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## Rational microeconomic decisions and their non-optimal macroeconomic outcomes: the role for social institutions

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### ABSTRACT

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The paper analyzes possible policy and institutional responses to underconsumption (deficient consumption spending that leads to depressed economic activity). Underconsumption is an effect of a specific market failure; uncoordinated rational microeconomic decisions to keep labour costs low result in sub-optimal macroeconomic outcomes. Traditionally, any manifestations of demand constraints have been corrected with expansionary fiscal and monetary policies. These methods have ceased to be effective and viable. Alternative measures aimed directly to change income distribution are considered. Such measures (progressive income tax, stronger labour unions) would rather not gain acceptance of entrepreneurs even though in principle they should boost business activity. Non-confrontational solutions are beyond the reach of economic policy but good apprehension of the problem at hand in the democratic debate might lead to a better compromise with respect to social distribution of incomes.

**Keywords:** underconsumption, market failure, economic policy, income distribution

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## Introduction

There are different views on the outcomes of uninterrupted functioning of the market. Extreme views could be related to the notion of efficient markets and to the idea of market failures. In the contemporary economics there is little room for a clear *laissez-faire* attitude which mirrors the belief in self-regulating and optimizing markets. As a consequence, the question of proper framing of markets with regulations, institutions and policies that ameliorate their functioning is central to the economic debate.

What is the proper framing depends on the character of the market failure identified. Market failures may have different reasons such as time-inconsistency, information asymmetry, bounded-rationality, transaction costs, non-competitive markets, principal-agent problems, externalities and public goods. Each of these reasons is a broad category, subject to specific theories. When it comes to the tools to correct market failures, they are numerous, extremely differentiated and often disputable. A general problem that relates to such corrective measures is its effectiveness. Intervening in the markets is often subject to skepticism or open criticism, sometimes related to the notion of government failure; a disability of governments/public organizations to make things better rather than worse. Different opinions with regard to this problem assume very specific forms with respect to individual issues at hand. An example might be endless – and very timely these days – debates concerning regulation versus liberalization of financial markets.

Problems become even more complicated when one turns to macroeconomic policy. Contemporary economists rarely claim that unfettered markets tend towards a stable, full-employment equilibrium. The idea of macroeconomic policies that actively seek to mitigate economic fluctuations and protect high employment and business activity is broadly accepted. Certainly, this is far from a statement that macroeconomic policies always have positive results or that they themselves cannot cause disturbances.

In this paper a specific form of market failure is considered; underconsumption due to low labour incomes. Its effects manifest as macroeconomic business fluctuations or recessionary tendencies. Optimizing, rational decisions of well-informed business managers bring about non-optimal macroeconomic, social results and eventually also inferior outcomes for individual entrepreneurs themselves; there is a lack of socially beneficial coordination of microeconomic decisions. Respectively, there should be room for corrective institutional measures and policy decisions.

The aim of the paper is to answer whether in this respect non-confrontational changes in social institutions framing the market are conceivable. The problem is considered from a theoretical point of view and it refers, firstly, to the macroeconomic hypothesis of underconsumption, which is not broadly discussed or tested in this paper. The hypothesis itself and its meaning for the interpretation of contemporary economic developments has been broadly discussed in the literature, including a recent article by the author of this paper [Koronowski, 2018]. Here the

hypothesis is taken as a starting point for, secondly, observations of contradictions between microeconomic rationality and macroeconomic optimization that results from price decisions of firms. These observations may be traced back to Kalecki and they are also presented as a game-theoretic problem. Since the equilibrium of the wage game is non-optimum and there is no market mechanism that could correct the result, thirdly, a question arises whether there is room for effective public intervention. With respect to traditional counter-cyclical Keynesian monetary and fiscal policies, it is argued that they are improper for permanent solving of the problem and eventually they become a problem themselves. Respectively, other public policies are considered within a new-institutional framework of the analysis. Unfortunately, the answer provided in this paper as the realization of its aim is very skeptical with respect to possibilities of solving the problem at hand with non-confrontational, economic, public policies; the solution depends crucially on a broader social and political consensus.

The next part of the paper presents and analyzes a theoretical problem of managerial, microeconomic attitudes towards wage costs and their possible negative outcome in the form of underconsumption and stagnation at high unemployment. The third part considers possible corrective measures and the fourth part ponders the chances for their acceptance by businesses. The last part of the paper concludes.

## 1. Non-optimal results of rational microeconomic decisions

Kalecki [1935, p. 84] wrote: “What is good for each entrepreneur individually possibly is not good for all entrepreneurs as a group”. This quotation, in a nutshell, presents the idea of socially inferior outcomes of rational, microeconomic decisions. Kalecki refers this possibility to underconsumption, i.e. a situation when low consumption spending financed from low wage incomes does not support new investment undertaken with the aim to augment production possibilities. Eventually, all private spending is low, there is a general problem of deficient demand and savings glut. This leads to a fall in production and employment; recession and stagnation succeed. In Kalecki’s words: “if one entrepreneur cut wages, he could, *ceteris paribus*, increase the utilization of his factory, but if all entrepreneurs cut wages the result (...) would be quite different”, they would find it impossible to sell their product [Kalecki, 1935, p. 84].

The idea of deficient consumption demand that limits investment, aggregate demand, production and employment is not quite firmly established in economics. It is still rather a hypothesis of underconsumption. However, it has a long and rich tradition of two hundred years, initially rooted in the works of Sismondi and Rodbertus [Koronowski, 2018].

The hypothesis of underconsumption is a strain of a more general attitude which accepts that the economy may be subject to demand constraints. The specific and very precise idea of underconsumption is older than the more general and less precise Keynesian theory of deficient demand. A broad discussion of the hypothesis of underconsumption is clearly beyond the scope of this paper. However, it is worth emphasizing that the hypothesis is being

rediscovered in contemporary, post-crisis economics as a theoretical paradigm that provides a good basis for interpreting contemporary economic developments [Wilcock, Scholz, 2016].

The results of underconsumption as presented by Kalecki in the above quotation are a case of a socially inferior outcome of rational microeconomic, management decisions. The outcome can be presented in a game-theoretic framework. The decision to keep wages (wage costs) possibly low is always rational (except for a very tight labour market or the motivating function of wages) from the point of view of a single entrepreneur. The equilibrium solution is, however, sub-optimal. If these individual decisions could be changed in a coordinated way, the result would be better.

If wages are cut, the shares of labour incomes and consumption in GDP also diminish. No firm invests more than is necessary to preserve the potential to meet the demand for its products at a given technique that relates the product to capital inputs. It makes high investment (in the consumption goods sector and consequently, in the investment goods sector) lack justification. Production and capital incomes eventually fall, too. The economy shrinks, in particular, employment falls.

It is a fall in real wages that is important; it causes a real economic contraction. It is debatable whether flexible prices could revert this negative mechanism of underconsumption. This is an old problem which was analyzed, among others, by Kalecki [1935] and then it was deeply considered by Baran and Sweezy [1968]. Shortly speaking, in contemporary economics it is typically claimed that prices are sticky. Moreover, as underlined by Kalecki, if an economy faces the problem of underconsumption due to low wages, a decline in both prices and wages does not solve the problem. When only wages fall (fall faster than the price level) the problem aggravates; it is quite probable when unemployment is rising. Only falling prices and profits at fixed wages would be a solution; this process restores the shares of labour incomes and consumption that are consistent with macroeconomic equilibrium (not necessarily full-employment equilibrium, it may be less-than-full-employment, 'Keynesian' equilibrium, if the volume of consumption does not justify full utilization of existing production capacities and does not support new investment).

In the framework sketched above, wage cuts bring about economic contraction; wage increases should consequently make the economy unwind and employment grow. Certainly, to raise wages is in sharp contradiction to microeconomic rationality and wage increase is not a probable outcome of unfettered market mechanisms; it cannot happen unless some institutional, corrective mechanism is in place.

## 2. Activist policy against economic slumps

In the contemporary mainstream economics, problems of business cycle fluctuations and recessionary tendencies are to be solved by fiscal or monetary measures. The manifestations of fluctuations (high unemployment in particular) are subject to activist policy but their

reasons are not addressed, nor even properly recognized. Typically, Keynes in his *General Theory of Interest, Money and Unemployment* claimed that investors exhibit ‘animal spirits’ and that resulting economic slumps might be cured with fiscal intervention. Certainly, the idea of ‘animal spirits’ is a simple version of non-optimal coordination. Since such behaviour allegedly lacks any regular mechanism behind, it cannot be systematically, scientifically analyzed and addressed. In this case, policy makers can only diminish its negative results in the form of depressed economic activity.

If there are persistent tendencies to stagnation (possibly due to underconsumption), expansionary fiscal and monetary policies tend to be on average biased towards an expansionary stance. This has been the case in recent decades. With respect to fiscal policy, it is reflected in ever-growing public debts in the developed world. When it comes to lax monetary policy, it is conducive to excessive growth of private debt (financialization, ‘privatized Keynesianism’ [Crouch, 2009]). It fuels speculative bubbles and it generally fails to boost sustainable growth and provide economic stability even when it meets its strategic aim of low inflation [White, 2006, 2006a; Koronowski, 2009; Koronowski, Ryan, 2009]. Both fiscal and monetary policies seek to improve economic situation, but they are not targeted at the deep reasons for the problems they address and they only – in the Keynesian way -- try to affect the outcomes. They eventually fail and – in the meantime – they cause negative side effects and create new imbalances and tensions. To solve the problem of underconsumption, alternative policies and institutions are necessary. They should address social income distribution.

It does not mean that high wages could not be a supply-side barrier to more production. If wages are high, accumulation may be much restricted and it may not supply financial resources that could be otherwise reasonably invested. On the contrary, if wages are too low, accumulation is excessive with respect to profitable investment opportunities and eventually profits fall in line with weakening economic activity. In this article I take the perspective of a low share of labour incomes. This perspective seems timely. A fall in the share of labour incomes in GDP in recent decades is a well-established statistical fact that seems to be the reason for underconsumption and tendencies to stagnation [Stiglitz, 2012; Piketty, 2014; OECD, 2012; ILO, OECD, 2015]).

Economics is far from giving a clear advice whether economies are wage-led or profit-led. There are, however, up-to-date analyses that document a negative impact of higher income inequality on economic growth and stability [Berg, Ostry, 2011; Berg, Ostry, Tsangarides, 2014; Dabla-Norris et al., 2015; Diallo et al., 2011]. Equilibrium is a matter of proportions and there is no single, universal and correct policy recommendation. It means that sustainable economic growth depends on a balance that may be shaped with institutional settings and policies that co-determine the proportions discussed.

In the case of too low a share of labour incomes (underconsumption), a corrective mechanism could basically take two different forms. Firstly, since the problem discussed is rooted in income distribution and specific spending patterns typical for different categories of incomes, it can be addressed with redistributive policies; progressive income tax is the most typical tool

in this respect (another solution to the same problem was suggested by Malthus and Kirchman who argued for high, conspicuous consumption financed from capital incomes [Dziewulski, 1989]). Income redistribution as a means to solve the problem of underconsumption is an old idea that was proposed as early as the beginning of the 19th century by Sismondi and Rodbertus. Income redistribution through progressive income taxes as a solution to the problem of underconsumption was then proposed by Hobson at the end of the 19th century [Richmond, 1978]. The same proposal of progressive income tax has been recently made by Piketty [2014]. His claims, however, do not refer directly to underconsumption but to Piketty's pretentious 'laws of capitalism' [Koronowski, 2018].

Secondly, another mechanism that can play a similar role may be the increased power of wage bargaining due to stronger labour unions. Supply-side economics argues for the opposite. If economies stagnate because of deficient demand (underconsumption), the recommendation to cut wages is counter-productive. The present economic problems may be in part an effect of supply-side policies of the 80s, such as the reduction of the role of labour unions. Certainly, labour unions were not intended as a means to correct macroeconomic effects of wage setting but eventually, they could have played this role. Having in mind the arguments presented above, economists might and should reconsider their attitudes towards labour unions. Creating or dismantling economic institutions obviously needs good theories that correctly describe and explain the economy; this statement should be valid even when we agree that any economic theory cannot provide one-directional recommendations which are always correct irrespective of a specific situation.

### **3. Is a non-confrontational solution possible?**

Rational wage decisions of managers bring about neither a full-employment macroeconomic equilibrium nor eventually optimal results for individual firms. Corrective institutional/policy measures could possibly improve the situation of businesses. However, a question arises whether managers are able to recognize and accept the need for institutions and policies that should modify the effects of their decisions. Possibly managers may exhibit bounded rationality in the sense that they are well-informed and rational within the scope of their typical, individual, microeconomic decisions but they may not recognize the macroeconomic results. Whatever is beyond the scope of their individual decisions may fall into a dark area of constrained cognitive possibilities of managers. It is also possible that they would rationally reject corrective measures because they can understand consequences broader than just game theoretic solutions of the narrow problem.

Any attempts to set corrective measures that influence income distribution may encounter strong resistance. Such measures would violate a well-established view of 'proper', business-friendly regulations and policies and the respective system of powers and interests. Typically, managers and capital owners would claim that any analysis of income structure is

purely ideological and lacks an economic background; until recently the mainstream economics supported this attitude. Lucas [2004] famously claimed that income distribution does not belong to professional economics. However, business people and neoclassical economists also used to argue that wage increases would be harmful to the economy. The two claims together are inconsistent. Individually rational decisions at the corporate level to keep wages low, allegedly backed by mainstream economic theories and a lack of reasonable, alternative, coordinated and non-confrontational solutions all create strong barriers for businesses to consider a case for income redistribution (higher labour incomes).

However, the attitudes of business people that resist any attempts to establish or strengthen public institutions and policies of income redistribution may still be rational. Firstly, some managers may be afraid that the impact of general wage increase on their business could be discriminatorily negative; this would be the case of labour-intensive industries, income demand elasticities also matter. Secondly, business people might reluctantly let the balance of power shift towards labour (or government); power may be highly appreciated for itself, a shift may also create risks of excessive wage increase denting profits that could be reasonably invested in the future. Thirdly, in an open economy, rising labour costs make domestic firms less internationally competitive, which has negative sectoral and macroeconomic consequences. In principle, the last reservation can be lifted with respect to the macroeconomic impact if a flexible exchange rate allows adjustment needed; however, the results would be again different for different firms.

The case of income redistribution through progressive income tax is different. Most arguments that relate to wage increases do not obey in this case. However, resistance to such a change among higher, capital income earners may be strong.

It may be difficult to grasp the idea that if profits remain little taxed, their net amount earned may be lower. The idea can be explained with a simple, numerical example: let in the equilibrium wages be equal to  $\frac{2}{3}$  of GDP (so profits and investment are equal to  $\frac{1}{2}$  of consumption demand), in the low-employment equilibrium wages are equal to 2 and profits to 1. Due to an incentive the economy starts growing; wages are equal to 3 and profits rise to 3; now the new proportion of labour and capital incomes leads to underconsumption, eventually profits cannot be realized, they settle at 0.5 of consumption demand and are equal to 1.5 (and the economy shrinks from 6 to 4.5, for simplicity it is assumed that the shrinkage does not dent wages). However, if income tax left net profits equal to only 2 (out of 3 before taxes) and the tax proceeds were spent as (public) consumption, proportions that guarantee an equilibrium would be preserved at wages (private consumption) equal to 3, profits equal to 2 (which is still more than 1.5) and public consumption equal to 1 (all together again sums up to 6). There is no public deficit. The mechanism is in principle the same as the balanced budget multiplier.

Anyway, higher taxes always encounter reluctance; it may be against a well-established intuition that it is better not to dispose of one's own money easily, even in a coordinated manner. In the same way as in the case of wage increases, business people may rationally oppose a shift in the institutional balance of powers and interests. A general remark that concerns

the shift of power is that the state (an even more, labour unions) does not guarantee that it would use its new prerogatives to act impartially, without biased political motivations and to effectively reach the desired macroeconomic equilibrium. In other words, government failure would be more than probable.

The opposition to the measures discussed does not mean that the measures are not to a degree economic and social reality; however, their scope and power matter. Labour unions still exist, although they are not cherished by entrepreneurs. Public budgets play a redistributive role. Specific solutions depend on a 'social agreement' as a product of a political debate that has an aspect of organized and controlled confrontation, both power and arguments matter in the debate. Anyway, it is clear that these measures of income redistribution have not been considered a means to shape macroeconomic equilibria.

It is worth noticing that occasionally there may be some room for policy maneuvers that redistribute incomes and boost consumption in a non-confrontational manner. An example is massive social spending programs in Poland in recent years. Their impact on consumption, economic activity and growth [NBP, 2017] may be interpreted as a case when the constraint of underconsumption is eliminated, probably to an excess. Unfortunately, these public funds have not been used to cut public charges levied on wages or to raise wages in the public sector; this could also have positive supply side effects or improve public services. Moreover, it is clear that such spending can be financed only due to extra proceeds of the budget and it is dubious whether the situation is sustainable. Finally, motivation behind the programmes was political and not clearly related to underconsumption, although some booming effect must have been considered.

In spite of the skepticism expressed above with regard to the acceptance of the corrective measures discussed, there is evidence that some institutions and activist policies get business acceptance; entrepreneurs are not principally against state intervention. This is the case of the Keynesian-type, expansionary fiscal policy which is not opposed by entrepreneurs, managers or capital owners. This was noticed and explained by Baran and Sweezy [1968]. Fiscal expansion and budget deficits do not impair profits after taxes, they boost demand, they let profitably invest a financial 'surplus' in government bonds. This policy does not refer to underconsumption and income distribution, it is precisely in line with the interests of capital owners, it is business-friendly. This is supposedly the main reason for its popularity in recent decades. The trouble is that it has the negative side effects mentioned and – together with the easy monetary policy – it ceased to be a viable solution to the problem of deficient demand.

## Summary

The problem analyzed in this paper is a specific market failure in which rational, optimizing microeconomic decisions to keep wage costs low result in sub-optimal, macroeconomic outcomes. The outcomes are determined by an effect of underconsumption that relates a low



share of labour incomes in GDP to deficient consumption demand and weak economic activity in general. The problem seems timely and important in the light of the developments in the global economy in recent decades; rising income inequality, falling shares of labour incomes, instability and stagnation. These developments have also found a reflection in economics in a renewed interest in income distribution in general and in the hypothesis of underconsumption in particular.

Since market failures need specific corrective measures – policies, regulations, institutions – it is important to consider what measures could be applied to correct the effects of underconsumption. The aim of the paper is to ponder whether non-confrontational measures framing the market are conceivable with respect to underconsumption.

This task is firstly realized by an assessment of traditional activist fiscal and monetary policies that are aimed at mitigating business fluctuations and keeping economies possibly close to full employment. Such policies do not address the reasons for inequilibrium; the mainstream economic theory has not provided much useful insights in this respect. As a consequence, both fiscal and monetary policies have been excessively expansionary trying to correct the effects, while the reasons possibly have remained unaffected. Eventually, such policies created side effects of unsustainable public debts, excessive private debts and financial instability. Activist, counter-cyclical macroeconomic policies ceased to be effective and they become more and more problematic. This situation calls for new measures, which should possibly refer directly to the origins of the problem; in this paper the origins are related to underconsumption.

Respectively, two basic measures can be conceived; strengthening the wage bargaining power of employees/labour unions and progressive income tax. Although individual, narrow microeconomic rationality stays at odds with macroeconomic optimization and eventually brings on average inferior individual outcomes, it may be very difficult to gain acceptance for these corrective measures. A refusal by business people of the measures may arise from managerial arguments that are reasonable/rational within a broader context; the target function of a firm may be compounded, managers may take into consideration time-inconsistency and partial policy decisions government failure, the balance of economic powers, etc. An individual impact of corrective measures may also depend on a particular situation of each firm and it would be impossible to assess it *ex ante*. Any policies or institutions implemented with the goal of wage increase are doomed to be rebuffed by businesses. It explains the popularity of fiscal interventions that seemingly solved the problem of economic slumps and did not impinge on interests of any social group.

It may be impossible to build proper, efficient and non-confrontational institutions or run policies that seek to tackle the problem of underconsumption. However, the case of Poland in recent years suggests that at least occasionally there may be some room for policy maneuver that would redistribute incomes and boost consumption spending and thus, lift the barrier of underconsumption. What motivation lies behind policy decisions and whether they are designed rationally in economic terms is another problem.

The analysis of the market failure related to underconsumption does not support an opinion that new measures should or could be implemented. Moreover, the measures considered – redistribution through the public budget and labour unions – are present in the contemporary economy; they are not used, however, as a means of the management of the aggregate demand and specifically of eliminating the constraints of underconsumption. Any efforts of that kind would probably be subject to major government failures. Such efforts aimed at income redistribution understandably would be opposed by entrepreneurs. In spite of that, it is important to understand that managerial decisions may be inconsistent with macroeconomic, social optimization. It would be naïve to believe that decisions and opinions of managers should lead economic thinking; on the contrary, it is theory that must explain the functioning of the economy and provide guidance. Biased and false recommendations may aggravate problems. When good guidance is in place it may shape a better public debate and policies that respectively constitute and arise from the democratic process leading to a reasonable compromise. Such a compromise is not necessarily identical with conditions for a full macroeconomic equilibrium. It may, however, reflect understanding of the problem at hand. A failure to reach a viable consensus that brings positive results may lead to economic and political instability.

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