BENEFICIAL ECONOMICS

Significant advances in the domain of economics that have potentially beneficial practical significance

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During the last year, policy focus has been on the recovery from the Covid-19 pandemic. Whereas most imagined there would be a transition to refocusing on climate change the state of the economy linked to the cost of living and then the invasion of Ukraine, and sanctions applied, in particular, have exacerbated the cost of living crisis as a result of sanctions causing a sharp rise in the prices of petroleum, gas prices and petroleum derivatives. The combination of the Covid-19 and sanctions on the economy have accentuated the realization of the risks associated with dependency on imports for critical goods and commodities. An increasing attention is being given to the subject of national economic resilience against a background of lower income countries facing the combination of high debt, rising energy, fertilizer and food commodity prices. Therefore, increasing attention is directed at ways to reduce reliance on debt associated with economic development loans, in the future. With these concerns, the subject of climate change actions appear to have taken a lower priority position in governments with constituents being faced with increasingly serious short term cost of living issues.

Effective responses depend upon a correct foundation of economic theory that provides the basis for policy design and implementations that are practical and financially feasible and secure the intended beneficial results. There is a need for policies that have traction by delivering the intended results within the desired time frame.

Having identified those developments in economics we judge to be of significance in opening up new potentially beneficial theoretical and policy vistas, we have concentrated this Review on the following topics:

- The analysis of macroeconomic policy theory and instruments
- Issues arising from monetary policy practice, central banks & the democratic deficit
- The essential role of public choice in achieving recovery and sustainable real growth

The analysis of macroeconomic policy theory and instruments

Recent analysis and reviews have raised doubts as to the efficacy of macroeconomic policy instruments related to an apparent inability to stem significant and continuing rises in income disparity and inflation in financial and physical asset prices as well as goods and services.

The conventional policy instruments include:

- the setting of interest rates
- target money supplies through banks to retail and commercial customers
- target monetary supplies through government borrowing and direct expenditure
- Taxation:
    - personal income tax
    - corporate tax
    - circulation taxes e.g. VAT
    - levies of various kinds e.g. on fuel
    - social insurance levies

The presumption of policy makers is that these instruments fit into a cause-and-effect relationship. Therefore, the instrument tends to be associated with a policy target, objective or desired result. Another way to view this is for policy instruments to create incentives for changes in behaviour.

It is difficult to analyse the efficacy of this policy theory without determinant models which provide a formula linking policy instruments as determinants of the policy targets. There is, and there have been, serious issues associated with the application of correlation statistics between indicators and associated changes in economic factors which quite often are not, in reality, cause and effect relationships.

One of the early criticisms of monetarism was made by Nicholas Kaldor in his paper, "*The new monetarism*" in the Lloyds Bank Review in 1970. In reviewing Milton Friedman's work, Kaldor observed and reasoned that Friedman had assumed that data correlations were the result of cause and effect relationships where the determinant as money volumes and the effects were "*raised demand*" and economic growth. Kaldor's main conclusion was that Friedman's cause and effect relationship was the wrong way round, with monetary injections not having the effects predicted. This position, if correct, was a prognosis for significant problems if monetarism was adopted as a central macroeconomic policy component in the future. However, in 1975, the Labour government adopted a monetarist approach as did increasing numbers of governments in that period, in an attempt to control stagflation.

Today, many monetarists and, in particular, central banks and governments still adhere to this Friedman logic generally summarized in the Quantity Theory of Money (QTM).

On the question of the introduction of externally injected money volumes (exogenous) causing inflation Kaldor observed that it is banks that respond to endogenous demand for investment funds in the supply side production of goods and service sectors. Since most such investment is generally applied to expand plant or efficiency through technological and technique innovation, the use of such money seldom causes inflation and in reality is often deflationary in the sense that increased downstream efficiency, higher wages, higher profits and prices set at relatively lower levels to increase market share. Therefore, this presents a relatively stable situation in terms of prices (inflation) and it is also a wholly endogenous function managed by the supply side and adequately handled by banks or savings with no need for exogenous monetary injections. The main point is that under such circumstances higher money volumes are not inflationary.

In order to comprehend Kaldor's logic it is useful to review work initiated in 1975 by Hector McNeill who analysed stagflation and by 1976 had created the foundation for a new perspective on economics, "*The Real Incomes Approach*". McNeill showed that inflation under the conditions of the 1970s was caused by cost-push inflation and that under competitive conditions money volumes have no impact on the price of goods and services because this central bank action does not set prices. Prices are set by companies to maintain sales or increase market share and therefore they have no reason to raise prices simply because money volumes in the economy have increased.

As an added detail, McNeill spoke in terms of real growth (more for less) which is also the line of thought followed by Kaldor. In subsequent analysis, McNeill also established that not only that price levels are entirely set by companies and that money volumes have no effect on this process. In all economic conditions, the principal reasons for inflation come as corporate responses to rises in input costs or cost-push inflation.

Kaldor did not refer, and neither did Friedman, to the situation with respect to assets (physical and financial). In 2020, McNeill, based on the results of quantitative easing (QE), which generated a bubble in asset prices, drew attention to the fact that the Quantity Theory of Money (QTM) contains no variables that relate to assets. McNeill referred to the Cambridge equation, which is a version of the QTM with the single liquid asset of saving added, as an improvement of the QTM. Considering this to be an inadequate representation of monetary dynamics, McNeill extended the Cambridge equation by adding all of the principal missing variables, nine in total, including land, buildings, precious metals, financial assets, shares, rare art objects, crypto-currencies, commodities, savings and offshore investment. The resulting equation is referred to as the Real Money Theory (RMT). It is very apparent from this new identity that these 9 additional encapsulated markets significantly reduce the impact of money volumes on the prices of goods and services. The conclusion to be drawn, therefore, is that Friedman upheld a somewhat unrealistic representation in the form of the QTM and seems to look for data to support its

evidently unreliable predictions of the impact of money volumes on the prices of goods and services. On balance it would seem that Kaldor's observations were more correct.
Stagflation, starting in 1975, was an extreme case of cost-push inflation caused by the rapid rise in the international price of petroleum, an across-the-board major imported input for most economies in the world.

It needs to be registered that Kaldor's Review article was published in 1970, a year before the demise of the gold standard, three years before the petroleum price crisis and Black & Scholes derivative hedging model was published, eleven years before Reagan allowed companies to buy back shares in 1982 and twenty years before the Bank of Japan experimented with quantitative easing (QE) and 40 years before the introduction of QE in the USA, EU and the United Kingdom. Therefore. the discussion on monetarism in the 1970s might have been considered to be irrelevant to the significantly different conditions now, some 45 years later. In spite of this, Kaldor predicted that the domination of monetarism would result in a decline in industry and manufacturing in the UK, the deskilling of the workforce and a decline in the real value of wages. Kaldor proved to be right on this score also.

The paradox is that the QTM was never updated to account for what McNeill refers to as the massive rise in "*asset entropy*". On the other hand, as McNeill has observed, land, buildings, precious metals and other assets have been around as long as the QTM has existed, so this fundamental theoretical oversight is puzzling.

McNeill's RMT provides a measure of the proportion of money volumes taken up in non-productive physical and financial assets. This absorption is mainly augmented by a speculative price inflation of physical and financial assets and, as observed during 12 years of QE in the UK, this was proportional to the volume of exogenous fund tranches under QE injected into the economy. Under QE, the QTM incorrectly predicted the rise in inflation in goods and services with increases in money volumes while ignoring the significant rises in asset prices. McNeill has shown that after about 8 years of QE there was a leakage of the inflation occurring in land, building, houses and some speculative commodities into the inputs of supply side production imposing conditions that resulted in rises in output prices. However, still in its uncorrected form, the QTM identity provides a better prediction of physical and financial asset inflation than goods and services price inflation.

McNeill observed in his RMT papers that Friedman never provided a satisfactory explanation of the actual mechanism whereby money volumes cause inflation in goods and service prices. Friedman’s stock response to this question was always, "*It happens in the long run*" which, as McNeill has observed, is not a mechanism.

Following McNeill’s work on price-setting by companies it was found that applying the standard supply and demand diagrams (the S line and D line and the E equilibrium point) it is virtually impossible to relate this to the determinants of price-setting. This is because the relationship of sales and consumption to price accessibility to each level of disposable income and the unit costs of production are not represented in such a simplistic representation.

An interesting contribution of the real income’s approach to analysis has been McNeill’s development of an integrated analysis in the form of so-called “transactional envelopes” within which all transactions will take place. These diagrams which combine a vertical axis to locate: maximum feasible prices according to disposable income, unit costs associated with total production and sales and the horizontal axis as the distribution of disposable incomes of the population. This permits an identification of the proportion of constituents whose income categories cannot afford basic essentials, demarcated as “occlusion zones” which are close to the unit costs line. The novel aspect of transactional envelopes is their direct relationship to the RMT function enabling the tracing of the impact of input inflation on disposable income purchasing power.

This analysis not only enables the tracing of the impact of inflation on lower income constituents it provides an oversight of the main variables involved to guide the resolution of the problem of inaccessibility of essentials for low income constituents.

Issues arising from monetary policy practice, central banks & the democratic deficit

With the collapse of the Gold Standard in 1971, the International Monetary Fund (IMF) was at risk of being closed down. However, on the occasion of the 1973 international petroleum price hikes, Johan Witteveen, the new Managing Director of the IMF, revived the prospects of the IMF by arranging for the rapidly accumulating petrodollars in OPEC countries to be recirculated, initially through the IMF to provide loans to low income countries to purchase petroleum at ever-increasing prices. Soon after this initiative private financial institutions began to lend on, or direct investment including for the so-called sovereign wealth funds, all based on recirculated petrodollars.

It was notable that the IMF action actually assisted the OPEC strategy while augmenting debt in poor countries.

However, this resulted in a consolidation of the IMF and under its coordination, a rise in the influence of central banks in general. In the United Kingdom, the Bank of England (BoE) was made an independent institution by the Labour government in 1997. The effect of this was to distance decisions made by the BoE from government and parliamentary oversight. Such decisions entered a domain apparently dominated by “experts” who were not to be questioned by others. Indeed, with the very significant growth in financialization boosted by petrodollars and a widespread deregulation of financial services, including the removal of regulations separating commercial and retail banking, monetarism came to dominate macroeconomic policy.

Monetary policy and the continuing application of money volumes and interest rates to manage demand and inflation by central banks continued in spite of the fact that the fundamental monetary theory and assumed functional relationships were flawed. The result is that such policy decision remained beyond the scope of political party manifestos and, as a result, remain beyond the influence of constituents. Constituents in practical terms have no choice in the matters concerning monetary policy.

Work by RAND Corp and SEEL-Systems Engineering Economics Lab has shown that since the 1970s and, in spite of the development of "supply side economics", in general terms, asset holders and traders making up less than 5% of constituents of most countries, have become increasingly wealthy while the majority of wage-earners have seen their real wages decline. At the same time the degrees of income disparity have reached such levels as to have around 20% of wage-earners face extreme difficulties in purchasing bare essentials. It therefore becomes very apparent that the political system faces significant challenges which can be characterized as being a democratic deficit because the decisions and policies causing prejudice remain beyond parliamentary control.

Work on an explanation of these policy impacts and the diametrically opposed interests of asset holders and traders on the one hand, and wage-earners, on the other, has been completed by McNeill. Note 6 issued by the British Strategic Review on this topic, was issued in early July, 2022, under the title of "*The constitutional crisis created by monetary policy*". The interesting aspect of this Note is that it links this phenomenon directly to the analysis made possible by the RMT. It represents an advance of knowledge on this particular issue and a new front for constitutional economics.

The essential role of public choice in achieving recovery and sustainable real growth

In a period where climate change, a worsening cost of living crisis exacerbated by the kick-back of sanctions imposed on Russian energy resources, which have affected many petroleum derivatives and commodities the global economy, has returned to the situation prevalent in the 1970s-1990s. The evolution of policy that occurred during that period is argued by many to have been the cause of the 2008 financial crisis. The "solution" in the shape of QE made things worse by finally creating an endemic cost-push inflation.

It is notable that the bulk of economic papers and new policy propositions remain firmly within the monetary camp all of which support the aggregate demand paradigm which assumes inflation to be demand pull. They all deploy the same policy instruments and include Keynesianism, monetarism,

supply side economics and the more recent and widely reviewed modern monetary theory. However, the RMT map which represents more accurately where money goes and what effects it has does not map over these conventional approaches because they are all market interventions imposed by government and/or central banks. The common impact is the creation of winners, such as asset holders and traders, losers, such as wage-earners, and some who somehow remain in a neutral policy-impact state.

The RMT explains why monetary policy is ineffective and that such policies not only reduce the funds available to production, investment and productivity enhancement but also create a structural endemic cost push inflation. Since the majority of constituents are prejudiced by this policy approach McNeill has concluded that there is a need for a more effective public choice to be brought to bear on such policy decisions. As recounted above, Kaldor made the important observations that since most investment is generally applied to expand plant or efficiency through technological and technique innovation, the use of such money seldom causes inflation and in reality is often deflationary in the sense that increased efficiency can result in higher wages, higher profits and prices set at lower rates to increase market share. He also observed that this presents a relatively stable situation in terms of prices (inflation) and it is also wholly endogenous function managed by the supply side and adequately handled by banks or savings with no need for exogenous monetary injections.

McNeill, accepting Kaldor's logic, has developed the real incomes approach to present a Real Incomes Policy (RIP) that relies on supply side production goods and service companies to effectively control monetary growth through an incentive-based promotion of productivity as the main driver of real economic growth. This form of economic growth promotion is not inflationary. RIP operates on the basis novel policy instruments and indicators. In order to manage the performance of companies in moderating prices a measure of price efficiency for each company is proposed as the Price Performance Ratio (PPR). This is the policy performance indicator and it measures the degree to which a company increases, passes on or reduces input inflation. Companies remain free to allocate resources to attempt to reduce their contribution to inflation. However, the risks of doing so are reduced and the benefits increased through the use of an instrument which acts as a performance incentive levy. The levy paid is linked to the value of the PPR achieved. This, so-called, Price Performance Levy (PPL) can therefore be reduced through sound operations management to increase productivity and lower unit costs so as to end up paying a lower levy. In fact, RIP can be designed to allow particularly efficient companies to pay no levy at all. The logic behind this interesting policy proposal is that any relative price moderation or reductions under inflationary conditions have three immediate and important impacts:

- In general, consumer and workforce real wages or real disposable incomes rise
- Lower wage constituents gain immediate relief without additional support schemes[1]
- The market share of these companies rises as a result of more competitive pricing

In terms of government revenue foregone, this is compensated by the generalized gain in real economic growth and rise in production efficiency and competitivity and relief provided to the lowest income constituents.

McNeill has a considerable amount of experience in planning and managing investment projects and has designed RIP operations to gain short term price moderation or reductions so as to have an immediate impact to reduce the cost of living. This is achieved by business rules and well-established operational management techniques centred around the learning curve. Expected future unit costs associated with rising throughout are projected forwards and the lower feasible unit price associated with this future projection is established as the current unit price. The function of the PPR and the PPL is to minimize the risks and to make up the lost margins as the companies penetrate markets and grow leading to real growth in the overall productivity of the supply side production of goods and service sectors. The most compelling case for this approach is that it is able to integrate the necessary structural changes and advance in productivity and price moderation across the economy in all sectors. As a result, it is possible to avoid the ad hoc sector-specific initiatives by spreading this mode of development of embodying a more-for-less growth path applied across all sectors and regions supporting:

[1] The relief would be characterised by its continual reduction in number of low income constituents not being able to afford basic essentials.

- Climate change actions
- Levelling up
- Reduction in income disparity
- Bringing inflation under control on a permanent basis
- Establishing a stable basis for real economic growth
- Help raise real wages in line with productivity
- Helping raise import substitution
- Helping raise exports
- Reduce unemployment
- Stabilizing the value of the national currency
- Improving the balance of payments

McNeill, writing in the British Strategic Review, pointed out that, in reality this combination of factors is not an impossibility. In the period 1945 to 1965 Britain underwent a period of unprecedented growth during which most of these beneficial conditions, being assigned to RIP, were experienced. The notable issue is that although this period has been referred to as the "*Golden years of Keynesianism*", Robin Matthews published a paper in 1968 entitled "*Why has Britain had full employment since the War?*". His analysis showed that Keynesian policies were not in fact applied since there was no unemployment to speak of and policy, if anything was very deflationary. It is interesting to note that McNeill acknowledges the contribution of Matthews in helping make RIP a general macroeconomic approach as opposed to a specific counter-inflationary policy. This came about as a result of Matthews providing feedback to McNeill on a monograph on RIP published in 1981, at which stage RIP only referred to inflationary conditions. Matthews suggested that in order to test the model more completely across all possible conditions, it would be advisable to include the condition of falling input prices. (deflation). McNeill acknowledges that this contributed to RIP becoming a general macroeconomic framework able to handle any condition.

From a search of existing literature, papers and announcements, a missing element in the work supporting RIP is the answer to the question of the management of monetary policy. Half the answer lies in the exercise of public choice by companies in organizing their own investment and thereby helping raise real wages. Naturally in this process companies can choose to borrow money or use savings as own equity. There is no reference to assets but then these encapsulated markets have their own operational financial relations with banks and other financial intermediaries. In most cases, there is no obvious reason why asset markets would be affected by the changes introduced by RIP which target supply side production of goods and service companies of all sizes. We understand that a specific paper is under preparation by Cambridge-Economics Network entitled, "*The real incomes approach to monetary theory & practice*" expected to be published in August 2022.

Conclusions

The real incomes approach and RIP is a distinctly different theory and practical proposition to all current macroeconomic theories and policies, all of which lie in the aggregate demand and monetarist camp. Its formulation is not speculative but it has been established on the basis of meticulous attention to subtle misunderstandings as well as very evident oversights and significant errors in logic in monetary theory. However, rather than leaving this as a matter for theoretical discussion, McNeill has advanced the applied propositions founded on a considerable amount of quantitative evidence generated by Kenneth Arrow, Robert Solow and Nicholas Kaldor concerning the role of learning, innovation and productivity in real economic growth.

Indeed, the RIP model of how the economy works is strongly aligned with the models developed by these economists which align with the legacy contributions of Jean-Baptiste Say who highlighted the importance of entrepreneurs in applying resources more efficiently to enhance growth and explaining the significance of wages as being the main determinant of consumption rather than the monetarists' notion of "demand" based on the exogenous injection of money.

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