

The human element in the new economics: a 60-year refresh for economic thinking and teaching

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Abstract

For more than half a century the discipline of economics has been based on an inadequate and misleading description of human nature. Translated into what students remember, and what has increasingly risen to the top in Anglo-American culture, this description promotes the idea that only selfishness is rational.

Many economists and others have noted that the working out of the “rational economic man” image denies both the social and the moral nature of humankind. At the same time it produces theoretic results, and influences some real-world behaviors, in ways that mimic the initial assumption.

The first four sections of this paper will describe aspects of the old economic theory that are based on the rationality axiom. Sections 5 and 6 will outline some of the findings of the relatively new school of behavioral economics, which is leading a major challenge to the neoclassical economic edifice – the first such challenge that (so far) mainstream economics has been unable effectively to marginalize.

Sections 7 and 8 will build on behavioral economics with attention to some issues in human motives and behavior that should be addressed in a reformulated economic theory. This will include a reconsideration of rationality, as well as discussions of the social and ethical contexts for economic behavior.

The last two sections of the paper will propose some steps toward the changes in structure and content that are required in order for economic theory to come into line with the realities of the 21st century. Section 9 will propose a modest alternative starting point for modeling economic behavior, and section 10 will consider some of what this means for the teaching of economics.

Overall, the paper will focus on economic theory as it is taught in colleges and universities, because that is the main source of understanding of the economy for most of the population, including politicians and policy-makers.

1. The content of standard introductory economics courses

Economics textbooks are not only written for students. At two critical points in the history of economic thought textbooks have played significant roles in defining the field, not only for what is taught, but more importantly (in terms of real world outcomes) for the understanding of the economy that is used by politicians, policy makers, and the public, when it votes its approval or disapproval of how the government is affecting the economy.

This started in the 1890s, when Alfred Marshall wrote the first edition of his text, called *Principles of Economics*. It went through 8 editions, the last being published in 1920. For a large part of the English-speaking world Marshall’s textbook continued to define the field (especially the microeconomics basics) until the middle of the 20th century, when it was replaced by Paul Samuelson’s *Economics* (first published in 1948). That set the standard for about the next 60 years.

These textbooks have not only defined economics for students, they also set clear standards

for how people in general should think about the economy, having great influence on government policies and also on the economic research that supports policy. Samuelson was well aware of the impact of his texts, saying in an introduction, "I don't care who writes a nation's laws – or crafts its advanced treaties – if I can write its economics textbooks." Every year about 5 million people in the U.S. graduate from college having taken at least one economics course. These courses, and the textbooks that shape them, in turn contribute to a shared understanding of how things work in the world – and to a general consensus on whose voices will be heard on economic subjects.

Consider, for example, what might be called "Obama's dilemma": If you are not, yourself, deeply immersed in economics, how do you select economists to advise you on policy? Should President Obama have chosen his advisors based on reputation in the discipline? Or on personal economic success? I don't pretend to know in any detail what political constraints or motivations would have dictated what the president asked of his advisors, but it appears that he relied on both of these screens. Based on the first screen – reputation in the discipline – his choices would not have included anyone thinking about the new economy of the future, for the discipline has closed ranks very firmly around insiders, providing little opportunity for academic outsiders to become widely known. The second standard – being good at making money – moved him to select a number of his advisors from Wall Street, which has in recent years been among the most lucrative areas for amassing modern fortunes. If economics is about money, then, the reasoning goes, financiers must know a lot about it.

Without trying, here, to assess the effectiveness, or the goals, of Obama's economic policies, I will simply note that the problems in the economy that led to the 2007 crash and the Great Recession have not been solved; bubbles keep building up, enriching some people in the short run, and creating the potential for, once again, severe economic suffering for "main street" in the not so distant future. Neoclassical economic theory has failed to anticipate a number of severe problems that have been building up over the time of its intellectual dominance. To name just a few of the trends that have resulted from the system supported and celebrated by neoclassical economics, these include:

- ever greater income and wealth inequality;
- ever greater concentration of economic and political power in ever larger corporations – with severe negative impacts on the operation of democracy;
- a global climate that is rapidly changing in ways that threaten human health, the viability of many cities, the agriculture systems that feed humanity, and the diversity of plant and animal species on earth.

We are now at a time when economics is in need of another 60 year refresh. The heart of this need is in the question: How are human motivations and behavior to be understood in this human science? This paper will describe just one aspect of the new economic thinking that is laid out in the textbooks that I and my colleagues have written¹. It will work toward a model of

¹ Goodwin et al, *Microeconomics in Context, third edition; Macroeconomics in Context, second edition, and Principles of Economics in Context, first edition* – 2014, published by M.E. Sharpe. The other authors on the current editions are Jonathan Harris, Julie Nelson, Brian Roach, and (on the macro text) Mariano Torres. Earlier editions included Thomas Weisskopf and Frank Ackerman as my co-authors, with significant contributions by Kelvin Lancaster. The micro text has been translated into Italian, and, in a Transitional Economies edition, into Russian and Vietnamese.

economic behavior that considers how real people select goals; what we know about how behaviors are influenced by goals; and the limitations and influences that constrain both choice and action. I hope this can provide a good start to an alternative to utility theory, as a basis for understanding and presenting enough essential facts about human beings to support a useful and realistic economic theory.

Before considering an alternative I will briefly survey some of where we now are.

2. How we got here: Adam Smith minus Karl Marx; Keynes tortured by Samuelson

Adam Smith, generally regarded as the begetter of modern economic theory, stressed issues of growth and distribution, based on an image of smoothly functioning markets. The pieces of Smith's legacy that remained significant for what I will refer to as 20th century economics (though I will focus especially on the second half of the past century) were the emphasis on *growth*, and admiration for *markets*. This truncated legacy greatly reduced the emphasis on *distribution*, while also missing Smith's concern that markets might not always function optimally. He especially pointed to monopolistic behavior as a problem, and supported various kinds of government intervention to keep the market on track. Ignoring these caveats, 20th century economists pursued the optimistic program of modeling a world in which perfect markets lead to optimum social outcomes.

The classical economists – those holding the stage approximately until Marshall's time – also included Karl Marx, whose concerns for inequality and class conflict were shared by Smith (though they expressed themselves very differently). Marshall's deepest concern was with poverty, and the ways that (as he saw it) the poor were deprived of the means to develop their mental and moral capacities – what might be called, today, their human capital. Moral concerns were shunted aside in the positivism that overtook the field after Marshall's time. What remained of classical economic thought in the 20th century development of microeconomics was Adam Smith minus Karl Marx.

What of macroeconomics? We can see early strands in the work of the physiocrats (Smith went to France to study with them) who were concerned with issues of the balance of trade between nations – concerns that Ricardo took up a little later. Marx had a special focus on the macroeconomic instability of markets and he also, along with Ricardo, Malthus, and John Stuart Mill, raised some of what continue to be the critical macroeconomic questions:

- How is the total wealth generated by a society divided between those who own the means of production and those who work for them?
- Is the existing division optimal?
- What are the forces that determine how society's wealth will be divided?
- And: what are the goals of the economy?

None of these questions have been in the foreground of 20th century economics. Instead, in the second half of that century the field developed almost as though no one aside from

In addition to my debt to all the co-authors on the various editions of the "contextual" textbooks, I especially want to acknowledge Brian Roach for materials he contributed to Chapter 6 of *Microeconomics in Context, third edition*, which appear throughout this paper, especially in section 5.

Ricardo had ever thought about macro issues until Keynes came along, to prescribe how to get out of the Great Depression of the 1930s.

From the point of view of those who began to call themselves *neoclassical* economists there were some problems with Keynes' prescriptions. Politically, Keynes was on what came to be the losing side, in his conviction of the importance of government's role in stabilizing economies. Methodologically as well his approach did not fit the Procrustean bed on which Paul Samuelson laid the thinkers he worked over to come up with his *Principles* texts. The bits that hung over the bed and had to be chopped off included a belief in the probability of market failures. The bits that were too short and had to be stretched to fit Samuelson's passion for the tidiness and precision of mathematics were any ideas that could not easily be described in formal models.

Thus, if the skeleton of 20th century microeconomics was Adam Smith minus Karl Marx, that of macroeconomics was Keynes tortured by Samuelson.

3. Mainstream economics teaching in the late 20th Century

There are some true and useful things to be learned in standard 20th century economics, such as the basic concepts of supply and demand intersecting to create wages and prices. However if you ever took an economics course you may have since discovered that many other things also affect prices, such as advertising, or consumers' lack of information. And wages involve even more complicated human interactions, habits and expectations. These complexities and exceptions don't get much hearing in introductory courses – and, surprisingly, they get even less at the upper levels, where, instead, progressively more mathematics are imposed on a progressively more abstract picture of an economy. Meanwhile the students are also being taught a lot that is dangerous. Here are some of the take-aways from standard economics course:

- We don't need to worry about material resources – the price system and human ingenuity ensures that all resources are directed to their most valuable uses (with "value" determined by ability to pay).
- Concentration of economic power is not much of a problem. Its entanglement with political power doesn't merit any attention at all.
- Increased consumption (regardless of the content) is the primary measure of wellbeing.

About 40% of college students in the United States take at least one economics course. Students who, two years later, have forgotten the diagrams and equations, are likely to still retain an impression that only selfishness is rational, that limitless greed is a universal human characteristic, and that economic success – of a nation, or an individual – can be assessed strictly in terms of the dollar value of consumption. Beliefs like this are the background for a culture that will accept as perfectly normal Ponzi schemes and cooked accounts, tax fraud and tax havens, the exploitation of children, women and immigrants, and corporate expenditures to get the most favorable political environment. Institutions – from governments and legal or banking systems, to the institutions of the family or formal education – are

shaped by socio-cultural norms whose roots can be traced, in some significant part, to the standard teachings of economics – especially what it says about human psychology.

In recent decades the sorry state of the economic culture (e.g., on Wall Street) has repeatedly bubbled up into disasters. But the economic culture has not yet changed in significant ways – and neither has the economic theory beneath it. This poses a significant challenge. The economics profession is one of the most tightly closed in all of academia. Economists who write about different ways of understanding the economy don't get published in the mainstream journals. Faculty who disagree with the mainstream generally don't get tenure.

Fortunately, as the core of the profession has continued to marginalize those who disagree, there has come to be a growing outer circle of hyphenated economists: institutionalist-, Keynesian-, ecological-, feminist-, radical-, social, socio- economics, and many more. Some of the better known names associated with alternative views include John Kenneth Galbraith, E.F Schumacher, and Herman Daly, as well as Wassily Leontief, George Akerlof, Joseph Stiglitz, and Amartya Sen; the last four are among the Nobel prize winners who continue to pose serious challenges to the mainstream. The closed ranks of academic economists has been able – thus far – to keep out even those who have received such recognition in the world (creating, for example, Obama's dilemma). However the alternative voices are increasingly being heard – especially the new group of behavioral economists. This paper aims to provide a summary, and a little additional forward motion, for some of these critical alternative ideas.

4. The psychological “foundations” for neoclassical economics

When I was beginning my studies in this field economist Robert Solow commented to me that the great strength of economics is that it is *fully axiomatized*; the entire edifice can be deduced from the basic rationality axiom, which says that *rational economic man maximizes his utility*. The origin of this axiom is often traced back to Smith, whose most widely quoted phrase comes from a passage in which Smith approvingly notes that merchants take what, today, we would call, a protectionist position – doing so, not with any thought for the good of society, but because their security and profit is tied to domestic industry. Thus, he says, the merchant “is in this as in many other cases, led by an invisible hand to promote an end which is no part of his intention.”² Excerpts such as this have been used as a justification for the 20th century economic model's vision of an ideal world in which a society comprised of entirely self-interested economic actors would make the society as a whole better off, and the idea that

² To give the flavor of the full quote: "As every individual ... therefore, endeavours as much as he can, both to employ his capital in the support of domestic industry, and so to direct that industry that its produce maybe of the greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security, and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain; and he is in this, [as in many other cases] led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest, he frequently promotes that of the society more effectually than when he really intends to promote it." Adam Smith, 1982, *The Glasgow edition of the Works and Correspondence of Adam Smith*, Oxford University Press. vol.2a, p. 456.

As an example of the widespread misuse of Smith's writing, it is interesting to note that people often refer to the “invisible hand” in arguments that cite Smith as a *proponent* of free trade – ignoring that Smith's use of the phrase speaks approvingly of protectionist merchants.

pursuit of self-interest is the *only* thing that is done by rational economic actors – and that anything else is *irrational*.

When Alfred Marshall set out to codify the ideas of the economists before him, his starting point regarding human nature was essentially the same as Smith's, with one interesting addition: Marshall took cognizance of a particular group of humans – economists; a group that did not exist, as such in Smith's time. Though Marshall did not say so directly, it is evident from his writings that he assumed that the motivation for this particular group was to improve the human condition; specifically, to reduce poverty so as to allow people to develop their higher moral and intellectual faculties, rather than being condemned to lives of desperate effort for simple survival.

Traces of this optimistic view of economists' motivations can be found in most texts since Marshall's time, but they were increasingly buried beneath the far more pessimistic and narrow view of human nature in general that came in with Samuelson (even though Samuelson, as a person, would fit reasonably well within Marshall's optimistic view about the character and motivations of economists).

The problem was the old desire, stemming from the beginning of the 20th century, to make economics truly a science, in the model of physics. As Philip Mirowski has spelled out³, neoclassical economics clung to a physics template from the 19th century which natural scientists had mostly discarded by the early 20th. Among the problems with that template (and they were many) was a positivist view of knowledge – a view that physicists themselves largely abandoned as they confronted the indeterminacies rife in quantum mechanics, general relativity, chaos theory, Heisenberg's uncertainty principle, etc.. The natural sciences have largely come to recognize that their practitioners are human beings, who have values, and that value-free science is virtually impossible. Neoclassical economics got stuck in an attachment to mathematics as the way to ignore the roles of values, history, institutions, politics, and other inconvenient subjects. Mathematics has much to offer to economics, but it is unlikely to find its best use when thus employed as a means of denial.

5. Behavioral economics

Neoclassical economics claims to be based entirely on a view of human nature which is not only morally repugnant, but which also both leaves out a great deal about how people actually do operate, while it brings in seriously contrary-to-fact assumptions about what people are capable of. The latter have included assumptions about consistency (including that preferences change slowly, if at all, and that if A is preferred to B and B is preferred to C, then C cannot be preferred to A); about information (people are able to act as *if* they have perfect information); about self-knowledge (people know what they want, and are best served by getting what they want); and about influence, or power. The last of these assumptions includes the idea that human wants and preferences are endogenous, generated entirely from within; it ignores the extent to which people's choices and decisions may be manipulated by those who have an interest in persuading the public to buy certain things, or vote in certain ways. It ignores the reality that market economies are rife with powerful actors who do have such an

³ In *More Heat Than Light: Economics as Social Physics, Physics as Nature's Economics*; Cambridge University Press, 1989

interest, in both the economic and the political spheres.

A paper on the sociology of economics⁴ would describe how these unrealistic assumptions have been fostered in a profession with skewed motivations. Promotion and tenure in college and university economics departments depend on publication in a short list of acceptable journals. The editorial boards of those journals have an interest in keeping the ideology unchanged, for several reasons: Their status depends in part on the mystification of arcane language and hard-to-swallow assumptions; these characteristics, as well as emphasis on difficult mathematics, erect barriers to entry to the profession; control over the supply of economists results in an ability to command higher salaries than most other academics, as well as the possibility of much higher pay in the service of business or politics, where there is also an interest in maintaining the status quo⁵.

In the last few decades the narrow economic view of human behavior has been challenged by a strong alternative called behavioral economics. Studies in this area suggest that a more sophisticated model of human motivations is required to explain such behaviors as those that lead to stock market swings, the ways that people react to good and bad fortune, and why people often seem to act against their own self-interest.

Perhaps the most famous contemporary behavioral economist is not an economist at all. Despite being trained as a psychologist, Daniel Kahneman, along with his frequent colleague Amos Tversky, won the 2002 Nobel Memorial Prize in economics. Kahneman's research has found that people tend to give undue weight to information that is easily available and vivid – a detour from 20th century assumptions of economic rationality that he calls the “availability heuristic.” For example, suppose college students are deciding which courses to take next semester, and they see a summary of evaluations from hundreds of other students indicating that a certain course is very good. Then suppose they watch a video interview of just one student providing a negative review of the course. Even when students are told in advance that the negative review was atypical, they tend to be more influenced by the vivid review than the summary of hundreds of evaluations.

Kahneman has also shown that the way a decision is presented to people can significantly influence their choices, an effect he refers to as “framing.” For example, consider a gas station that advertises a special 5-cent per gallon discount for paying cash. Meanwhile, another station with the same prices indicates that they charge a 5-cent per gallon surcharge to customers paying by credit card. While the prices are exactly the same, experiments show that consumers respond more favorably to the station advertising the apparent discount.

An effect similar to framing is known as “anchoring,” in which people rely on some not necessarily relevant piece of information as a reference point in making a decision. In a real-world example, a high-end kitchen equipment catalog was selling a particular bread maker for \$279. Sometime later, the company began offering a “deluxe” model for \$429. While they did not sell many of the deluxe model, sales of the \$279 model almost doubled because now it

⁴ See, e.g., Goodwin, Neva, 2008 “From Outer Circle to Center Stage: The maturation of heterodox economics”.

⁵ To give just one example of the latter point: standard utility theory, as portrayed in 20th century economics, *could* be used to show that a high degree of economic inequality is bad for economic stability, and reduces overall well-being. This conclusion is too rarely drawn in the standard literature, even though a few writers such as Robert Frank make plain the logic.

seemed like a relative bargain.

A conventional view of rationality is that emotions get in the way of good decision making, as they tend to interfere with logical reasoning. Again, however, research from behavioral economics suggests a more nuanced reality. Logical or rational reasoning is most effective when making relatively simple economic decisions, but for more complex decisions we can become overwhelmed with too much information. For example, Ap Dijksterhuis, a psychologist in the Netherlands, surveyed shoppers about their purchases as they were leaving stores, asking them how much they had thought about items prior to buying them. A few weeks later, he asked these same consumers how satisfied they were with their purchases. For relatively simple products, like small kitchen tools or clothing accessories, those who thought more about their purchases tended to be more satisfied. But for complex products, such as furniture, those people who deliberated the most tended to be *less* satisfied with their purchases.

6. Bounded rationality

Rationality has become a loaded word in economics, bringing with it the baggage of earlier models that did not anticipate the findings of behavioral economics or take into account other every-day observations. The traditional rationality model includes the assumption that rational behavior is optimizing behavior (“rational economic man *maximizes* his utility”). In the 1970s an extreme version of this made the further assumption that rational economic actors have “perfect information.” A slightly more modest version says that people will collect information until the perceived costs of acquiring additional information exceed the perceived benefits.

One of the most effective challenges to the traditional assumption of rationality came from Herbert Simon, another non-economist winner of the Nobel Memorial Prize in economics (1978). Considering whether it is indeed possible for people to identify the optimal point at which one should cease gathering additional information, Simon showed that one first needs to have complete knowledge of all possible choices in order to identify that optimal point. Determining what additional information might be out there, and then gathering it, can be very costly in time, effort, and money – if it is even possible. Accordingly, Simon maintained, people rarely optimize. Instead they do what he called “satisficing;” they choose an outcome that would be satisfactory, and then seek an option that at least reaches that standard.

Given constraints of time and other resource limits, satisficing seems to be a reasonable behavior. If an individual finds that the “satisfactory” level was set too low, a search for options that meet that level will result in a solution more quickly than expected, or perhaps even multiple solutions. In this case, the level may then be adjusted to a higher standard. Conversely, if the level is set too high, a long search will yield nothing, and the “satisficer” may lower his or her expectations for the outcome.

Another deviation from rational behavior as traditionally defined has been called “meliorating;” this may be described as starting from the present level of well-being and then taking any opportunity to do better. A simple example is a line fisherman who has found a whole school of haddock but only wants to keep one for his supper. When he catches the second fish he compares it to the first one, keeps the larger, and throws the other back. Each subsequent

catch is compared to the one being held in the bottom of the boat. At the end of the day, the fish he takes home will be the largest of all those caught (and the sea-gulls will have become very fat!).

One result of using melioration as the real-world substitute for theoretical optimization is its implication that *history matters*: People view each successive choice in relation to their previous experience. It is commonly observed, for example, that people are reluctant to accept a situation they perceive as inferior to previous situations. This psychological path dependence – the way feelings about the future depend on previous experience – is relevant to how people feel about rising prices, and even more so to attitudes toward declining wages.

Satisficing and meliorating may both be included under the term “bounded rationality.” The general idea is that, instead of considering all possible options, people limit their attention to some more-or-less arbitrarily defined subset of the universe of possibilities. Usually these subsets consist of the options immediately evident, along with others specifically sought out through some simple decision rule. For example, when deciding what to spend her money on, an individual may at one time confine her consideration to “major expenditures,” such as a college education or an apartment; at another time she might contemplate “expenditures on food”; and at another time she might sit down to work out budget categories, pondering, for example, “How much should I spend on food each month, how much should I devote to entertainment, and how much shall I set aside for a major need like an apartment?” With satisficing or meliorating behavior, people may not choose the “best” options available to them, but they at least make decisions that move them toward their goals.

7. The role of influence

Herbert Simon received the Nobel Prize in 1978. This fact had little or no influence on subsequent economics textbooks, which sometimes mentioned bounded rationality, but did not reduce their dependence on the old rationality postulate as the foundation for deducing all human behavior.

Simon was not the first critic to be so dismissed. Decades before behavioral economics came into fashion “alternative” economists were complaining about the unrealism of the neoclassical view of humanity. They especially focused on the fact that, as Smith had so well recognized, people are social animals. Relatively few of our actions are taken completely without regard for what we have seen other people do, or what we expect that other people will think. Even popular books on finance refer to the “herd instinct” in reference to the way investors follow fads and fashions of thought. There appears to be an inborn tendency for people to act as part of some kind of human collective, rather than in isolation. Yet this had no place in the neoclassical understanding of human behavior.

Since the social nature of human beings has been discussed at great length in writings from many disciplines, the remainder of this section will focus on a different aspect of our social embeddedness that has been seriously overlooked in neoclassical writings: The intentional influence exerted by people with a political or a sales agenda.

Behavioral economics has shed light on a number of ways that others can affect our

decisions, by setting a “frame,” or providing extra emphasis on one conclusion at the expense of others. Available information is, of course, a critical feature, and actors other than the decision maker may have a strong influence on what information is available. These, and other ways that decisions may be distorted by influences not related to the goals of the particular actor, have long been well known to politicians and advertisers, who, since the early part of the 20th century, have often based their successes on assuming *irrational* consumers and voters.

For example, food companies are well known to cater to people’s innate physical attraction to sugar, fat and salt. These three elements support health when eaten in appropriate amounts, but they were rarely available in sufficient quantity during most of human evolution. We are all therefore born with some degree of craving for these substances, yet our health suffers if we do not recognize when we have had enough. Television teaches children at a very early age to recognize logos that are associated with sugar, fat and salt. Kids then often become loud advocates in grocery stores for the products that will keep them from learning how to recognize “enough.” Obesity and other forms of ill health are the obvious results. These outcomes could be mitigated if parents and other consumers were acting on a rational, well-informed understanding of how health is affected by food choices. That they often do not do so may result from a combination of poor (frequently misleading) information, persuasive marketing, and short-term desires (to answer a sudden craving, or quiet a screaming child) that override long-term understanding of cause and effect.

On the side of politics, we increasingly witness voters supporting political platforms that are against their own interest, or simply impossible. To give just a couple of examples in the U.S. context: The states that receive substantially more federal monies than they pay in federal taxes are, on the whole, the ones whose voters are most anti-government. Kansas is the state that (because of frequent tornadoes) is the third largest beneficiary of aid from FEMA (the Federal Emergency Management Agency), yet Kansans vote for representatives who vote to reduce funding for FEMA. Gail Collins, op-ed writer for the New York Times, notes that the current governor’s race is dominated by denunciations of federal spending on government activity – even while Alaska gets more federal money per person than any other state. What’s especially striking about such public discussions is their denial of reality. As Collins continues, “there’s virtually no discussion of eliminating anything its residents – who pay no state income tax or sales tax – get now,” including “Alaska’s super-subsidized mail service.” (August 16, 2014). This position, being popularized by potential state governors, is not only against the interests of the people, it spreads a false belief that you can get what you want from government while tearing it down.

A central belief of the ideology of 20th century economics has been that individuals are always the best judge of their own well-being, and of what will contribute to it. This has made it impossible to incorporate anywhere within the theory a recognition of how economic and/or political power can influence individual goals, choices and actions. What would it mean for economic theory to recognize this reality? What use would it make use of evidence that institutions and policies can be constructed to encourage people to make better decisions?

A 2009 book titled *Nudge: Improving Decisions About Health, Wealth, and Happiness*, written by an economist and a legal scholar, suggests that governments and other institutions could and should play a role in promoting better decision making. For example, the authors use a

cafeteria as an example of a setting in which people might be encouraged to make “better” decisions if, say, healthier options at the salad bar were placed at easier reach than the less healthy alternatives. A growing recognition that corporations are promoting bad food choices has added to the effects of the 2007-8 recession to motivate some rethinking of the “markets-are-always-the-best-place-for-individuals-to-make-decisions” ideology. An alternative view that is beginning to get a hearing is another recent New York Times op-ed in which Mark Bitman says:

If the most profitable scenario means that most food choices are essentially toxic – in the sense that over-consumption will cause illness – that’s a failure of the market, not of individual choice. And government’s rightful role is not to form partnerships with industry so that the latter can voluntarily “solve” the problem, but to oversee and regulate industry. Its mandate is to protect public health, and one good step toward fulfilling that right now would be to regulate the marketing of junk to children (June 18, 2014).

8. Ethics, goals, and well-being

Twentieth century economics supported, implicitly when not explicitly, the idea that neither ethics nor history nor the institutions of law or culture were of much economic importance – as long as these things did not get in the way of “free” market functioning. This case was pressed with special vigor from about 1970 to the end of the 20th century by economists from what was known as the Chicago School.

Even early on in this period there began to be concern that individuals acting solely to achieve their personal goals could not be counted on to operate a business in ways that would be good for the business itself. This real-world concern, combined with the dogma that people only act on the basis of self-interest, resulted in various efforts to motivate business leaders by offering rewards for specific markers of success (such as the price of the company’s stock). These efforts had the unintended consequence of escalating compensation of top management in the United States to levels that were many times greater than anything that had previously been considered normal (or were normal in other countries). They also resulted in an increasingly short-term vision on the part of business leaders. Very large scale frauds, Ponzi schemes, tax evasions, and environmental and human costs that businesses externalized during this period have made it increasingly evident that society cannot afford to encourage a culture of economic activity that ignores all normal human motivations except the selfish pursuit of personal gain.

With the advent of behavioral economics, and the various streams of psychology that have fed into it, there is increasing recognition for an alternative position, that a well-functioning economy cannot rely only on self-interest. The notion of “social capital”,⁶ which began to gain traction in the 1990s, formalized the idea that, without ethical values that promote trust,

⁶ See Goodwin, “Five Kinds of Capital”; also "[The Limitations of Markets: Background Essay](#)." It is worth noting that one of the most famous institutionalists, Gunnar Myrdal, was co-awarded a Nobel Prize in 1973 for explaining why values are always with us. The current lack of attention to institutionalists, including those who have received such attention, is another example of the ability of neoclassical economics to marginalize ideas, and their proponents, that do not fit within the rigid neoclassical paradigm.

inefficiencies would overwhelm any economic system.

Absent such values as honesty, for example, even the simplest transaction would require elaborate safeguards or policing. Imagine if you were afraid to put down your money before having in your hands the merchandise you wished to purchase – and the merchant was afraid that as soon as you had what you wanted you would run out of the store without paying. Such a situation would require police in every store – but what if the police themselves operated with no ethic of honesty? If everyone in business cheated whenever they thought they could get away with it, business would grind to a halt. If everyone in the government worked only for bribes, meaningful governance would disappear. And it is hard to imagine how the human race would survive if altruism was not common enough so that people would be willing to make sacrifices of time, convenience and resources to meet the needs of those who cannot take care of themselves, such as children or sick people.

Among economists some attention is again being paid to the fact that many real-world problems would be difficult, if not impossible, to solve if there were not in fact a reasonable number of people willing to work for the common good – the general good of society, of which one's own interests are only a part. Fortunately, recent experiments on human behavior demonstrate what most people who are not blinded by models of “rational economic man” have realized all along: That people really *do* pay attention to social norms, and they are willing to reward those who follow these norms and to punish people who violate them, even

when this has a cost in terms of their narrow self-interest.⁷ This point has great importance for a discipline that has the potential for affecting social norms. People who have studied economics in recent decades have carried away from those studies, into the wider culture, messages that only selfishness is rational, altruists are suckers, and one does not need to think about goals or values to know that private enterprise is always more efficient than – and therefore preferable to – any kind of collective action, including government.⁸

⁷ A well-known example from behavioral economics is the “Ultimatum Game” in which two people are told that they will be given a sum of money to share, say \$20. One player gets to propose a way of splitting the sum. This person may offer to share \$10 with the second person, or only \$8 or \$1, and plan to keep the rest. The second person cannot give any input to this decision but can only decide whether to accept the offer or reject it. If the second person rejects the offer, both people will walk away empty-handed. If the offer is accepted, they split the money as the first person indicated. If the two individuals act only from narrow financial self-interest, then the first person should offer the second person the smallest possible amount – say \$1 – in order to keep the most for him or herself. The second person should accept this offer because, from the point of view of pure financial self-interest, \$1 is better than nothing. In fact, however, researchers have found that deals that vary too far from a 50/50 split tend to be rejected. People would rather walk away with nothing than be treated in a way that they perceive to be unfair. In the context of social relations, even the most selfish person will gain by serving the common good and thus walking away with somewhere around \$10, rather than just looking at his or her own potential personal gain and quite possibly ending up with nothing.

⁸ A number of studies have shown that economics students and faculty are less altruistic than others. In one example, economics students expressed a lower willingness to contribute money to pay for public goods than other students. The same was found of economics faculty, in spite of their average pay being higher than the faculty in the other disciplines to which they were compared. (Bauman, Yoram, and Elaina Rose, 2011.) Similarly, “...researchers who undertook a number of free rider/prisoner's dilemma games, found students with a training in economics to be more aggressive, less cooperative, more pessimistic about the prospects of cooperation, and more prone to cheating than students who had not undertaken any economics subjects (note that selection bias was controlled for in these experiments). The characteristics that developed as a result of taking these economics courses persisted long after their education had finished.” (Frank, Gilovich & Regan 1993, 1996, cited in Thornton, 2013.

Economics, over the last 60 years, has set itself directly at odds with the basic ethical concerns of all major philosophical and religious teachings. In this respect economics is an inferior guide. From the point of view of society as a whole, purely selfish behavior will often fail to promote social well-being. Economists are finally beginning to recognize this reality, first with the reluctant admission that externalities do exist, such that market outcomes (often equated with the invisible hand) do not reflect all the impacts of market behavior, as they would do in the ideal, perfectly functioning market. Even the economic actors themselves – whether they are business people, individuals acting in their family or community roles, or governments – may lack the information needed to make what 20th century economics assumed as the rational decisions that would lead to social optima.

Economic theory, and the textbooks through which the theory is summarized and passed on, need to catch up to these realizations. A good start would be to broaden the debate on goals. In the 21st century it is increasingly evident that ecological problems and constraints are coming into serious conflict with the goal of maximizing GDP, for any one country, and especially for the world as a whole. A more appropriate goal for our time could be stated as: *To maintain and increase human well-being, without further harm to the ecosystem.* (The final clause of that goal statement could be rephrased as ...*without increasing consumption of the high-end goods now typical in rich countries.*) This may be followed with a further proposition: *An important goal of the discipline of economics should be to help people understand how to move their economy toward its goals.*

If or when such a shift in goals occurs it will dramatically alter a good deal of what is taught in economic textbooks. Among other things, if the well-being that we would aim to support cannot be defined concretely and quantitatively enough to lend itself to the use of the calculus, can or should we be talking about *maximizing* well-being? Or is a subtler approach required – one that does not posit objectives that can be weighted into a single maximand, but that is prepared to use judgment to deal with tradeoffs? (The issue of judgment will be discussed in the last section of this paper.) Other questions raised by the adoption of more complex goals include: What kind of economic growth or development can promote present well-being while preserving productive resources for the future? Can we imagine changes in values and in the economic culture, as well as the broader culture, that will make it easier to promote the most well-being-serving growth or development? How are the answers to these questions different for rich vs. poor countries?

These difficult questions are not discussed, but are glossed over by an implicit assumption discernable in 20th century economics texts: That an economist has, and can turn to, a client – whether this is an individual or a maker of national policy – who has a clear idea of his or her goals. In real life, outside of textbooks, *macroeconomists* do frequently have clients, who present them with questions into which goals may be read – but often the client (such as President Obama in 2008) is hoping that the economists will help to clarify the goals and the priorities. If the overriding goal is “Get the country out of this mess!” should the first priority be to save the banking system, or to protect jobs, or to keep people from losing their homes? Is there a necessary order in which these problems must be tackled? Obama’s team came up with one set of answers and priorities; a different group of economists would have defined the question, the goals, and the priorities, differently.

This means that economists are not off the hook. Their values, and the goals that arise from them, are inevitably relevant, not only for the advice they give to heads of state, but also for many smaller tasks – and, importantly, for how they teach economics in schools and institutions of higher education. Unless they have a client whose goals are unusually well-defined, macroeconomists still need to ask, Who speaks for society? When democracy is working well, there are discernable answers to that question; when it is not, the economist will more often be left to define a large part of the question, as well as the answers.

There is a tradition in microeconomics of assuming that individuals are the best judges of what will provide them with well-being, with the exception of young children and the mentally ill, who often fail one test of rational goal selection: that is, to select goals such that, when they achieve them, they will be glad in the long run that they have done so. Overall, even while assuming that more consumption is always more desired than less, economists have been wary of commenting on the goals people set. Yet recent research has indicated that the happiness people experience in life is strongly related to the goals they set. This is relevant to economics if happiness, as a component of well-being, is a goal for an economy. Anthropologist Tim Kasser, economist Robert Frank, and others working in the area of hedonic psychology show happiness and mental health to be negatively correlated with strongly materialistic goals, especially when the goals are set in relation to others' achievement (i.e. the goal is to have something more or better than ones reference group).

This idea is not new. Alfred Marshall assumed that the moral structure which is part of the foundation for individual motivations is, or should be, one of society's most important ends: The ultimate public good lies in a kind of progress wherein human wants are educated so that individuals will increasingly want what is good for them. What is good for people, Marshall felt, is to want the kind of reward that a good person wants: i.e, distinction, honor, and the pleasure, for its own sake, of serving others. If the moral structure of society and of its individual participants can gradually be brought to this orientation the whole society will be better off, for honor could partially replace pay as the reward at the higher levels of work effort, permitting an even distribution of income without loss of productivity; and consumers as well as workers will be better off, as individuals at every level take more pride in the quality of their work.⁹

Tibor Scitovsky, in *The Joyless Economy*, contrasted Americans' pursuit of pleasures that do not require effort to Europeans who, as he saw them (from a mid-20th century perspective) expected to put in effort to learn to enjoy, for example, challenging works of art, whether in music, writing, or other forms. Amartya Sen attempted to formalize this notion in his concept of a "two stage utility function" wherein he imagined that first people decide what kinds of utility are involved in a given problem (i.e., are we after the utility we will feel by doing our duty; by that associated with self-improvement; or is it simply hedonistic pleasure?) Having made this choice, we then choose the activity that will maximize the preferred type of utility.¹⁰ Albert Hirshman cogently remarked that:

Men and women have the ability to step back from their "revealed" wants, volitions and preferences, to ask themselves whether they really want these wants and prefer these preferences, and consequently to form metapreferences that may differ from their preferences....

⁹ Alfred Marshall, 1907, "The social possibilities of economic chivalry"

¹⁰ Amartya Sen, 1977, "Rational Fools"

When a change in preferences has been preceded by the formation of a metapreference... it typically represents a *change in values* rather than a change in tastes. (“Against Parsimony: Three Easy Ways of Complicating some Categories of Economic Discourse” 1984. Italics in the original.)

Behavioral economics derives its view of human nature from observations of behavior, often under carefully controlled experimental conditions. The neoclassical view derives all expectations of human behavior deductively from the rationality assumption. For a period in the 20th century it seemed that evolutionary theory gave scientific support for the latter approach, when early writings in sociobiology suggested that the individual survival imperative would always prevail over any other motives. In the latter decades of the century this simplistic view was strongly rebutted by other sociobiologists who pointed out that even the most “selfish gene” operates so as to promote the future continuance of the group that carries this gene. This may be seen in action, for example, when birds court danger as they try to lure a predator away from their young. But other-regarding behavior goes beyond simple gene preservation, as in the many stories of human heroism which illustrate human choices to sacrifice individual survival for the sake of other people, whether or not they are genetically related.

9. The model of economic behavior in contextual economics

This paper has described how neoclassical economics has managed to stretch, shrink, or ignore ideas, such as those of Karl Marx, Adam Smith, and John Maynard Keynes, as well as the institutionalists, femanists, ecological economists, etc., wherever these ideas threaten the essence of the neoclassical paradigm. Can we hope that behavioral economics will finally be able to drive home the points that Simon, Kahneman, Sen, Hirschman, Myrdal, etc. were making over much of the last century? A somewhat discouraging view on this is given by Tim Thornton in his impressive doctoral thesis on possibilities for changing economics curricula:

Earl (2010), in part drawing on the work of Sent (2004), makes the point that what now passes for behavioural economics — what he terms the ‘new’ behavioural economics — is in key ways a betrayal of the ‘old’ behavioural economics founded by Simon (1957). The existence of a ‘new’ and ‘old’ behavioural economics is actually part of an established pattern, where we have a ‘new’ and ‘old’ institutionalism (Rutherford 1994) and Keynesian and post-Keynesian economics (King 2002). The paradigmatic strictures of orthodoxy prevent a proper engagement with, and understanding of, the original ideas (Earl 2013). This means that new ideas are only absorbed into the mainstream on the mainstream’s own terms, leaving most of the original and more challenging ideas to exist only within marginalised and largely ignored schools of economics.

The conservative nature of much of the ‘new’ behavioural economics is evident enough in the assertions of its key contributors and textbooks. Behavioural economics is seen as an approach that “extends rational choice and equilibrium models; it does not advocate abandoning these models

entirely” (Ho, Lim and Camerer cited in Wilkinson 2008 p.4). The prominent new behavioural economist Matthew Rabin is “adamant that he wants to create a sense of continuity that allows people to see the changes that are happening as incremental changes to a fundamentally unchanged science” (Bateman 2007 p.6). In summary, while the mainstream research frontier is different enough to confound conventional notions of the orthodox-heterodox dualism, [it] is not a revolutionary force that is changing the face of economics.”¹¹

Thornton is certainly correct that behavioral economics is encountering the expected resistance, in the form of an apparent embrace – what might be termed a “smothering embrace” – which struggles to preserve the core of the old paradigm, even when that requires damaging the new ideas. Complexity economics (a subset of the various kinds of complexity theories that have excited and energized several branches of the natural sciences and mathematics in recent decades) has similarly been touted as an unstoppable force for change in the discipline, while also meeting subtle resistance to its potential for change. The same can be said for events in the world, outside of theory: the Great Recession (and the failure of economics to identify, before the fact, the economic trends that were leading to it), and the related recent emphasis on inequality. Might all of these forces together break through the barriers to real change in economic theory, teaching and practice? I cannot predict this, but am somewhat optimistic. And, in my optimism, I have written this paper to propose an alternative to the starting point of neoclassical economics.

I have suggested that the axiom “rational economic man maximizes his utility” does not stand up to tests of logic, evidence, or the needs of society. Twentieth century neoclassical methodology depended heavily on this radically simplified statement to underpin its boast of being scientific, in being “fully axiomatized.” Even mathematics no longer accepts that as a realistic requirement. In an economics designed to grapple with the complexities of the world in the 21st century it is neither necessary nor possible to formulate a statement that will be used as an axiom from which all the rest of economic knowledge and understanding can be deduced.

With that said, I propose the following statements concerning motivations and behavior as reasonable starting points for this human science.

Normal economic behavior must be understood within:

1. The social context: People care what others think and do. Individual actions are not only motivated from within, but also by a sense of group identity.
2. The ethical context: Experience and observation suggest that most people pursue a variety of goals, normally including some mixture of self-interest and concern for others or for the common good. Goals are not identical to revealed preferences; people’s values come into play in the actions they undertake and the goals they set for themselves, for their children, and for their society.

¹¹ Thornton, 2013. In a personal communication (July 2014) Thornton notes that he is generally hopeful about the prospects for a reformed economics, but argues that it will require the adoption of a diverse suite of strategies, as well as some adjustments in our understanding of the nature of the problem to be solved.

A reasonable definition of rational behavior includes:

3. Choosing goals such that (a) when the actor achieves the goals, she or he will be glad to have done so; and/or (b) the pursuit of the goal itself contributes to well-being.
4. Pursuing those goals in a manner that the actor reasonably expects will lead toward their achievement.
5. Limits to rationality: Most adults who are not suffering severe psychological or cognitive handicaps attempt to act rationally, as just described. However, sometimes lack of information, or the influence of conflicting emotions, or influence from others pursuing different goals, may cause generally rational actors to choose goals that are not consistent with well-being, or to do things that lead away from their own goals.

Can this description of rational behavior, set in social and ethical contexts, and clearly looser than the old utility-maximizing axiom, be used as the basis for models that will look like the models held up by neoclassical economists as the ideal way to present the world for economic analysis? The following seems to me a good answer to this question:

... a more radical reformulation would discard altogether the idea that a universally applicable model, in which all key relationships are predetermined, can describe the economic world. Economic behaviour is influenced by technologies and cultures, which evolve in ways that are certainly not random but which cannot be described fully, or perhaps at all, by the variables and equations with which economists are familiar. Models, when employed, would therefore be context specific (John Kay, 2013).

What would economic theory, teaching and application lose, and what would it gain, by replacing the 20th century model of human psychology with the looser set of statements suggested above? The loss would be a good deal of the edifice of neoclassical economics – that portion that is in fact built upon the very narrow definition of human behavior, in economic contexts, as purely motivated by self-interest. This narrow definition had been encrusted with some further assumptions about rationality, including consistent preferences as well as the possession of information that was either “perfect” or “sufficient” to make optimally self-interested decisions. These assumptions have been shown to be invalid and must also be abandoned.¹²

A deep refresh for economic thought which begins by abandoning these assumptions opens up important new possibilities in several areas of content as well as methods, including many that are beyond this paper. I will conclude with comments on just one of the topics to which there may be a new opening: Consideration of economists as human beings.

¹² Milton Friedman famously stated that it did not matter if assumptions reflect reality, as long as the theory based on them can make good predictions. Economics has dramatically failed to predict many important aspects of the last 50 years – from the unintended consequences of motivational pay at the top corporate level (based on principle-agent theory) to the repeatedly swelling and bursting bubbles in the 1990s and into the next decade. The assumptions of rational maximization have failed by Friedman’s test as well as on the reality tests imposed by behavioral economics. See Goodwin, 1991 “Stories That Blow up: How to Anticipate When the Realisticness of Assumptions Will Matter,” chapter 11 in *Social Economics: An Alternative Theory* (New York, St. Martin’s Press.)

10. The education of economists

This paper has been largely about the people whose actions are the subject of the discipline of economics. This final section will consider some issues to do with economists themselves. There is much to be gained by respecting each individual as a source of knowledge about human beings, and assuming that most individual economists possess (whether or not they draw on it) more knowledge about human motivations and behaviors than can be summarized in any “model” or other set of statements.

The previous section proposed a basic summary statement of what economics, and economists, should know about people. Those who accept this summary as reasonable will also note that it is very far from being a full description of “what people are like.” Volumes and libraries can be devoted to that question without laying it all out. The only complete model of a human brain is that brain; computers full of algorithms cannot provide the information on you that is contained in your memory, intuition and knowledge.

Economists, like other people, are not simple calculating machines. Students entering the field bring to it their life experience and their personal qualities such as judgment, caring, hope, imagination, and intelligence (of many kinds). A good educational experience will build on these qualities – it will provide more and deeper knowledge and experience, ways of critically analyzing information, and ways of researching new information, both alone and working with others. These goals for education are quite well known.

While schools of education are concerned with the goals of education, economists have accepted very narrow goals – “learn what you are taught,” but not “think about the meaning and the application of what you learn.” I referred earlier to the convenient assumption that economists out in the world will have clients who will be able to define any necessary goals. Since the reality is often not so simple, perhaps writers and readers of macroeconomics textbooks should take on themselves the role of the client; for example the first and the last class meeting in any macroeconomics course could include a discussion of the appropriate goals for the economy.

Another, more specific goal that has not received sufficient attention within economics (though it turns up in some other places in higher education) is that of training judgment. This quality is, in fact, as essential for neoclassical economics, with its strong emphasis on techniques of analysis, as it is for a less formal approach. There is nothing inherent in any technique *per se* that assures that it will be used in the right place. The correctness of the conclusions, however they are drawn, will depend upon judgment at several points:

- Judgment is required, to start with, in deciding what topics are more or less interesting to analyze.
- Where any empirical facts are used, judgment is critically required for the selection of which facts to focus on.
- Different techniques applied to what appear to be the same materials are likely to produce different results – aside from the fact that the choice of technique may impose restrictions on the selection of the variables under consideration. (For example, hard-to-quantify variables may be ignored in a model that requires

quantitative representation of its subject matter). It is a matter of judgment which is the most appropriate technique for the analysis of a particular subject.

- Any abstraction from reality, whether it is a formal model or a narrative chain of reasoning, requires some assumptions; judgment is required in their selection.¹³
- It is also required for the reading, evaluation, interpretation and application of the conclusions that emerge from any analysis.

Judgment can, and should, be informed by the gathering of information – but, as Herbert Simon pointed out, it is generally impossible to know exactly what is the information we need that we don't have, or when we have enough. Judgment also can and often should be assisted by analysis – but, as was noted above, complex decisions may actually be hindered by excessive ratiocination, and may be more effective when taken quickly, calling on emotion or intuition. Thus, to add to the list of bulleted points above,

- Judgment is required to know when to stop gathering information, and when to call on intuition as an aid to analysis¹⁴.

Humility is another valuable quality, too seldom found in economists. No individual can be expert in all the fields that are relevant to the important subjects for economics in the 21st century – fields such as ecology, systems theory, sociology, psychology, history, nutrition, anthropology, philosophy, political theory, etc. Each economist should have studied enough outside of economics so as to be able to talk comfortably with people from other disciplines, and to know where to look for insights that economics lacks. This means that economists have to talk in terms that non-economists can understand – i.e., not jargon.

Humility tells us that we don't know all the answers: imagination is required to find solutions that are not obvious. Imagination is the quality that may be hardest of all to teach, but at least economists could learn to recognize and value it.

Thus I come to a list of the qualities that would, ideally, be promoted in people who are learning to be economists. The list includes judgment, humility and imagination, as well as good communication skills – the ability to learn from others, and the ability to communicate with people with different educational and cultural backgrounds. Because humanity now confronts so many difficult problems, economists also need to be attuned to recognizing and defining problems. And along with humility they need to have hope and optimism that they can find solutions.

Finally there is the quality that existed in Adam Smith and Alfred Marshall – and, indeed, in Paul Samuelson – and in most of the other great economists: That is the quality of wishing to

¹³ Just as one example, when analyzing the likely effects of a tax an economist may draw on existing estimates of the price sensitivity of consumers. Judgment may be required to choose which existing estimate to use, or whether any estimate, often drawn from different situations, is good enough to use, or if it should be adjusted before being used.

¹⁴ This last point may seem especially surprising, so it is worth giving an example. Recall the conclusion, earlier, that while ratiocination assists in good decision making in relatively small matters, it may be better to give room for intuition in larger ones. Thus, suppose an individual is presented with the decision about what research area she should choose for the next several years – or even for her life's work. Most economists who have both been successful and have enjoyed their life's work would probably agree that this decision was not made purely on a cold-blooded, rational basis. Once it is made, then intuition will often (but not always) take a back-seat to logical analysis.

contribute to making the world a better place. Many students come to economics because they have this wish, but those who are most concerned with it are the ones who, in recent decades, have been turned off and dropped out of the field, disgusted with the lack of overt values of caring and community, and the presence of implicit values of greed and selfishness.

Neither I nor anyone else should insist on what “better” (as in “making the world a better place”) means to each person who studies economics – only that they should, ideally, be open-minded to the possibility that their notions of better and worse states of the world might change in the course of their education. Unlike imagination, the quality of caring is relatively easy to teach – by example; for it is intrinsic in people to pick up on and internalize what matters to influential people around us. Thus it is all the more important that those who teach economics investigate within themselves what matters to them, and how they think the economy, and economic theory and teaching, could contribute to a better world.

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