Constrained by Economics
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Introduction

Neoclassical Economics is defined in terms of the economy and human behaviour, a science of choices and effect of scarcity and coordination of processes. Thus it's defined as the science of decision-making and studies how the society uses limited resources.

The digital economy is flourishing, while a new more egalitarian society is waiting to emerge in the 21st century, but the mindset and economic institutions that need to change in order to facilitate this transition are locked in the past. This paper examines how out-of-date assumptions and industrial-era myths continue to constrain the transition to a more creative (knowledge-based) economy.

Capitalism has fuelled growth and innovation for generations, lifting millions out of poverty. Economics, as an analytical framework for the study of capitalism, once served us well. But the digital revolution and the rise of intangibles have fundamentally altered the ‘engine of growth’ and operating system of modern capitalism; it is increasingly clear that neoclassical economics is no longer fit for purpose.

What needs to be done? The field of capitalist thought needs rethinking, reorientation and renewal. Since economics informs the rules of accounting, the impact of economics on accounting practice is also discussed. ‘Constrained by Economics’ then sets out a few principles of normative economics: a framework for building a better future.

The Great Betrayal

Free Market Capitalism: The purest form of capitalism is free market or laissez-faire capitalism. Here, private individuals are unrestrained. They may determine where to invest, what to produce or sell, and at which prices to exchange goods and services. The laissez-faire marketplace operates without checks or controls.

The growing distrust in capitalism is not irrational. Systemic flaws in neoclassical economics have created a faith like belief in the ‘miracle of the market’ which instead of adequately rewarding participants in the capitalist system, concentrates wealth while actively discriminating against wage earners, innovative start-up businesses and the creative fields of endeavour that young people were encouraged to build their futures in.

For young people today, the world looks much darker that it did for previous generations. In the immediate post-war era, there was a strong sense that the ‘west’ – although far from perfect – was the great liberator of humanity, a champion of justice and equality. Regrettably, ‘free market’ capitalism has been unable to deliver on that noble promise, and in its place a stagnant corpus of institutional elitism has emerged that has dangerous consequences.

Today a combination of climate emergency, gender and racial inequality has turned the most highly educated, worldly, and creative generation in silent opposition to the status quo. And it is little wonder, the lives of many young people today are governed by fear, not hope; hesitation, not optimism; and presuming they want an education and a normal life, a fear of never escaping the well laid debt-trap that will entangle them for the rest of their lives.

But, all this can be addressed if a normative approach to economics and accounting are employed. What follows is a summary of the myths and contradictions in the capitalist system, as well as the opportunities that will emerge if we break ties with the bounded thinking of our past.
Constrained by lack of historical perspective...

In this next section we will examine the limitations of neoclassical thought. We will be introducing some of its out-of-date operating theses and antiquated assumptions (spoken or unspoken) and comparing them with the ‘real’ economy.

Neoclassical Myth #1: The past has no bearing on the present.
Neoclassical Myth #2: Capitalism is a set of fixed institutions that cannot be changed.

The distinction between the science of economics and capitalism presents a serious problem, for capitalism encompasses a much broader subject area than neoclassical economics. It is true; economics can be described as a highly articulated set of fixed (largely mathematical) formulae. Capitalism on the other hand is not now, nor has it ever been, a set of fixed institutions; on the contrary, capitalism is a dynamic historical flow that experiences phase-like transformations that are equivalent to ice becoming water and then steam.

This historical flow is driven by a series of asset revolutions that radically altered the engines of growth in the economy at critical points in history. Asset transformations have created value eruptions that triggered a variety of intended and unintended consequences. In the first instance it was new rights of property that materialized in society, which tended to concentrate wealth. But shortly thereafter, human and civil rights strengthened in order to balance and/or rebalance the capitalist system. The reality is, capitalism is a dynamo that has experienced several quantum leaps, resulting in greater productivity growth, and eventually a wider distribution of the product of capitalist production.

Western capitalism has evolved through a series of changes in its underlying ‘engine of growth’ – with accompanying asset revolutions.

- Wave #1: The first revolution began with the rise of trade and the introduction of a new suite of mercantile assets in the 16th century. That was capitalism’s First Wave.
- Wave #2: The Industrial Revolution was capitalism’s Second Wave. It launched another asset revolution that expanded society’s productive capacity by orders of magnitude. Industrialization started in the economy but soon transformed life and culture, creating in time a unique ‘industrial society’ based on the consolidation of the new ‘Factory Model’ of production, nation building and the political empowerment of the property-owning middle classes. This was followed by the consumer revolution that dominated later decades of 20th century capitalism.
- Wave #3: Today, capitalism’s Third Wave is rising on the back of another asset revolution. This time the transition is launching a creative revolution that is underpinned by intangibles like software, networks-of-value, big data, and knowledge; it is generating new classes of assets and formalizing the value in human relationships on an unprecedented scale.
Constrained by an industrial mind-set...

Neoclassical Myth #3: ‘real’ capital is all the physical manufactured elements in the productive process

It is commonly accepted amongst orthodox economists that economic value is created through a process whereby ‘real’ capital (and financial capital) is combined with labour to create something of value. This orthodox production assumption was established in the late 19th century and remains current to this day. Ever since those industrial days, capital for an economist (and accountants) has been all the physical manufactured elements (plant, equipment, and machinery) that are involved in the Factory Model of production. Labour is simply the means to mobilize the ‘real’ capital for productive purposes.

But today capitalist production is no longer confined to centralized factories employing physical capital (tangible assets). Over the past half-century new digital value drivers and intangible capital forms have emerged in the marketplace and they now dominate the commercial world.

Normative economics acknowledges the importance of these deep changes and employs six capital forms. The normative production formula involves the combining, mixing and merging of these various forms of capital (the raw material of value creation) to generate asset quality commercial value forms.

**Newer Intangible Capitals**

- **Human-Creative Capital**: Perhaps the most significant change in the ‘new’ economy is the rise of labour to a new status as human-creative capital and – at long last – equivalence with more traditional capital forms. Orthodox assumptions concerning labour regarded the ‘human’ component of production as a (troublesome) cog-in-the-machine. Today in a knowledge economy, humans’ ability to create, innovate and cooperate for productive purposes are the keys to success for the modern corporation.

- **Intellectual Capital**: Most of the innovations taking place in the economy today involve the creation of asset quality products and services like social media ‘apps’, software, patented technologies, copyrighted materials, and trade secreted technologies/business processes derived from the creative process.

- **Social and Relational Capital**: The most difficult form of intangible capital for many to understand is social and relational capital. While it is true you cannot own your employees, customers or investors, a company can ‘own’ (i.e. take responsibility for) the relationship, and strengthening that relationship builds asset quality value. The relationship-based assets derived from this capital form include various networks-of-value, such as customer equity and corporate reputations. Consider that one of the world’s most valuable assets is Facebook’s network (user base) of volunteer data contributors. However, despite the obvious commercial value, neither this network asset (nor the big data assets it generates) appears on any balance sheet.

- **Natural Capital**: Natural capital incorporates the limited and often irreplaceable resources of our natural world. Of course, natural capitals in their industrial form, oil and gas leases, mineral wealth and water rights etc. have existed for centuries. But the rise of the natural environment, as a vital social concern has raised the issue of downstream carbon and waste management ‘liabilities’ to a fever pitch. The costs of these liabilities are increasingly being apportioned to corporations to the distress of management and investors.
The creative endeavour of the intangible economy is how our society is choosing to generate wealth now and in the future. Yet the core economic institutions we use to formalize the value in capital are stuck in the industrial past and need to be updated with the reality of how our economy really works.

**Constrained by economic theory...**

**Neoclassical Myth #4: economic thought is a set of universal and unalterable truths.**

Truth is economic thought has evolved in the past and needs to continue to do so. For instance:

- The classical school of political economy, initiated by Adam Smith and David Ricardo, emphasized ‘production of goods and services’ in a broad ranging study of wealth creation in society.
- In the late 19th and early 20th century, a mathematical ‘science’ of economics narrowed the field of study to the ‘exchange of goods and services’ studied in idealized market exchange conditions.
- In the 1930s, John Maynard Keynes shifted macroeconomic thinking away from market exchange to aggregate demand (total spending in the economy). He advocated utilizing fiscal and monetary policies to mitigate the impacts of the Great Depression.
- More recently, monetary policy became the major controlling agency of national economic output in the short run and on price levels in the longer run.

**Neoclassical Myth #5: Capitalism can be explained through studying market exchange processes**

When it was introduced in the late 19th century, neoclassical economics narrowed the field of study of economics and significantly changed its analytical focus. The effect transformed the language of economics to a mathematical one and left major areas of economic analysis (those that lay outside the narrow confines of the market) to an institutional “twilight zone” called externalities.

Important issues, such as capital and how it evolves, or how a capitalist system ought to deal with environmental pollution or the distribution of wealth, were now – technically – outside the scope of economics – secondary fields of study that should be left to other professions rather than the primary focus of study.

**Normative Economics...**

**Normative Economics**: is a part of economics whose objective is fairness or what the outcome of the economy or goals of public policy ought to be. Normative economics includes social choice theory and public economics, which studies the effects of the public sector on society and the economy as a whole.

Normative economics differs from traditional orthodoxy in that its policy objectives are linked to socially acceptable outcomes. Normative economics is both deductive and conspicuously focused on the ‘just’, what ought to be. Normative belief systems are, in other words, proactive. These principles stand in contrast to positive economics that is reactive and impartial; economists of this school claim to simply reflect scientific (i.e. market determined) reality ‘as it is’.

Like orthodox neoclassicism, normative economics begins with the premise that capitalism is founded in the private ownership of property. However, since both the own-able ‘things of value’ and the legal institutions that provide individuals’ title to property are social in their origins; society, its norms, values, and sensibilities are both the starting point and strategic goal of normative economic thought.

Rethinking Capital’s version differs from conventional normative economics by deliberately shifting focus away from the market as a central analytical framework, while encompassing a broader scope that includes:
- Market precursors or ‘internalities’ like the institutions of property and ownership and the capital forms that drive modern value creation.
- Market ‘externalities’ like the accumulation and distribution of wealth (which in neoclassical thought are assumed to be optimized by efficient markets), and issues of urgent social concern like carbon pollution.

Rethinking Economics...

1. From market purity to pragmatic realism

Neoclassical economics biggest flaw is its conceptual framework, which elevates the importance of abstract theoretical models analyzing frictionless market exchange processes. It is little wonder that the profession missed the 2008 Financial Crisis; economists of the neoclassical school were theorizing in an alternative universe where such crises simply do not occur.

Normative economics is based on normative theory/approaches. It starts from a position of pragmatic realism; it focuses on capital and the real economy and examines the evolving nature of capitalism as a dynamic force rather than focusing narrowly on markets; moving beyond simple (objective) exchange value to encompass the idea of (subjective) value-in-use.

2. From scarcity to abundance

Neoclassical economics relies on:

- **Markets being perfect, either in equilibrium or trending toward it** – which simply is not the case in the practical world. Irregular, multiple disequilibria is a far more likely outcome.
- **Economic laws that are contingent upon the Iron Law of Scarcity** - the idea that all capital goods are physical and, as such, subject to limitations on supply and have a definitive cost of production.

Normative economics appreciates that real markets are human structures of power that generally sustain themselves in disequilibrium over very long periods of time and recognizes that scarcity only applies to physical capital. Abundance and not scarcity has increasingly become characteristic of the digital economy. This new 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.

3. From markets to capitalism-as-a-whole

Economics is (or should be) capital centric, not market centric.

An over-focus on market exchange processes confuses cause and effect and diverts attention in economics from the issues that really matter. Focusing on market exchange ignores the fact that capitalism is rooted in capital. Capital and its derivative assets form the productive heart of capitalism. They are the source of output (and therefore corporate earnings), the engine of growth and mechanism of change in capitalism. They are the keys to resolving divisive issues such as the social responsibilities of business and clarifying the theories of accumulation and distribution of wealth in capitalist economies.

4. From labour to human-creative capital

The fatal flaw that lies at the heart of neoclassical theory is the unequal treatment of capital and labour.

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1 According to accounting historian, Richard Mattessich, normative theory construction consists of testing all basic underlying assumptions for social alignment; the application of deductive logic together with supporting evidence; leading eventually to as many practical applications (models) as feasible.
Regrettably, because economists’ equilibrium models do not have a third dimension incorporating the axis of time, neoclassical analytics exists only in a moment in time, determining optimal output and price in instantaneous exchange transactions.

Although labour and capital are recognized as equivalent factors of production, capital presently owns the future; all the assets (and profits) generated in the productive process, where value-added returns and capital accumulation takes place over time. Labour was (and largely remains) structurally excluded from ownership of these longer-term sources of value.

In simpler language, neoclassical theory supports a system where real (and financial) capital gets rewarded twice: economists talk of the cost of capital (i.e. the marginal utility of capital) and the returns to capital. Labour on the other hand is only a cost (i.e. the market utility of labour); in other words, human capital is rewarded only once and with the least valuable consideration. Consequently, economic inequality and class conflict are built into economic theory, and by association, the capitalist system at the foundational level.

This has led to a century and a half of societal violence, labour disputes, Trade Union movements, conflict and huge concentrations of wealth and power. This structural flaw has now become critical as ownership of all intangibles, including private personnel data, is concentrating into the hands of a very tiny digital minority – disenfranchising the majority and further unbalancing the capitalist system.

How normative solutions can address the challenges we face...

Example: Resolving the climate emergency

Start with Alignment to Social Norms:

Social Norm: the carbon problem has become an overwhelming societal concern. Social norms are moving rapidly as this crisis grows ever more dangerous. Normative economics would acknowledge this evolving social norm and set rapid implementation of carbon mitigation as a strategic goal of policy.

Analyse Present beliefs:

Economic beliefs: Neoclassical theory defines capital narrowly as physical plant and leaves the societal outcomes of environmental policy to the ‘magic of the market’.

Accounting beliefs: Accountants treat corporate expenditures invested to create a ‘Green Future’ as costs on the income statement, thereby creating financial disincentives for corporations that want to transition to net-zero.

Deductive Logic:

1. Carbon emissions create a real environmental liability.
2. The responsibilities for carbon pollution are not distributed equally, corporations consider their emissions as ‘externalities’, which means they become society’s problem.
3. Deductive logic demands that emitters of carbon should take responsibility for their carbon emissions and contribute to building a sustainable restorative economy.
4. Traditional accounting does not recognize newer intangible assets like environmental design, specialized implementation processes, and corporate reputation assets.
5. The urgency of the crisis demands that the problem is dealt with expeditiously, ideally with minimal intervention.
6. If the practice of accounting can be modified to rectify this problem, then accounting reform is the option of choice.

**Model(s) to Implement:**

**Balance sheet capitalization model:** the minimum possible intervention to accomplish this goal is to modify the practice of accounting. Action to acknowledge the full range of intangible assets on reformulated balance sheets and to formalize the treatment of green investments is step one.

This would allow any qualifying expenditure incurred in the mitigation of carbon liabilities to be capitalized on the balance sheet into appropriate intangible asset classes, and therefore not charged to the income statement. Such a system would reverse the financial incentive structure for net-zero investments, encouraging planning and investment while strengthening shareholder equity and accelerating climate mitigation.

**Meaningful Outcomes:**

This model is logical, conforms to existing International Accounting Standards, reinforces growing societal concerns and – implemented widely – would meet the challenge of accelerating the transition to net-zero carbon emissions and climate sustainability.

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**RETHINKING CAPITAL**

Rethinking Capital believes that answers to the many challenges we face as a society lie in capitalism. But by reinventing economics, and examining capitalism’s complex terrain through a normative lens, economic thought can simplify the complex and clarify the solutions considerably.

*Normative theory provides an approach that is practical, proactive, deductive and focused on what ‘ought to be’. One that balances optimal value with well-being and puts society, with its changing norms, values, and interests at the heart of economic study. When fully implemented it has the potential to unleash capitalism’s much underappreciated potential for good and pave the way to creating a more prosperous, just and equitable society.*