

## THE SCIENCE OF PUBLIC ECONOMY UNDER CRITICISM AS THE BASIS FOR DECISIONS ON ECONOMIC POLICY

### Introductory thoughts on the current situation

Already since the time more than six years ago when the banking and financial crises started which led to the catastrophic expansion of public debt in the main industrial countries, the postulates of public economy and the resulting conclusions drawn in the field of economic policy for the solution of topical problems have been increasingly questioned. Researchers of public economy are having increasingly heated discussions on the pragmatic solutions for exiting the debt crisis. Is it primarily important to reduce the state budget deficit with the final goal of achieving a tolerable debt burden level? Or should the state expenditures be increased and consequently primarily an increase in public debt be allowed to stimulate demand, production and economic growth in national economy? In the case of the second alternative described, it would be easier to reduce public debt though increasing tax revenues. If we ignore the *central part of the causal chain* in the sequence of related impacts „increasing public debts → increasing economic activity → increasing tax revenues“, *the controversy of this proposal becomes evident: We have to borrow more to be able to repay our debts.*<sup>1</sup>

By now the reputation of the science of public economy has become so low that quite a few economists are asking themselves to what extent their speciality can be called a science at all.<sup>2</sup> Even the fact that the Central Bank of Sweden established the Prize in Economic Sciences in memory of Alfred Nobel in 1968<sup>3</sup> that has been issued annually since 1969 does not reduce such doubts.

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<sup>1</sup> This was more or less the essence of the statement of Christine Lagarde, Managing Director of the International Monetary Fund (IMF), at the international conference in Aix-en-Provence in July 2013.

<sup>2</sup> One of the many similar opinions: Robert J. Shiller from the Yale University, Nobel Prize laureate in 2013: *Is Economics a Science?* (November 2013) in the publication: *Jewish Business News*, 01.01 2014, par. 13.

<sup>3</sup> This '*Prize of the Central Bank of Sweden in memory of Alfred Nobel*' like it is officially called, was awarded in 2013 to Eugene F. Fama and Lars Peter Hansen, both from the University of Chicago, and also to Robert J. Shiller from the Yale University. These three researchers of public economy were rewarded for their studies on the issue of whether and how the movements in stock prices can be predicted. And at least Fama and Shiller have reached completely opposite positions in this respect. Fama emphasises the efficiency of financial markets, as the whole important information is included in the stock market prices in his opinion. Shiller, however, disputes this hypothesis; as an important representative of behavioural finance he states that price fluctuations in financial markets can mainly be explained by psychological factors and that consequently people tend to overestimate or underestimate stock prices, which may cause price bubbles. So a neutral observer is faced with the problem of what to think about the science of public economy if studies with completely opposite conclusions are awarded prizes in the same year with the value of several millions of Swedish krona.

For almost two centuries the construction called *Homo oeconomicus* ruled in the science of public economy. According to this, all persons engaged in economic activities are similar. They are said to be in principle strictly rationally acting beings led by clear preferences and motivated by egoistic interests; they are said to adopt their decisions considering full market transparency. This assumption has led to the concept of *invisible hand* which removes with the help of free markets all disharmonies which may have appeared meanwhile and will in principle direct economic activities in such a way that optimal results are achieved.<sup>1</sup>

Representatives of the neo-classical school which was active during the second half of the 19th century (above all William Stanley Jevon, Carl Menger, Marie Esprit Léon Walras) completely ignored psychological components of human behaviour analogously with the above-mentioned theories. Also the conception by Friedrich August von Hayek is based on the assumption that a fully informed economic agent always acts rationally and egoistically. Also the positions of the neoliberal school (Milton Friedman; in Germany Alfred Müller-Armack, Wilhelm Röpke and Ludwig Erhard) – with certain modifications – are largely based on this assumption. The assumption described served as a foundation for the mathematical treatment of the science of public economy. This created an illusion that it is possible this way to detach oneself from social sciences and obtain very exact results through marginal analysis, like in natural sciences.

The most influential researcher of public economy who vividly pointed out the questionable nature of such wishful thinking of economic theoreticians was John Maynard Keynes: "*Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits – a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.*"<sup>2</sup> The recent crises have demonstrated that John Maynard Keynes was right. He has referred again and again in his public statements to the inherent instability of market economy which has been left to its own devices. This again supports the analogy with animal behaviour if we observe the herd behaviour and mob mentality of agents in financial markets who often tend to feel exaggerated optimism or pessimism. A similar phenomenon can be seen also in other economic areas although not in such drastic forms as in the extremely volatile financial markets .

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<sup>1</sup> This figurative expression does not come from Adam Smith as it is often mistakenly thought nowadays but the researcher just used a saying which was quite common at that time for the clarification of certain connections. Smith studied the principles of psychological and moral philosophy of individual behaviour. This has been forgotten in the course of centuries and people tend to ignore that. For him, economics was a subdiscipline of moral philosophy. (Smith, A., *The Theory of Moral Sentiments*, Edinburgh 1759)

<sup>2</sup> Keynes, J. M., *The General Theory of Employment, Interest and Money*, London 1936, pp. 161-162; Akerlof, G. A./Shiller, R. J., *Animal Spirits, How Human Psychology Drives the Economy, and Why it Matters for Global Capitalism*, Princeton/Oxford 2009.

In the opinion of Joseph Stiglitz the instability of market economy systems is due to insufficient information. He bears in mind asymmetric information, in case of which some people know something which others do not. For Stiglitz, *invisible hand* is invisible because it does not actually exist. Consequently, markets are unable to direct the economy both efficiently and effectively at the same time without competent state regulations and interventions.<sup>1</sup>

Starting from the middle of the 1970s there has been an increasing opposition to the theoretical model of profit maximisation led by rationality. Models designed in such a way ignore the important factors determining human motivation. Therefore facts of psychology, biology and neurology have been increasingly taken into account in treatments of public economy. Such approach has led to the development of behavioural economics.<sup>2</sup> The most important statement is as follows: *Homo oeconomicus* does not exist. This construct, if used at all nowadays, can be regarded as a delusion of economists who are fond of models. Man is an extremely complicated being. Contrary to neoliberal approach, human behaviour is instinctive, contradictory, irrational, often influenced by social environment – e.g. by advertising or dominant opinions – and often also led by emotions. Human behaviour cannot always be regarded as egoistic but is often based also on moral principles shaped by education, personal characteristics and level of intelligence. Human behaviour may be guided by ethical considerations of general welfare or religious beliefs or be misled by religious sects or fundamentalists.

Neither consumers nor entrepreneurs are soulless cold calculators who calculate the probability of every possible future event and make their decision only on the basis of the result obtained. Even if they are economic agents who essentially proceed from strict rationality, they cannot act like *Homines oeconomici* in real world and achieve their objectives in all cases. They are unable to foresee all possible future events. People always adopt their decisions more or less under the influence of the factor of uncertainty. The more distant is the future, the higher is the degree of uncertainty. The sequence in time of adoption of decisions on economic activities, actual performance and results may be influenced by unforeseeable events in the surrounding environment, which may considerably change the actual final result.

Thus it is uncertain from the very beginning what the developments initiated by individuals eventually lead to. This applies to both individuals and the whole nations. Consequently, postulates of the science of public economy and the expected results of measures of economic policy taken on their basis can be achieved only to a limited extent. The belief that macroeconomic developments can be exactly

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<sup>1</sup> Stiglitz, J. E., *Making Globalization Work*, New York 2006, Preface, p. 7.

<sup>2</sup> An in-depth treatment of anomalies of human behaviour can be found in the publication: Kahneman, D./Tversky, A., *Prospect Theory: An Analysis of Decision under Risk*, *Econometrica*, Vol. 47 (March 1979), pp. 263-292.

described by using certain models,<sup>1</sup> is an illusion, let alone their definite forecasting. The science of public economy has to overcome the customary thinking along the *ceteris paribus* lines and the resulting tunnel vision.

Economy does not follow the laws of natural sciences which are characterised by clear causality, i.e. connection between cause and effect. Processes taking place in economy are mainly determined by actions of people made of flesh and blood, therefore economic agents are the determining factors who spontaneously change their opinions and can behave completely differently than expected. It is mistaken to believe that economic processes can be described and forecasted by using mathematically structured models based on statistics. Models of public economy are said to *describe people rather than magnetic resonances or fundamental particles*.<sup>2</sup>

Atypical developments have been observed in financial markets in the low interest rate phase. Positive information on economic cycles usually lead to the recovery of markets and increase in rates. The experience has shown, however, that an extremely slack interest policy may lead to an opposite response. This happens when market actors are afraid that banks will soon return from the monetary policy of the crisis to normal monetary policy. On the other hand, ample supply of liquidity and low interest rates may induce investors to risk more to earn higher profits. Consequently, the risk of excesses increases. Also the investment behaviour of businesses shows signs of uncertainty as decision-makers do not know whether and when a change in the direction of central bank policy and in the whole economic development can be expected.

It is not enough to study the coming into existence, distribution and use of limited resources. This describes only pure exchange economy. Supply with financial resources and the financial markets, knowledge of sociology, psychology, neurology and biology, also philosophical, ethical and ethnic aspects have to be taken into account in scientific research as much as possible. The science of public economy can be brought closer to reality and become more plausible and therefore provide a competent basis for the adoption of decisions on economic policy only if it is better related to the results achieved in other research areas.

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<sup>1</sup> Researchers of public economy often use the vague expression *ceteris paribus* in their theoretical discussions when making any assumptions – in a way this has the effect of absolutism in advance.

<sup>2</sup> Shiller, R. J., Is Economics a Science? (06.11.2013) in the publication: Jewish Business News, 01.01 2014, par. 13.