Rethinking Economics

The formal study of economics is now several hundred years old. It has grown and advanced as a field of study through a turbulent history of democratisation, industrialisation, World Wars, Great Depressions and now a globalised digital economy of uncertain consequences. The most famous definition of economics was Alfred Marshall's, in the early 20th century:

> "…*Economics is a study of mankind in the ordinary business of life; it examines that part of individual and social action which is most closely connected with the attainment and with the use of the material requisites of wellbeing. Thus it is on the one side a study of wealth; and on the other, and more important side, a part of the study of man*." [1]

In later decades, a movement to make economics more scientific reduced its scope and restructured it as a market-based science focused on exchange processes. As a result, the definition of economics also changed. Pick up any modern microeconomics textbook and you'll read something like this:

> *"Economics is the social science that examines how people choose to use limited or scarce resources in attempting to satisfy their unlimited wants."*

Today neoclassical economics has strengthened to the point where it represents a kind of sacred orthodoxy – the cornerstone of legitimate thought and policy. However, this orthodoxy is now being challenged by the reality of persistent financial crises and economic challenges on an historic scale. Neoclassical economics' strengths as an exchanged-focused science are also its weaknesses. A narrow market-centric field of study and an analytical reliance on scarcity can be argued to have contributed to many of the ills that plague modern society. Neoclassical economists are seemingly unable to deal with growing inequality, the rise of a new digital economy or to help identify undocumented risks, because – in part – the complexity of capital is an understudied area of economic thought.

Why we need to rethink economics today?

It is important to rethink economics because the economy has changed its engine of growth and expanded in scope to include digital forms of value. In the '50s, neoclassical assumptions about the nature of capital were reasonable; the national economy could then fairly accurately be modelled by aggregating industrial output, fixed capital inputs and productivity. However, given the paradigm shift that has taken place over the past few decades, commercial reality is forcing a radical rethink of the entire structure of value creation, capital theory and economic thought. Incorporating modern forms of capital value into the analytical framework of economics will have transformational consequences for us all. Now is the time for innovation, revision and re-launching a newer modernised study of political economy.

Normative economics – acknowledging the importance of these deep changes – employs a Six Capital analytical framework.[2] This expanded inventory of capital forms includes the three industrial forms, 'real' capital, financial capital and (limited) forms of natural capital, but – in addition – provides an expanded capital framework which recognises that human capital, intellectual capital and relational capital (networks) are the principal drivers of commercial value today.

The normative productive formula provides strategies for mixing and combining a wide variety of new and existing capital forms to create different kinds of value with very different (management and accounting grade) intangible assets.

To illustrate the disconnect between neoclassical thought and the real economy, we will do a quick summary of some of economists' outmoded assumptions.

A critique of modern economics

Is economics a hard science?

It is not true that economic thought is a set of scientific and therefore enduring truths. Economics is and always has been a dynamic system that aligns itself around the value creation activities of the period. For example, Adam Smith, (a professor of moral philosophy, not an economist) was fascinated by the productive power of industrialism. As a result, the economic study he initiated – subsequently advanced by financier David Ricardo – emphasised '*production of goods and services'* as the key focus of what was to become economic analysis.

Neoclassical economics, dating from the Marginal Revolution in the 1870s, shifted the focus of economic thought from production to market exchange processes. As such, the neoclassical school emphasises the '*exchange of goods and services'* as the key focus of economic analysis. More recently, monetarism, the latest version of the neoclassical school, hypothesised market efficiency to such a high level of frictionless perfection that *'monetary policy'* became the controlling agency of national economic output in the short run and on price levels in the longer run.

There is no doubt that the majority of economists operating in the neoclassical system support a 'scientific' framework. But there have been notable exceptions. Thorstein Veblen, an American heterodox economist writing in the early 20th century, recognised the social dynamics underpinning economic phenomena and suggested an alternative framework that he called 'institutional' economics. Veblen recognised that market relations were not governed by immutable scientific laws or ordered like the movement of planets in our solar system. Market relations are a function of human passions, interests and desires. Economics then should vary with the times, responding to the changing landscape of society and the particulars of value creation in a given era. While Veblen's institutional approach did not seriously impact neoclassical orthodoxy, it did begin a process of incorporating normative phenomena into economic thought.

Economics is an abstract field of study

Economists define their science as the study of market exchange processes. From this perspective it is not surprising to find that the surface phenomena of economics are those of exchange: supply, demand and price, all quantifiable elements that lie within the boundaries of the market dynamic. According to economic historian Eric (Lord) Roll: "*…even the transactions of the productive processes are seen to resolve themselves into the purchase and sale of raw materials, capital goods, money capital and labour…"* [3] The central problem of economic inquiry becomes the explanation of the exchange process or, more particularly, the explanation of the formation of price.

The normative critique of orthodoxy begins at the core i.e., the idealisation of markets and market forces that underpins the neoclassical analytical framework. Neoclassical economists romanticised markets, elevating them to near divine status. Markets were thought of as frictionless institutions of attuned perfection whose internal mechanisms allotted value dispassionately in a supra-rational scientific order. As a result of this generalisation, neoclassical economics became divorced from the practical world. It's little wonder that the profession missed the 2008 Financial Crisis; economists of the neoclassical school were (are) theorising in an abstract universe where such crises simply don't occur.

Neoclassicism's flawed organising principles

Economics has a variety of outdated industrial assumptions, like capital theory and the labour theory of wages. For example, the assumption of scarcity, which underpins the mathematical integrity of all econometric models, depends upon the physical limitations of capital inputs. These restrictions in part explain why economics is so often associated with control and exclusion.

The new digital economy is dominated by intangibles that do not obey the laws of scarcity, do not necessarily erode over time and – in the case of relationships – have complex underpinnings that do not lend themselves to mathematical reduction. While it's true that scarcity remains relevant for physical capital, new forms of capital today are increasingly common in modern value creation. Abundance and not scarcity is rapidly becoming the central organising principle of the digital economy.

Orthodoxy also tends to ignore accounting, a core area of normative thought. Things of value have always existed, but wealth accumulation in western capitalism dates from the introduction of double entry bookkeeping in the 16th century. Why? Because wealth is stored in assets, and it is the alchemy of accounting that formalises 'things of value' into leverageable wealth. Assets are important; they are the source of both earnings and the institutional form within which value accumulates. Neoclassical thought under appreciates these strategic value sources, over-focused, as it is on price determinations, in the moment.

Regrettably neoclassical thought also has deeply buried class biases. Because neoclassical models ignore asset production, the returns to 'real' capital and human capital are disproportionate. Presently, 'real' capital and money capital own all the underlying assets and equity of the corporation. This is where value-added returns and capital accumulation takes place. Labour, although acknowledged as a significant contributor to the productive function, remains (with the exceptions of investment banking and the tech sector), structurally excluded from the returns generated from these longer-term sources of value.

These flaws in theory are not confined to the science of economics; they influence, and prejudice, downstream disciplines such as accounting, financial reporting, and business decision-making.

History confirms that capitalism advances on two major long-term trends:

1. Capitalism expands the property matrix. This can be demonstrated in successive (and accumulative) revolutions in property institutions from feudal agricultural to mercantile to industrial to digital economies; major paradigm shifts in capitalism's engine of growth has driven massive expansion in society's asset foundations.
2. It has (somewhat after the fact) widened the estate of ownership, increasing the proportion of individuals owning and controlling those productive assets, levelling the playing field of value distribution.

In the digital era, we're failing on both fronts. We do not recognise the new assets of the digital era, thereby betraying trend #1, and through uncontrolled digitisation of the economy, a vast concentration in property 'ownership' is taking place with mega tech firms monopolising ownership of (trespassing upon?) individuals' private data, effectively reversing trend #2.

Normative reset for economics

Normative theory continues the tradition of reinterpreting economic thought in line with how value is created.

Normative theory starts with the reality that the industrial era with its factory-based system of production has been supplanted by a new digital economy. These new intangible knowledge-based engines-of-growth are global, instantaneous, and vastly different from the mechanical industrial-type production of the 20th century. And, importantly, the new economy's capital base and asset foundations are different-in-kind, often behaving in contradictory fashion to existing institutional norms and operating assumptions.

Over the last 15 years, Rethinking Capital, and now through the Foundation, has been exploring ways to answer one fundamental question:
How can we rethink and adapt modern capitalism to create a more prosperous, just and equitable society?

We therefore question:

- Is modern capitalism creating the future we want?
- Is it creating the environmental and social outcomes we need for a more just and equitable society?
- Is it aligning private interests with the evolving expectations of the public?
- Do we understand what is driving value in our economy?
- Do we know how to identify and account for this value?
- Do our decision makers have the transparency and accountability needed to drive future growth in a sustainable way?
- How can we address the levels of debt and economic stagnation we are suffering?

A revised economic paradigm would begin with a study of capital, understanding '*what it is', 'how it changes'* and *'how it drives value'* as a core competency, leaving markets/exchange processes as a secondary (if vitally important) arena of study in the capitalist value chain.

And our approach is simple. We take a normative rather than a market determinism approach to economic phenomena, while employing existing International Accounting Standards and other proven tools to solve economic problems.

The Rethinking Capital Foundation has embarked upon a root and branch reform of orthodox theory.
In the process we are mapping (a revised) normative theory's impact on economic thought, government policy-making, accounting practices and the prevailing 'theory of the business' in order to resolve economic imbalances and restore public trust in capitalism.

References and notes

[1] Marshall, Alfred. Principles of Economics, Book 1: Preliminary Survey. Originally published in 1890

[2] The Six Capitals framework for economics is primarily associated with the work of the International Integrated Reporting Council (IIRC). The IIRC is a global coalition of regulators, investors, companies, standard setters, the accounting profession, and NGOs.

[3] Roll, Eric Roll. A History of Economic Thought. First published @ Faber and Faber Limited, London 1938. Modern Economics, the second generation, page 395