments which are not predicted to have a sufficiently high rate of return. All of which has a large and negative impact on the real economy.

So, all in all, an important book which should be considered essential reading by all radicals — otherwise you will be at a disadvantage when debating those who take economics seriously.

nomic irrelevance of an exchange-only economy, or a production economy in which growth does not occur. (p. 194–7) Equally important is his critique of the standard model of the labour market which shows that “wages are highly unlikely to reflect workers’ contributions to production” (he notes that economic theory itself shows that workers will not get a fair wage when they face organised or very powerful employers unless they organise unions). This is because economists treat labour as no different from other commodities yet “economic theory supports no such conclusion.” At its most basic, labour is not produced for profit and the “supply curve for labour can ‘slope backward’ — so that a fall in wages can cause an increase in the supply of workers.” (pp. 111–2 and pp. 118–9)

He stresses that the idea of a backward sloping supply curve for labour is just as easy to derive from the assumptions used by economists to derive their standard one. Thus economic theory “fails to prove that employment is determined by supply and demand, and reinforces the real world observation that involuntary unemployment can exist” as reducing the wage need not bring the demand and supply of labour into alignment. While the assumption of an upward sloping supply curve is taken as the normal situation, “there is no theoretical — or empirical — justification for this.” Sadly for the world, this assumption is used to draw very strong conclusions by economists (arguments against minimum wages, trade unions and demand management by government are all based on it). Yet such important policy positions “should be based upon robust intellectual or empirical foundations, rather than the flimsy substrate of mere fancy. Economists are quite prone to dismiss alternative perspectives on labour market policy on this very basis — that they lack any theoretical or empirical foundations. Yet their own policy positions are based as much on wishful thinking as on wisdom.” (pp. 121–2 and p. 123)

Keen also debunks the really ridiculous neoclassical theories of the stock market, noting that the modern theory is rooted in the

there is only one industry.” Thus “when a broadly defined industry is considered, changes in its conditions of supply and demand will affect the distribution of income.” This means that a “change in the capital input will change output, but it also changes the wage, and the rate of profit … The distribution of income is to some significant degree determined independently of marginal productivity … to work out prices, it is first necessary to know the distribution of income … There is therefore nothing sacrosanct about the prices that apply in the economy, and equally nothing sacrosanct about the distribution of income. It reflects the relative power of different groups in society.” (p. 135)

Keen shows the unscientific nature of economics by looking at the notion of diminishing marginal costs required to produce a downward slopping supply curve. He presents a summary of the empirical evidence which contradicts this key assumption of economics. How has economics handled this consistent evidence accumulated over many decades? By ignoring it. This speaks volumes for the way that economics handles contrary evidence to accepted beliefs. Not that this should come as a surprise, given that the notion was originally invented to ensure that neoclassical economics did not suggest that the economy would become dominated by big business (that this was precisely what was happening in the real economy at the time was considered irrelevant). It should be noted that the empirical research simply confirmed an earlier critique of neo-classical economics presented by Piero Sraffa in 1926, a critique Keen ably summarises. (pp. 66–72)

No other science would think it appropriate to develop theory utterly independently of phenomenon under analysis. No other science would wait decades before testing a theory against reality. No other science would then simply ignore the facts which utterly contradicted the theory and continue to teach that theory as if it were a valid generalisation of the facts. This strange perspective makes sense once it is realised how key the notion of diminishing costs is to economics. In fact, if the assumption of increasing marginal

costs is abandoned then so much of neoclassical economics. It is worthwhile quoting Keen at length on this:

> "Strange as it may seem … this is a very big deal. If marginal returns are constant rather than falling, then the neo-classical explanation of everything collapses. Not only can economic theory no longer explain how much a firm produces, it can explain nothing else.
>
> "Take, for example, the economic theory of employment and wage determination … The theory asserts that the real wage is equivalent to the marginal product of labour … An employer will employ an additional worker if the amount the worker adds to output — the worker's marginal product — exceeds the real wage … [This] explains the economic predilection for blaming everything on wages being too high — neo-classical economics can be summed up, as [John Kenneth] Galbraith once remarked, in the twin propositions that the poor don't work hard enough because they're paid too much, and the rich don't work hard enough because they're not paid enough …
>
> "If in fact the output to employment relationship is relatively constant, then the neo-classical explanation for employment and output determination collapses. With a flat production function, the marginal product of labour will be constant, and it will *never* intersect the real wage. The output of the form then can't be explained by the cost of employing labour… [This means that] neo-classical economics simply cannot explain anything: neither the level of employment, nor output, nor, ultimately, what determines the real wage …the entire edifice of economics collapses." (pp. 76–7)

Demand is just as bad, with neoclassical economics itself proving that you cannot aggregate individual demand curves unless you apply some very surreal assumptions. This was forced upon it as the original versions of utility theory were used to justify the redistribution of wealth. To avoid that conclusion economists had to show that "altering the distribution of income did not alter social welfare. They worked out that two conditions were necessary for this to be true: (a) that all people have the same tastes; (b) that each person's tastes remain the same as her income changes, so that every additional dollar of income was spent exactly the same way as all previous dollars." The former assumption "in fact amounts to assuming that there is only one person in society." The latter assumption "amounts to assuming that there is only one commodity — since otherwise spending patterns would necessary change as income rose." The net effect is that one essential building block of the economic analysis of markets, the demand curve, "does not have the characteristics needed for economic theory to be internally consistent." (p. 24 and pp. 25–7)

This is important because "economists are trying to prove that a market economy necessarily maximises social welfare. If they can't prove that the market demand curve falls smoothly as price rises, they can't prove that the market maximises social welfare." In addition, "the concept of a social indifference curve is crucial to many of the key notions of economics: the argument that free trade is necessarily superior to regulated trade, for example, is first constructed using a social indifference curve. Therefore, if the concept of a social indifference curve itself is invalid, then so too are many of the most treasured notions of economics." (p. 50)

Keen also debunks Say's law and the notion derived from it that involuntary unemployment and recessions are impossible under free market capitalism. Say's law "evisage[s] an exchange-only economy: an economy in which goods exist at the outset, but where no production takes place. The market simply enables the exchange of pre-existing goods." This is "best suited to the eco-