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Cliodynamics: The Journal of Quantitative History and Cultural Evolution

A Textbook of Heterodox Economics

A Review of *Foundations of Real-World Economics*, 3rd edition, by John Komlos (Routledge 2023)

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Imagine yourself dictator of a low-income state. Your goal is to grow the gross domestic product (GDP) of your country. This will accomplish two goals: increase economic well-being of your subjects and, thus, their support for your regime; and increase the tax revenues that you can extract, giving you more resources to reward followers and buy off potential rivals. You invite an international crew of economists to advise you on the best way to accomplish this goal. They explain to you the Principle of Competitive Advantage, one of the fundamental results in economics, and recommend opening up your country to international trade. Following this advice, you slash the barriers to imports and remove all subsidies to exports, and then settle down to wait for the promised economic miracle. But things go wrong. Export-oriented production based on modern technologies fails to materialize. Manufacturing firms, previously protected by high tariffs, start going belly up. Workers are fired and have no recourse but to look for employment in informal service sectors, such as petty trading. Overall economic productivity declines, and so does GDP per capita. Tax revenues collapse. Disgruntled lieutenants, whom you cannot bribe anymore, turn into opposition leaders who mobilize the immiserated population against your regime. You are lucky to escape with your life (and a suitcase of cash) by jumping on your personal jet to fly to Miami.

This is just a fairy tale or, if you will, a "morality play." But the real-life experience of countries that successfully modernized their economies, from the 19th century US to 20th century East Asian "tigers", invariably involved (initially) high protective tariffs and direct subsidies to their budding industries—the opposite of what the Washington Consensus urged them to do (Rodrik 2015). Furthermore, models that were developed to understand how markets really work in low-income countries explain why countries that followed the Washington Consensus failed. Yet, according to a survey conducted by the University of Chicago's Booth School of Business, nearly all economists—96 percent—strongly agree with the following statement: "Free trade improves productive efficiency

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and offers consumers better choices, and in the long run these gains are much larger than any effects on unemployment" (Turchin 2017).

What's wrong with economics? Why do economists give such spectacularly bad advice? If you want to find an extended and persuasive answer to this question, read John Komlos' *Foundations of Real-World Economics* (FoRWE).

Typical economics textbooks, or "black board" economics, as Komlos refers to it, start with, and spend most space on, the core principles of neoclassical economics. The fundamental assumptions of mainstream economics include *homo economicus*, perfectly competitive markets, and perpetual equilibrium. Most textbooks at some point discuss real-world complications, but these tend to come as an after-thought.

The approach of Komlos is radically different. Let's take one of the fundamental assumptions of mainstream economics, that economic agents aim to maximize their utility, expressed in purely materialistic terms, without regard for the preferences of others. There is so much wrong with this assumption that it is little wonder that an economics theory based on it yields wrong predictions. Here are some of the most important ways in which real people differ from *homo economicus* (for a more comprehensive list, read Chapter 4 of FoRWE).

Most people are motivated by additional considerations, rather than just material advantage (aka greed). Considerations of honor, a sense of fairness, and a concern for the well-being of others, to name just a few, may trump purely selfish motives. And thank God for this, as selfish rational agents could never cohere in a functional society (Turchin 2016).

Real people don't have complete, precise, and detailed knowledge of the state of the economy to determine which choices lead to *maximizing* utility. Instead, we use heuristics and aim at *satisficing*, achieving a "good enough" outcome.

Our desires and aspirations, once we satisfy basic needs (food, shelter, etc.), are heavily shaped by others, as well as society at large. This results in conspicuous consumption, following fashions and fads, and imitating prestigious individuals. Stock market bubbles cannot develop in a *homo economicus* world.

Most people are risk averse. In a situation where you either get $50 with certainty, or $100 with 50% chance (and zero if you lose), the overwhelming majority of people choose a certain gain of $50, even though the expected utility of the gamble is the same.

The utility function is reference-dependent; it's relative, not absolute.

The last point is particularly important, so let's dwell on it a bit. To illustrate this principle, Komlos uses an example. Cathy learns that her investment of $4 million declined in value to $3 million, while Susan learns that her wealth increased from $1 million to $1.25 million. Who is happier? According to the standard economic theory, Cathy is happier because her level of wealth (3 million) is much greater

than that of Susan (1.25 million). In real life, of course Cathy is despondent, while Susan is jubilant.

This insight has important implications for many real-world issues. For example, in my recent book *End Times* (Turchin 2023), I discuss why many people in US and EU feel immiserated, even though they are immensely more wealthy than, say, a typical citizen of Chad. This is because the reference point for them is not Chad (of which they have no direct experience, anyway), but the level of economic well-being they experienced while growing up in their parents' homes. As one participant in an anti-government demonstration in Athens expressed this principle, "It is not right that children should be worse off than their parents!"

Komlos doesn't stop at critique; he also sketches out how real-world economics should be reformulated by basing it on more realistic models of human behavior. In particular, he describes "prospect theory" as a possible future foundation of economics. It is an alternative formal model of human decision-making, based on experimental observation of how people weigh risks and rewards, and is being incorporated into what is called "behavioral economics" (Thaler 2015). This theory was developed back in 1979 by Daniel Kahneman and Amos Tversky (the fathers of behavioral economics). According to Wikipedia, it was cited in the 2002 decision to award Kahneman the Nobel Prize. However, it is rarely discussed outside specialist circles, so the first time I, not being a professional economist, encountered it was in FoRWE. There is a pattern here. At one point (p. 5), Komlos lists 10 economics Nobelists, including Kahneman, and asks, what do they all have in common? The answer: their contributions are omitted from mainstream economics textbooks or, at best, relegated to obscure footnotes.

Note that Komlos proposes prospect theory as the *future* foundation of economics. But such an economics has not yet been developed to the point where we can throw away *homo economicus*, relegating it to a mere mention in the historical section of economics textbooks, just as phlogiston is mentioned in physics textbooks. Equally important, we need to toss on the trash heap of history many other assumptions of the conventional economics, which has been discredited by experimental evidence: efficient markets, perfect competition, the invisible hand (which is "often invisible because it is not there"), and perpetual equilibria. In later chapters of FoRWE Komlos illustrates how the flawed foundations of "black board" economics resulted in failure to foresee the negative effects of globalization, the financial crisis of 2008, and the rise of right-wing populism.

FoRWE doesn't offer a systematic presentation of theory for real-world economics, based on the alternative foundations that would be buttressed by our accumulated knowledge regarding how real people behave. This is not a critique of Komlos, because such an immense labor cannot be done by a single person. Furthermore, an alternative theory of economics would have to abandon the

simple analytical models that can be solved on the blackboard. Instead, the new theoretical corpus needs to be built by models capturing real-world complexity that are solved on the computer. Such work is ongoing, if incomplete. You will soon be able to read about in a forthcoming book by my complexity science colleague Doyne Farmer (Farmer 2024).

Meanwhile, I recommend without reservation *Foundations* by John Komlos to all who are dissatisfied with conventional economics. I learned a lot reading this textbook and, I am sure, so will you.

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