

Today's Social Dilemma: Does a New Paradigm in Economics Demand Higher Ethics or Wider Regulation

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Abstract

The authors of the article, processed with the contribution of funds from the institutional support to long-term conceptual development of research, development and innovation at the Faculty of Finance and Accounting of the University of Economics, Prague in 2013, point out that the theory of economics has failed to yield a solid theoretical background in such critical situations as the period of the current financial and economic crisis and the transformation period of post-communist economies. Mainly presents crisis open the question of unsatisfactory status of economic science. While classical liberal or Keynesian concepts are failing, theorists cannot look to mathematical modeling for help. It seems that traditional concepts malfunction; financial market is particularly predisposed for this process. Function of mathematical models is overvalued. The article calls attention on possible influence and adequacy of regulatory attitudes on return to equilibrium, particularly in the EU and in the Eurozone. It seems that the part of ethics (relation goods) must be upgrade decidedly. The challenge for today's theoretical economists is to find a new paradigm of economic science for today's global world.

Key words: paradigm of economics, crises of the Welfare State model, regulatory projects, ethics of economic interaction, eurozone debt problems.

INTRODUCTION

More than two decades ago, following the collectivist ideology erosion, the post-communist countries of Central and Eastern Europe embarked on a journey of transformation of their economies towards market economy. This unprecedented process was also accompanied with complex and, in many aspects, unique transition from authoritarian political regime to a democratic system in such countries. The transmission economic process was characterized by absence of any theoretical instructions or recommendations. Two decades later, in the midst of an extensive financial and economic crisis, we have been compelled to state that existing economic paradigms apparently fail during the complicated global era, that neither liberal nor Keynesian approaches to economic policy were able to identify emergence of significant imbalances of global and national economics in a timely manner – i.e. to prevent gradual accumulation of crisis-related effects or at least mitigate their destructive force. Experts were more and more voicing their opinions that the present economic science does not feature sufficient theoretical instruments to cope with ultimate state of the economic world. In this connection, the question of Hayek emerges once again, with great argumentation power, whether or not it is important to start over in respect of scientific economic, from the level of determinism of the present world, from elementary philosophical and methodological

categories, and derive from the most fundamental and irrefutable axiom of Descartes: "I think, therefore I am". In any case, theoretical economists are faced with a task of implementing ethical dimension into economic categories and promoting the methodological foundation.

Economic Theory and the Crisis Origin

One of the major problems of today's economic theory, which has contributed to the economic imbalance and the birth of the crisis, seems to be a shift towards the mathematization of economic theory with an emphasis on a higher degree of accuracy of forecasts. Mathematics has been challenged by economists to function as a social science which does not correspond with its nature as a non-dialectic scientific discipline. Furthermore, economic theory has been struggling with unresolved issues in terms of general methodology of sciences, mainly their inability to forecast future developments of world phenomena and to move past and present conditions into the future. The current unsatisfactory state of the world economy proves that neither the neoliberal nor Keynesian approach provide theories, tools, and recommendations for the times of a deep economic imbalance. A trend towards formalizing mathematics kept on penetrating the theory of economics under the influence of Professor Samuelson whose philosophy pushed out economists' interest in the ethical dimension of a subject's behavior (homo

oeconomicus = relation goods). Thus, to lower volatility and lower risks in an environment of purposeless trading and money speculations, a rather axiomatic notion of an economic theory, i.e. model formalization and algorithmization, was to be implemented.¹ Modeling still remains a basis for regulatory projects for financial markets, particularly for banks and insurance companies. Such projects are currently intensely implemented with the intent to maintain moderate volatility and stabilization of financial markets and client security. At the same time, these projects should build on the “risk-based approach,” which is based on strict mathematical models of risk diversification. The current state of the world economy thus proves ineffectiveness of the 1990s approaches, which move possible mathematical risk management of economic processes onto a utopic level.²

Consequently, economic theory seems to be taking the wrong direction to a certain extent. In pursuit of short-term financial gains, it has not taken into account an enormous rise in speculative and untrustworthy conduct of economic entities. While typical only for certain instruments since the times of Aristotle, it has now become the final goal of economic efforts for most participants of economic interactions (as stated in L. Mlčoch in /2010/: malignant growth in money trading; T. Baťa as cited in 1932: moral starvation leads to the birth of a crisis). Obviously, an economic theory which tolerates or even supports such development is taking the wrong course, the impact of which is felt by everyone. Today’s high degree of mathematical formalization in the theory of economics leaves out an ethical aspect, including a legislative framework of the economic environment, which results in economic imbalances. This situation plays up to supporters of state interventionism, mainly to various political representatives. A new paradigm of economic theory is evidently needed.

Political Approaches to EU Crisis Phenomena

In this crisis period, European politicians are becoming anxious about the EU’s inability to promptly and effectively solve Eurozone’s debt problems, which is causing distrust towards the whole European project (Mlčoch, 2006: trust is the

most precious economic entity)³ as well as towards the internal EU organization and the economic rules of this integrated but too heterogeneous union. This union lacks mechanisms which compensate for undesirable factors of large non-homogeneity. Friedman’s improvisation of bureaucracy⁴ is thus gaining a very curious form: starting from attempt the quota executive women over the norm for shape for cucumbers and inflatable balls.

To ensure ethical behavior, Stability and Growth Pact of 1997, was supposed to introduce a debt threshold for all members of the European monetary union, which is now called for by the French and German governments. If the EU member countries had followed this pact, the debt crisis would not have arisen. Although Greece never met the criteria for the level of indebtedness in a single year, no sanctions were applied to leave such an unrespectable fiscal policy. Therefore, if an arbitrarily set debt allowance is to function, certain conditions have to be met first. For example, the amount of allowed debt should be tied to a meaningful indicator that cannot be manipulated and that can be regularly checked instead. Any violation of the indebtedness level must be effectively punished. The level of indebtedness should not be based on the whole deficit but on structural deficit only. Another issue is introducing an effective system of checks: Present experience shows that debt “brakes” have so far led to “creative accounting” practices which mask the actual state of economic issues.

The “Welfare State” Crisis

Valueless entrepreneurial intentions, which in their current shape and form cross the boundaries of Joseph Schumpeter’s popularized “critical frame of capitalist mind,” currently demonstrate themselves in an unprecedented income polarization. This situation disrupts social reconciliation among the poor and the rich, leads to demonstrations against greed of financial institutions and their representatives, and escalates discussions about the “welfare state” ideology. High debt collection and anti-debt fiscal measures result in unrest and political tensions which strengthen anti-European propaganda in the affected countries as well as in countries that are supposed to help in paying off the debt.

1 In his bestseller “Black Swan” N.N. Taleb /2010/ makes the following statement regarding forecasts of future crises and economic states of the world: Our inability to forecast the development of complex systems has been influenced by the “Black Swan” phenomenon, whose existence we are not aware of and which clearly points to self-assured professionals in the field as non-experts.

2 Professor J. Stiglitz, an orthodox supporter of the Keynesian approach towards an economic policy, claims /2010/: „There are two explanations why risk diversification does not work the way many have hoped for. First of all, financial institutions do not understand the risk they are facing and/or use deceptive accounting practices with the aim of deceiving regulatory bodies, investors, tax collectors, and eventually themselves. Another explanation is that the central models used by macroeconomists and financiers are faulty“ (p. 2).

3 L. Mlčoch in /2006/ sees the uniqueness of trust and the building of trust structures as a defense against potential moral hazard that has become a key explanation for instability in the late capitalist system. Robust trust networks can push out (a) social behavior of such entities whose “bigness” has become a tool for blackmailing the state for various benefits such as universal insurance coverage, loss coverage of the “big enough” entities, etc. Economics of trust is incompatible with the asymmetry of black and red figures; while the black figures are privatized, the red figures are automatically, almost cynically, socialized and transferred as responsibility of future tax payers.

4 M. Friedman, a right-wing liberal guru, has been pointing to Eurozone’s latent problems from the beginning: A monetary union cannot successfully exist without a common fiscal policy, particularly among culturally and economically heterogeneous countries.

The content of the “welfare state” term is not agreed upon by theoreticians. If we understand this term in the narrow, dictionary definition of a state providing well-being for its citizens, then this ideology, which has been impacting economic policy of affluent countries for about 60 years, is shaking in its foundations. This ideology which has lacked fear of debt and thus supported a constant overconsumption and tolerated its impact on economic (im) balance, has turned out to be self-destructive.

The “welfare state” can also be understood as a social state which is characterized by a centrally organized system of social services which are meant to ensure standard living needs for groups and individuals. Such a social state is to integrate society, balance out inequalities, and prevent social conflicts and destabilization. This concept of a social state collides with relativity of the living needs standards. In today’s environment of income polarization, it is highly disputable to what extent the state should balance out social inequalities, and opinions on such classifications differ greatly as currently seen in the attitude of Greek government workers, union representatives, protesters against bankers’ greed, etc. The rich stay among the most criticized because of their entrepreneurial activities in tax havens and because they refuse to take part in balancing out regional inequalities such as standard living needs of low-income groups. As taxes are applied via the mechanism of public financing, the middle class can no longer support the low-income group. Costly social systems thus support inadequate consumption and lower regional competitiveness and economic efficiency,⁵ which apply to most of Europe with exceptions of Sweden, Denmark, Holland, and Austria. These economies are exceptionally innovative in terms of growth proportion between their investments and consumption. These social states create a motivational environment enabling a high degree of consumption, which they are able to finance due to constant growth in productivity. They invest heavily into education, families with children, healthcare and health awareness, etc.⁶ It is hard, or almost impossible to create such an environment in economies with a low ethical degree of corporate governance and a high level of corruption, moral distortion, and hazard which are typical for some of the overly indebted countries and for post-communist economies prone to exhibit the same attributes.⁷

5 Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community 2000 assumed that the EU will shortly become a society with an educational system aimed at achieving a high degree of competitiveness.

6 According to Mertlik, P., /2011/: The Present Perspective of a Social State: A Macroeconomic View

7 As a result of the investigation into the share of the Greek oligarchy on the escalation of the social conflict, the Novinky.cz portal /2011/ cited the opinion of a British expert on the Balkans, Misha Glenny, who made the following conclusion in the Financial Times: „The European Union tolerated widespread corruption, criminality, and bad governments among Eastern

A Legislative “Blizzard” in Form of EU Regulatory Measures in the Banking and Insurance Sector

A tendency towards widespread regulation and an effort to repress and punish hypothetical “villains” prevail among political solutions and consequences of this crisis. Risk-taking and cyclical economic developments cannot, however, be avoided and/or eradicated. Instead, separation of the real business cycle from the financial cycle can be one of the experiences gained from this crisis. Bankers, who have been designated as the collaborators in the rise of the crisis, and rating agencies are now penalized by strengthening state regulation. EU banks must now submit to new supervisory bodies in connection with a new, (controversial) supervisory architecture. The Basel Regulatory Project is being intensely implemented. According to these new rules, banks will have to retain a higher volume of capital to withstand financial shocks. To counter excessive greed, material interest of top bankers is also becoming a subject to strengthened regulation.

In contrast to banks, the list does not include any insurance companies which have traditionally taken a rather conservative approach on financial markets. Nonetheless, even the insurance sector will continue to experience higher regulation. Implementation of the Solvency II insurance project in its current form, i.e. without necessary modifications, will exacerbate unresolved problems signaled by theoreticians, field specialists, and insurance companies. This particularly concerns higher demands on capital in relation to insured risks. The Solvency Model mainly works with past probabilities of past events, and, therefore, cannot anticipate future qualitative changes in the character of insured risks. It is also not able to predict newly occurring risks the consequences of which are similar to those of the traditionally insured risks. Namely, these “unknown unknowns” are not included in the past statistics which make it difficult to determine their probabilities. Instead, they are concerned with the future states of the world; no insurance mathematician has yet succeeded in projecting into the future past conditions under which past loss experience and its characteristic probabilities had started. To calculate yet unknown phenomena, one of the basic methodological paradoxes can be applied: making future loss experience a subject of scientific research before it exists as an entity. Consequently, mathematics cannot be used to solve certain economic issues which it is incapable of solving due to its non-dialectic character of understanding the world.

Furthermore, to satisfy capital requirements, mathematic models work better for homogeneous insurance risk portfolio. If insurance companies want

European applicants as well as among some of their Western European members.”

to take advantage of such approaches more effectively, they need to homogenize portfolio of insurance contracts by cutting loss experience, by introducing strict exclusions in insurance terms, and by setting maximum limits in insurance payments, which reflects itself as lowering insurance effectiveness. In synergy of rising costs of relatively detailed reports according to the third pillar of the Solvency II model, strict capital requirements may threaten yield of trade of small insurance companies. On one hand, the project strengths are being challenged due to a higher demand for ensuring client education; on the other hand, the requirement to make clients more knowledgeable will result in higher costs. Also, individual phases of regulatory measures are being implemented such as the preparation for the second phase of IFRS 4 which is to significantly affect life insurance billing accounts (e.g. separate investment life insurance reporting). It is also supposed to unify insurance obligations appreciation. These steps are inconsistent with the requirements of the third pillar of the Solvency II project. Obviously, individual regulatory projects have already started to take on a life of their own without considerations to real business and economic needs. In some cases, they even ignore common sense.

Similarly, the European Commission regulations will lead towards higher protection of the financial services consumers, which may again increase costs for insurance companies. Thus, a question may arise whether such an approach is not "border-line" despite the guarantee schemas of insurance services, which will continue to increase stability of insurance markets and client security. Moreover, one of the founding EU documents, the Treaty on the Functioning of the European Union, sets exclusion of discrimination as one of its major objectives. In March 2011, the European Union Court of Justice ruled that considering gender as a risk factor in providing insurance services such as life insurance is discriminatory, which had a highly negative impact on the insurance business. Other upcoming legislative measures include anti-discriminatory standards which prohibit age and health condition considerations for setting prices of insurance products. This situation might result in cancelation of some traditional insurance products offered by commercial insurance companies.

Like banks, insurance companies will have to respect new, central, pan-European regulatory bodies which have a lot of power but not enough responsibility. All such measures may turn out to be factors which actually oppose effectiveness of the insurance industry. This situation is worsened by the results of recent research studies which show stagnating productivity in the insurance sector.

CONCLUSION

To sum up today's most fundamental dilemma, we can either find a new economic paradigm with a high level of ethics in economic relations, or we can continue extending regulatory measures. As a result, the following question arises: Is substantial, extensive regulation, which reaches former "taboos" or areas affected by Smith's "invisible hand," an appropriate, defensive response to the current economic and social developments, which have resulted from widespread profit chasing? Another cardinal question is whether the current majority form of democratic political systems is able to create a corporate governance environment in terms of "relation goods" and positive, invisible assets of the common good. Mlčoch's /2010/ new social economics (which we strongly support) should thus not only be equated with knowledge but with wisdom. To achieve this, we may have to return to Descartes' "I think; therefore, I am," or even all the way to "Adam."

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