

SOME DEFINING CHARACTERISTICS OF CONTEXTUAL ECONOMICS

By Neva R. Goodwin

Microeconomics in Context, the first textbook exposition of contextual economics, begins by defining economics as:

*how people try to achieve their goals,
especially through exchange and resource allocation,
operating within an environment that includes*

ecology and technology

(the physical context)

as well as

human motivations, politics, culture,

institutions, ethics and history

(the psychological/social context).

1) Taking the contexts into account

Contextual economics has been shaped by a determination to embed economic understanding in the physical and the psychological/social contexts within which economies operate. To give some examples of the effects of a contextual awareness:

The **ecological** context has recently posed severe challenges to neoclassical economics, which has tended, in the past, to proceed as if economic systems operated in a physical vacuum. Raw materials are purchased from those who have property rights over them. Natural resources are invisible in neoclassical economic theory until they appear as property, when they are processed, sold, "consumed," and finally disposed of. Where they come from and where the waste products go have only recently been recognized as topics of concern. An example of how *Microeconomic in Context* has added ecological and other new insights to the neoclassical foundation is its treatment of the traditional "circular flow of economic activity." The stocks and flows normally depicted therein consist of money, produced capital, labor, and final goods. We have added discussions of natural capital as well as of social and human capital; we discuss how these essential stocks are created, how they are sustained, and what kinds of economic, cultural or other failures might degrade them, rendering unsustainable the economic progress achieved so far.

The **historical** and **technological** contexts are often cited together in contextual economics, explaining the contemporary experience in light of the technological, managerial and other changes that have produced the first (industrial), second (managerial), and third (information) revolutions in production methods. These historical/technological events have been important determinants of the rise of consumerism, mass production systems, economies of scale and scope, and other advantages for large producers. Such advantages (going beyond the economic) are critical factors in explaining the world we live in, dominated as it is in many ways by huge multinational corporations.

The **political** context recognizes the salience of power for economic outcomes. Contextual economics addresses issues of political power (i.e., the ability to have one's interests represented in government action), when this is either a cause or an effect of economic power. Economic power is most obvious, on the modern scene, in the way markets, industries, the work experience, and consumer tastes and behaviors are shaped by large corporations. However, economic power is spread more widely than is normally assumed. The division of society's total product between capital and labor -- an old Marxist concern -- is reexamined in the context of within-firm allocations of a potential surplus which may emerge at the end of the production process, in the form of profits, but which may also be claimed by other actors earlier in the game.

Our discussion of the **institutional** context pays special attention to an understanding of markets (including black markets). Beyond the special requirements of the first, Russian edition of *Microeconomics in Context*, the importance of institutions has been so well explored by the institutionalist school that (as with some issues central to ecological and to feminist economics) contextual economics does not have to break new ground here. In these areas it has the easier job of integrating excellent work by others into a systematic framework.

The contexts of **human motivations, ethics and culture** appear, in neoclassical economics, almost solely in the famous rationality axiom, which selects the pursuit of self-interest as virtually the only motivation worthy of economic attention. While it would be remarkably foolish to ignore this motivation, there is growing evidence that a culture that regards self-interest as synonymous with rationality risks destroying some of the foundations for a well-working economy. Adam Smith explored these foundations in his *Theory of Moral Sentiments*, and then took them for granted in *The Wealth of Nations*. Neoclassical theory, which looks only to the latter, ignores the ethical context which is an essential basis for the economic activity. Contextual economics stresses that transactions costs rise dramatically when contracts must be enforced by law, rather than by a sense of honor or obligation, or when shoplifting, employee theft, and other forms of larceny increase. It notes that virtually all successful enterprises understand the efficiencies that are derived from trust, and make efforts to create a cocoon of trusting relationships, even if, beyond it, they have to operate within a larger, untrustworthy world.

2) An emphasis on human goals

Mainstream economics texts often suggest that this discipline has no goals of its own, but will promote *efficiency* in achieving individual or social goals. Efficiency, in the economic context, means operating so as to maximize the value of the results (such as output) that can be achieved with a given set of resources (such as inputs). Contextual economics emphasizes that most standard economic goals (efficiency, earning money, or maximizing production or consumption) are best understood as *intermediate goals*, i.e., means to other ends. The relevant *final goals* might be defined to include, for example: the

satisfaction of basic physical needs; happiness (including a balance of comfort and stimulation); self-respect and the respect of others; self-realization; fairness in the distribution of life possibilities; freedom; democracy and participation; and ecological balance. Contextual economics encourages students to begin by considering the relation between their own final goals and the intermediate goals (efficiency, economic growth, consumption) that are assumed in most economic discussion.

3) An emphasis on equity

Neoclassical models are notoriously resistant to the introduction of concerns for social justice and for institutional and ecological health. Their greatest strength is to show how efficient markets distribute resources according to the willingness *and ability* of individuals to pay for those resources. However, ability to pay depends upon the previous distribution of resources. The goal of equitable distribution, in the present and between present and future generations, has remained the stepchild of neoclassical economics.

Contextual economics has drawn on philosophy and other branches of learning to take steps toward correcting this situation. *Microeconomics in Context* describes several definitions of equity, proposing a variety of decision rules that can be selected or combined for different circumstances. In the chapter on households and elsewhere we present facts about gender inequities in home and work settings. Throughout the book we remind the reader of the dynamic realities of economic systems, raising awareness of how current activities may affect future generations. In assessing the success of economic systems, the text pays equal attention to distributive justice, to productive capability, and to definitions of well-being.

4) A different approach to consumption

The neoclassical welfare goal of maximizing consumption is related to the neoclassical concept of consumer sovereignty -- a term that is commonly used both normatively and positively. As a normative term, consumer sovereignty means that all economic activity *should* promote the welfare of human beings in their capacities as consumers. This gives a drastically narrow focus to neoclassical economics. In reality, people are not only consumers; they are also workers, students, citizens, family members, volunteers, law-makers or other public servants, etc.. Economic activity should properly be directed toward enhancing the well-being of human beings in all of their roles.

Used in a positive sense, consumer sovereignty implies that all market activity *does* respond to consumer desires; that is, that the types and quantities of goods and services produced in an economy are ultimately determined by the true desires of consumers. This assumption exaggerates the ability of consumers to act independently in pursuit of their own desires, ignoring such issues as social interdependence and historical constraints, with associated path dependence. It also fails to account for forces such as advertising,

endogenous to the economic system, which play a large role in forming consumers' desires.

5) A different approach to production

Many of the ways in which the contextual economics approach to production differs from the neoclassical approach stem from a refusal to depend upon the theoretical ideal of perfect competition. Perfect competition, and the models and theories based on this assumption, are the foundation for a great deal of modern policy-making, regarding trade treaties, tax regimes, wage policies, and much else. It is widely recognized that this ideal diverges dramatically from the reality of modern markets. *Microeconomics in Context* advances this issue in a new chapter, "The Corporation and Modern Economic Life," which discusses how the goals of producers may diverge from the goals of consumers.

Perfect competition would force all producers to act as if their goal was to maximize profits, regardless of what their real goals might be. The reality, in a clearly not-perfectly-competitive world, is much more complex. A given enterprise may be made up of hundreds, thousands, or hundreds of thousands of individuals, who have many different goals that motivate their behavior on the job. Power (including the power that comes from knowledge, some of which may be possessed by a shop-floor worker as well as by anyone higher up) is important, as we examine outcomes via the question: what is the mix of goals that are expressed here?

6) Some notes on methods

The neoclassical notion of what it means for a social science to be "scientific" is not the only possible approach. Thinking this matter through afresh, it appears that certain basics must be present. These include:

- A respect for observed facts -- the visible wrinkles on the invisible fabric of truth.
- A continual attempt by researchers to be as objective as possible. To this end the contextual economist is encouraged to be aware of personal values and possible biases.
- Recognition of a scientific community which can, collectively, compensate (to some degree) for one another's biases and arrive at more certainty than is possible for a single individual.
- Findings presented in such a way that the logic of the argument can be understood and assessed by the larger community of potential users.
- A structure that permits and encourages the accumulation of knowledge and understanding.
- Efforts to achieve a reasonable degree of internal consistency in the theory -- noting, however, that a determination to achieve perfect internal consistency can result in premature closure, making it harder to incorporate later improvements.

- Openness to continual change, as the discipline accumulates knowledge and wisdom, as events disprove some tenets, as change occurs in the subject matter of the discipline, and as changing times require different emphases.

These guidelines (not all of which are observed within neoclassical economics) are the bases for continued development of methods and techniques in contextual economics. In addition, development of contextual economics methods will take into account the fact that all scientific theory exists in a tension between simplicity and complexity. Theory must abstract from specific cases, finding the generalizations that will fit a large number of individual cases. This necessarily depends upon a process of simplification, in which the complexity of the world is presented systematically, through a small enough number of terms and ideas so that they can be grasped, after a reasonable period of study. That process must begin with selection. A useful, relatively "true" theory is one in which:

- The necessary *selection and simplification* of facts and concepts is done appropriately, emphasizing the issues that are most important to human experience as well as those that are most useful for achieving an understanding of economic realities.
- The most critical *logical relations* (such as causality, temporal sequence, exclusivity, etc.) among the selected elements are appropriately identified.
- There are *contextual guidelines* to indicate the circumstances under which the selection of critical elements and the identification of their logical interrelations will be more -- and less -- relevant.

A social science theory may succeed quite well on the first two of these requirements but still fail on the third. When there is failure to recognize that every simplification has its appropriate range of application, then there is no guard against the tendency to misuse concepts outside of their range.

One motivation behind the growth in sophistication of neoclassical techniques has been the hope that more complex tools could handle a richer, more complex view of reality. Fifty years of intensive experimentation with this hypothesis have failed to confirm it; the evidence suggests, indeed, that this is a dead-end road. "More of the same" will not be the solution; a richer understanding of reality may require the use of simpler, rather than more complex tools. What the neoclassicals have gained by simplifying their subject matter, they have lost by mystifying their methods and, except for the very best of them, their exposition. Our emphasis is on clarity of expression, reduction of jargon, and reference to a real world which, by its familiarity, is intrinsically easier to understand than a counterfactual world of perfect markets and robotically simplified human beings.

Our goal is to develop an appropriate methodology to support an economics paradigm that is relevant to major human concerns; that can be defended as scientific; and that is cumulative, coherent, and communicable.

(June 2000)