

TEACHING ECONOMICS DIFFERENTLY

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Paper to be presented at the IIPPE conference at ISS, The Hague, July 2013.



Cover of The Economist, June 18th, 2009

Abstract

The paper will show how an introductory economics book, currently being written for (under) graduate students not majoring in economics, can be both pluralist and globally inclusive. The first principle, pluralism, will be shaped through presenting in each chapter first more general theoretical perspectives and ending with more narrow theories. The more general perspective will begin with theory-independent concepts, such as markets, prices, demand, and labour. The theories will range from socio-economics, to institutional economics, post-Keynesian and structuralism, to neoclassical economics as a special case under ideal conditions. The second principle, global inclusiveness, will be shaped through the applications and examples that each chapter will use. Instead of a US or EU oriented context, the book will relate to countries all over the world, including developing and emerging economies. For example, the labour market chapter will go into labour market institutions, policies and statistics from South Africa, whereas the chapter on financial markets will compare the 1997 Asian financial crisis with the current US and European one as illustrations.

The paper will argue why and how such a pluralist and inclusive approach is taken and will give examples from various chapters, micro and macro, of the book-in-process.

Introduction

The book is currently being written. I have started with the methodology, history and three micro chapters. This paper will show how these first five chapters try to present economics as a pluralist social science, for a global audience. Since the book is still in the making, it is not complete yet, and the draft chapters that have been written are under review by colleagues and will benefit from their inputs as well as from feedback from other for a such as this conference. I very much welcome your suggestions.

From CH 1 A short history and description of economics

Intro

Some economists, including myself, make a distinction between mainstream economics, followed by some 90% of economists, and a variety of other approaches, followed by the other 10%. This distinction is also referred to as neoclassical or orthodox economics, versus heterodox economics, which comprises a wide variety of theories and methodologies. I will explain this variation further in section 1.3. In case that you are curious where I belong? Well, I was trained as a neoclassical economists, was given a very brief view on heterodoxy by two lecturers, which stimulated me to engage in self-study on heterodox schools of thought, sent a clumsy paper to Amartya Sen whose work I greatly admired and to my surprise received a friendly and encouraging short letter back, and found a PhD supervisor after eight years of searching, who had the courage to guide my PhD research on the ethics hidden in economics.

The mainstream of economics is highly mathematized, relying on formal mathematical models. It has therefore earned the image of applied mathematics. But economics is part of the social sciences. It studies human behavior in production, consumption, entrepreneurship, labour, investment, and distribution. This behavior is not only located in markets, but also occurs through economic actors' interactions with the state (in particular through paying taxes and receiving public services) and with civil society, or what will be referred to in this book as the care economy (in particular through the creation of social capital in communities and supply of unpaid work in households). So, economics is a social science, which uses a plurality of theories and methods, both quantitative and qualitative, to explain economic behavior.

For those who insist on a definition, here is one: economics is the study of how

human beings interact for the provisioning of their livelihoods in markets, the state and the care economy. I admit that I do not make explicit how and why humans act in the economy as they do. The reason is that in the real world, human beings have a great variation of motivations to act, and an even larger variation of what they seek to achieve in their livelihoods – from satisfaction with a simple material basis to the desire for a luxurious life or the expression of high social status. So, a definition of economics cannot define economic actors' ends and motivations, although some specific economic theories do this to some extent.

What is the purpose of economics as a field of science? This was formulated half a century ago by Joan Robinson, a well-known British economist working in the years 1940s - 1970s. She said that the purpose of studying economics is not to acquire a set of ready-made answers to economic questions, but to learn how to avoid being deceived by economists. This statement is also a recognition that economics is not part of the natural sciences, with its generally accepted laws, categorizations and regularities, but that it belongs to the study of human behavior, with its inevitable social, political, cultural and moral dimensions. So, to some extent economics studies how we use means to achieve ends. At the same time, economics goes well beyond a means-ends study. That is because nothing is fixed. Ends are not fixed, and neither are means fixed over time and space.

Values

There is one more key concept to the description of economics, next to human interaction, markets, the state, the care economy, means, ends, and scarcity. That is the concept of efficiency. Efficiency is an ethical value, like equality or fairness. If you have to clean your house, you generally prefer to get it done with as soon as you can, that is, efficiently. Moreover, there are other economic values beyond efficiency, because economic processes go beyond simple means-ends relationships. These other values are important in themselves in social interaction, but may also have positive effects on efficiency. Such other values include fairness (if workers feel they are exploited they will not work diligently), trust (if a customer does not trust a supplier she will change shops), and equality (poor, unemployed people don't have the money to buy the products offered for sale by those who have the assets to produce them). In short, as John Maynard Keynes, a famous British economist has phrased it in 1938:

“Economics is essentially a moral science and not a natural science. That is to say, it employs introspection and judgments of value”.

History of economic thought

Time Line of Economics (with short descriptions of the works of ten influential economists):

Adam Smith David Ricardo Karl Marx Alfred Marshall Thorstein Veblen John Maynard Keynes Joseph Schumpeter Amartya Sen Elinor Ostrom.

Economic pluralism simply refers to the conviction that in economics, as in other sciences, a plurality of theoretical and methodological viewpoints is valuable and contributes to the advancement of science. Since present views may be false it is sensible to have a plurality of views available. Plurality is therefore a matter of open minds and the availability of a variety of perspectives. It involves a recognition of variation in real world economies, of the economic lives of men and women; of people living in rich and in poor countries; and of the functioning of markets as well as of states and the unpaid, gift-based care economy.

The global financial crisis of 2007/2008 is an example of the risks of the dominance of a single theory in the real world economy. Many large banks had used a financial model that appeared to be blind to tail risks and systemic risk. In other words, they underestimated the probability that losses for a single bank could become too big to bear and they underestimated the probability that the fall of one bank would bring about the fall of other banks. At the same time, the human resource management model of most banks relied on performance criteria and a financial incentive system that stimulate short-term profit making rather than long run objectives of continuity and client service. Both the financial model and the performance management system were based on neoclassical economics. There had even been Nobel Prizes being awarded for the underlying theories.

Theories

The broadest of the four economic theories, which this book presents is social economics (sometimes referred to as socio-economics). Its name already indicates that it understands the economy as part of society and economics as related to sociology. Its roots can be traced back all the way to Aristotle, who claimed that human beings are social beings rather than individualists.

Institutional economics regards markets as more than demand and supply meeting each other freely and regulated by the state to some extent. Rather, institutions matter too: they constrain behaviour or enable it in a socially structured way. This may be through formal institutions, which are codified rules, regulations and organizations and through informal institutions, which are unwritten rules, beliefs, and rules of thumb. Hence, not only the state is an institution, but also the market is an institution.

Its name already indicates its founder, John Maynard Keynes, whom we discussed briefly in section 1.2.7. His ideas were further developed and complemented by others, among them Joan Robinson, Michal Kalecki and Nicholas Kaldor. The Keynesian approach to economics can be characterized by the recognition of uncertainty, internal dynamics, instability, effective demand and the enabling role of the state in the economy. It recognizes that markets do not automatically lead to the highest wellbeing, economic growth, or efficiency, but that markets have in-built shortcomings.

Neoclassical economic theory, started with Alfred Marshall as discussed in section 1.2.4. I discuss this theory last, even though it is still a dominant theory in economics today. The reason is that it is the least broad economic theory of the four discussed in this section. It consists of a well-defined set of principles and assumptions, and thereby is developed for a specific economic context. This context is characterized by competitive markets (many suppliers, no market power) and perfect information, or at least, widely available information with known probabilities of possible events.

In this sub-section, three cross-cutting theories will be mentioned very briefly. The first one is behavioral economics, an empirical approach to the study of the behavior of economic actors under various conditions. Another cross-cutting theory is feminist economics. This emerged as a response to unexplained differences in the economic positions of men and women in basically every society. The last cross-cutting economic theory listed here is environmental economics. Like feminist economics, it can be integrated in any school of thought, even though it has a core of its own. That core is based on a serious concern with environmental degradation and global warming and recognizes the economy as not only embedded in society, as social economics does, but also as embedded in the natural environment, as an open system.

Next to Nobel Prize winner Amartya Sen, other economists from the global South have been influential as well for the development of economics over the past few decades. They have largely been influential in development economics, rather than in fields of finance or consumer theory for example. This section will briefly review the contributions of three major development economists from Africa, Asia and Latin America. Thandika Mkandawire (born in 1940), from Malawi, is a major contributor to social policy theory, working in the tradition of social economics and a combination of other heterodox economic theories. He served as director of UNRISD, the United Nations Research Institute for Social Development, based in Geneva. He has been a major critic of the World Bank policies for Africa in the 1980s and 1990s, which were carried out under the label of Structural Adjustment Policies. He has argued that the unbalanced focus in these policies on low inflation, urging high interest rates to discourage borrowing by firms, has constrained investment, and thereby limited employment growth in Africa. Raul Prebisch (1901-1986) was an Argentinian economist and co-founder of the structuralist school, which integrated Marxist thought in modern economics. He was professor at the University of Buenos Aires and has led ECLAC (Economic Commission for Latin America) and the UNCTAD (United Nations Conference of Trade and Development). He became well known for his interrelated contributions to trade theory and dependence theory, both in relation to developing countries, in particular Latin America. Gita Sen (born in 1948), is an Indian economist affiliated with the Indian Institute of Management in Bangalore, India and Harvard University in the US. Although a much in demand policy advisor in the international arena, Gita Sen combines her academic work first and foremost with NGO activism. She has been a major critic of development economics because of its dominance by economists and policy makers from the developed world and the marginalization of women from economic policy making. Being a feminist herself, she also criticized feminist movements from the North, which were more concerned with critiquing policies in and on the South rather than challenging policies in the North that negatively affect the lives of the poor and women in the global South.

From CH 2 Philosophy of economics

Intro

The new discipline of economics, led by neoclassical economists in the first half of the twentieth century, had the ambition to earn itself a key place in the modern sciences,

with its own Nobel Prize. It managed to do so, and economics even acquired the nickname of the 'Queen of the Social Sciences', by following two core ideas that were around at those times in the philosophy of science: positivism and falsification.

Positivism

Positivism is a philosophy of science recognizing only that which can be verified through observation or which is capable of logical or mathematical proof. This implies that it is very much concerned with empirical evidence, that is, acquiring knowledge from obtaining and verifying data received from the senses. Hence, economic methodology is shaped after the classical natural sciences where observations from seeing, hearing, or feeling result in data to be tested with theoretically derived hypotheses. For example falling apples from a tree to test gravity. This is quite different from the wider methodologies in modern physics (think of, for example, Einstein's relativity theory, which was developed intuitively and has not been tested completely yet) and the broad range of methodologies used in the social sciences at large, using intuition, induction from case studies, and interpretation of meanings of policy documents or the observation of human behaviour. The positive in this philosophy of science is defined as opposite to the normative, which is regarded as moral-based, as ordered from an authority (God, church, emperor or king) rather than testable with proofs from observed phenomena. Positive economics is empirical economics based on quantitative analysis of economic data. These data may be secondary data, available in statistics, or primary data, collected through experiments, accounting, or surveys.

Positivism was at its height in the philosophy of science between the 1920's and the 1950's. Again, precisely in the period in which neoclassical economics established itself as the core of a new science. Positivism has therefore strongly influenced neoclassical methodology, with its insistence on mathematical proof and empirical testing with quantitative data.

Falsification

Falsification, deriving from the philosopher of science Karl Popper, is a scientific method of assessing progress in science. Its main tool is the testing of deductive hypotheses. These are hypotheses that are derived from theory, not from a real world puzzle. A testable, deductive hypothesis can be either confirmed, which implies that its underlying theory is supported, or falsified, indicating that its underlying theory is flawed. Falsification does not mean amassing supporting evidence for a theory and its accompanying hypotheses. Instead, falsification is a dynamic process of problems,

tentative solutions (hypotheses) and error elimination, with the possibility of shifting to new, alternative theories.

The method of falsification, however, cannot function with only a hypothesis derived from theory and data. It also relies on proposed mechanisms that are often supplemented by additional assumptions, deducted from theory. The mechanisms are rejected if they are regarded as an anomaly, not explainable with deductions from the theory at hand. While they tend to be modified through adding even more assumptions in even more complex theories. This entails a danger, namely, that if a hypothesis cannot be confirmed, researchers may try additional theoretical assumptions to enforce confirmation. This is more likely the more abstract a theory is, because highly abstract theories depend on relatively strong assumptions about the real world.

Economics took up falsification in two ways: logical tests of theories through mathematical proofs, such as the Arrow-Debreu equilibrium proof, and empirical tests of theories with the use of real world data in models that were tested using statistics (this is referred to as econometrics). The inductive method has also earned its place in economics, by establishing regularities in human behavior leading to so-called behavioral laws. Examples are the law of supply and the law of demand, as will be discussed later in this book. These laws hold under strict behavioral and contextual conditions, generalized into theories, while there are recognized exceptions in the real world.

The method of deductive hypothesis testing has been the dominant method in economics since its establishment as an independent science over the past hundred years. But in the 1970s, criticism emerged because of the widening gap between increasingly abstract and mathematical theory on the one hand and the messiness of the real economy on the other hand. When can we regard a theory as right, as proven? How many times should hypotheses derived from a theory be tested? When applied strictly, one can only prove that all swans are white when all swans are tested and no black swan is found. But when do you know that you have observed all swans? Hence, deductive theory testing will only be able to falsify a theory, but never be able to fully confirm a theory. Moreover, additional assumptions that are added to enable falsification are often not tested themselves and become part of the problem of falsification rather than a solution.

So, while mathematical proofs lead to logical support for a theory in the abstract, empirical testing leads to empirical support for a theory. But the first has little to do with the real world, and the second appears to hold only under a small set of

controllable conditions and behavioral assumptions. As a consequence, philosophers of economics began to criticize falsification as the dominant method. They argued that it is too strict for the social sciences, and since economics is part of the social sciences and not the natural sciences, falsification is probably not the best suitable method for economics. This has led to the development of less strict forms of assessing scientific progress in economics. For example by combining qualitative and quantitative methodologies, by using case studies and comparative analysis as reliable inductive methods, and by using nonlinear dynamics, which is an open systems approach to mathematics allowing for uncertainty and vulnerable interactions with the natural environment. However, falsification still has a surprisingly high share of supporters in the economics profession today.

Paradigms

As a reaction to positivism and falsification, a major alternative approach in the philosophy of science came to development since the 1970's. The initiator is Thomas Kuhn, who argued that there exists no unified theory but there are instead paradigms in science. A paradigm is defined as a set of scientific and metaphysical beliefs that make up a theoretical framework within which theories can be tested. But between paradigms, the testing of the same hypothesis often makes no sense: each paradigm generates its own hypotheses. In the 1980s' Sandra Harding added to this view the insight that scientists, like any human being, have their own positions from which they cannot completely distance themselves. She argued that it is therefore better to make one's position explicit, through standpoint theory, rather than pretending objectivity. Amartya Sen has acknowledged this insight and came up with the term 'positional objectivity', to acknowledge that economists, like other scientists, reason not from nowhere but from a position in society, with their own beliefs, rules of thumb, and social identities, which may include personal interests.

Ethics

The opposite of positivism is normativity. According to positivists, only positive statements can be falsified, normative statements not, because they are value-statements, referring to what *ought* to be rather than what *is*. Positivism, hence, is argued to be morally neutral, whereas normativity is said to entail a moral position. Economists adhering to positivism claim that they do objective science, not influenced by ethics. Any ethical considerations should only come after economic analysis, namely in policy analysis and policy advice, they say.

However, normativity refers to a narrow interpretation of ethics, namely as morality, as judgments about good and bad. But ethics is much more than that. And it enters economic analysis. First, scientists are human beings, having their own political views, social positions, and career agenda's. The same counts for economists, of course. They are positionally objective, as was explained above by Amartya Sen, which means that they try to be as objective as possible, given their own political, social, and cultural positions. A second reason why economics is not value free is that many economic concepts are not value free. For example: poverty, class, free choice, free trade, and efficiency. Research on poverty makes use of politically inspired poverty lines, which have a clear basis in moral views of human need and fairness. The World Bank for example, uses a poverty line of 1.25 US dollar per day in its research of poverty in developing countries. Free trade reflects a liberal worldview emphasizing the gains from trade and paying less attention to unequal distributions of these gains or even trade losses for some trading partners. This is reflected in the position of the World Trade Organization, which strives for free trade between countries. Thirdly, **mainstream** economics entails an implicit idea of what a good economy is, or what economic progress is. Often, this idea involves free markets and efficiency. Efficiency is the major economic evaluation criterion, as was explained in Chapter 1, and in itself a highly ethical notion. It is all about maximizing output with a given distribution of inputs, or to state it differently, it is concerned with the minimization of waste of resources. Efficiency is an ethical value and at the same time the major evaluation criteria in economic analysis, dominating alternative evaluation criteria, which may have equal moral value.

Utilitarianism

The dominant ethical foundation of economics is utilitarianism. It is concerned with maximization of pleasure, or happiness, and minimization of pain. It is a consequentialist ethics, because it is only concerned with outcomes, not with principles or processes. The end justifies the means (as long as these are legal of course). Its founder, Jeremy Bentham, described utilitarianism as 'the greatest happiness for the greatest number'. This means that an act is considered right if the sum of total utilities produced by that act is greater than it would be by any other act that an agent could have performed. In economic terms, you maximize your utility from your last 10 rupiah if you buy mango juice with it rather than papaya juice if you like the first more than the second and the first is only slightly more expensive.

Neoclassical economics is based upon a utilitarian ethics and uses utility as its ordinal measure of individual wellbeing. Neoclassical microeconomics therefore is concerned with individual utility maximization, whereas welfare economics focuses on aggregate utility maximization, for an economy as a whole: the greatest happiness for the greatest number. Critics put forward two major problems with utilitarianism. First, they argue that many valuable things in life cannot be reduced to pleasure – for example the care for small children, which can give many headaches and considerably reduces your mobility and freedom of choice in daily activities. Second, the critics point out that not everything that people find valuable can be traded off against something, because some things are valuable in themselves. Who would easily trade-off friendship against more income, or one's vegetarian conviction against a 25% discount for tortellini bolognese in the local supermarket? Another major problem with utility maximization in economics is that the state of maximum utility, the best possible state in utilitarianism, can involve a very unequal distribution of income and wellbeing in a country.

Deontology

The best-known alternative to utilitarian ethics is deontological ethics. This is an ethics concerned with rights, duties and human dignity. It is therefore a principle- based ethics and is not concerned with outcomes. The founder of deontology is Immanuel Kant, who developed a famous rule to find out what the best course of action is, the Categorical Imperative: act in such a way that you like other people to behave as well.

In economics, deontology is expressed in three ways. First, in the rules that shape markets and ensure exchange contracts. This involves property rights, protection, money, courts of justice, accounting rules, and reliable information on prices. Second, deontology is expressed in economics through the rights and rules that constrain economic agents in their choices. For example, it is not allowed to maximize one's utility by driving through a red traffic light or using slave labour. So, deontology comes in as a formal constraint on utility maximization: it puts limits. The third way in which deontology finds its way in economics is through socially shared norms which influence behavior informally. For example taking the smaller glass from a plate with two glasses of beer that you can one choose from. Not because there is any utility maximization involved from the politeness of declining to take the biggest beer (you may be very thirsty and prefer to lessen that thirst over being polite). But because social norms require you to be polite, whether you like it or not, you simply have to do your social duty – because it is the right thing to do, and you expect others to behave like this as well.

Now we have three ethical reasons for choosing a small beer over a large beer:

- utility maximization when one has a strong preference for politeness, which gives more satisfaction than the extra beer
- deontology of the formal kind when one is planning to drive a car in half an hour and is by law not allowed to drink much alcohol
- deontology of the informal kind when one is being polite out of a moral duty, following a social norm, even when this feels frustrating

Virtue ethics and the ethics of care

A third ethical theory that deserves attention is virtue ethics, deriving from the ancient Greek philosopher Aristotle. This is a person-based ethics and depending on social embeddedness of behavior. Virtue ethics is not exclusively concerned with outcomes or with rights, but with good behavior in itself, as defined by the virtues. Important virtues are benevolence, courage, fairness, prudence, self-discipline, honesty, and generosity. Aristotle states that the good life is the virtuous life and that it is necessarily pluralist, going beyond pleasure. Virtues cannot be traded off against one another, while conflicts can be solved, at least to some extent, by deliberation with others in private discussions and public debate. This is very different from deontology where one searches for a universal rule to guide behaviour, instead of through a social context of deliberation and trial and error with social feedback. So, the businessman learns to become virtuous through his dealings with suppliers and clients. The famous theatre play 'Death of a Salesman' by the American playwright Arthur Miller, which won the Pulitzer Prize in 1949, shows what happens if a business man does acquire virtues in his tradings, but instead acts with arrogance, over-confidence, and treason. Miller's businessman, Willy Loman, loses his clients, his earnings, and eventually his family and ends up dead by suicide when he finally finds out that he made the wrong choices.

Virtue ethics is also very different from utility maximization, not only because virtues cannot be traded off against one another, but also there is no absolute point of reference – no maximum to be achieved. To the contrary, virtue is a means between two extremes, Aristotle argued. It is neither excess nor deficiency. His famous example is of courage. A courageous soldier does not run ahead of the troops straight into the spears of the enemy. Nor does he hide behind a tree to let his comrades do the fighting. The courageous soldier finds a middle road in between these two extremes, thereby contributing to a hopeful victory without sacrificing his own life or that of his fellow fighters. The same counts for the virtues in economic behavior: it is a mean between two extremes. Honesty implies that a seller of a product does not hide weaknesses of the

item, but it is also not necessary that she hands over her business accounts with all detailed information about personnel costs, investments, and profit made per transaction to each buyer of her product. Honest trade is somewhere in between.

Power

Economics has an ambiguous relationship with power. This is because it largely studies market behavior, that is, presumably free choices that people make to produce, exchange, or invest their resources and to buy goods and services. Free choice assumes that one is autonomous and not under the authority of someone else. When we look closer, however, there is some recognition of power in economics. Economists Samuel Bowles and Herbert Gintis have defined power of B over A as B being capable of affecting A's actions to serve B's interests, through threatening or imposing sanctions on A, while A lacks this capacity with respect to B. So, power in the economy is defined as asymmetric. In the economy, A and B may be firms, households, individuals in households, non-profit organizations, labour unions, communities, and the state. There are also more implicit forms of power. When B is able to divert A's wants, with advertisements, stereotyping, A's agency and the options from which A feels she can choose become more limited. Such power in the economy is often hidden or taken for granted as being part of local culture, and therefore difficult to challenge.

In a way, neoclassical economics assumes a situation of communism to exist first – sufficient availability of goods and resources for everyone. With that starting point, free markets can begin and every agent will be able to exchange goods and labour. In Marxist economics, free markets have been criticized precisely because this starting point does not occur in reality and therefore markets favour the have's over the have-nots. In post-Keynesian economics, there is an important economic reason for redistribution of resources and income. It helps to increase aggregate demand in the economy as a source of economic growth. First, through ensuring that everybody has sufficient purchasing power to buy goods and services, so that production and sales by firms are supported. Second, through redistribution from owners of capital to workers, because the poorer classes spend a higher proportion of their income on goods than on financial assets or savings, and are more likely to spend it on basic goods, like food, that is often domestically produced rather than on imported goods, such as holidays and fancy cars. This local-based spending pattern of the poor contributes more to economic growth than the globally sourced spending pattern of the rich.

In social economics, and in particular feminist economics as part of social economics, attention is drawn to an unpaid resource in the economy: unpaid labour and care. This resource is largely available in households, but its supply is distributed very unevenly: women tend, historically, to provide much more unpaid labour and care than men. This leaves them less time available for paid work, and hence, for earning an income. This inequality in the supply of unpaid labour time largely explains why female poverty worldwide is more widespread than male poverty. A more equal distribution of the supply of unpaid labour and care between women and men would reduce women's income poverty and increase the diversity of social capital and caring, with various positive by-effects for economic development.

Market power is the only form of power that is widely acknowledged among economists, independent of which theory they adhere to. This is because market power reduces free choice in the market, for competitors, new firms, and buyers. Market power undermines the market.

What is market power? It means that a supplier can influence the price level to his advantage or can prevent new entrants to the market. A free market consists of many suppliers, so that no one can set the price. This is also called a competitive market. As soon as one supplier would increase the price of her products, buyers would turn away from her business and she would go out of business soon. Market power, hence, is often to the disadvantage of buyers, independent whether they are firms, countries, or individual consumers: they all pay more than they would pay in a competitive market. That is precisely why many countries have laws against market power. Another form of market power consists of asymmetric information. If the seller has more information than the buyer of a good, the buyer may be misled and pay more for the good than it is worth.

The second form of power in economics is through the institutions that enable or constrain the behavior of agents in the economy. This occurs through asymmetric institutions: institutions that have different effects on different groups. The differential effect often hides power: power of the group that is advantaged over the other group. Remember from Chapter 1 that we distinguish between two types of institutions: formal and informal ones. Asymmetric formal institutions are laws, regulations, and organizations, which benefit one group over another. For example, workers with a migrant status may have less entitlements to pensions and unemployment benefits than regular workers in a country. This gives them a weaker bargaining position in the labour market of the host country as compared to the nationals. Next to asymmetric

institutions, there exist institutions that entail economic power simply by their historical or cultural dominance. An example is the old boys' network in which a professional and business elite distributes influential jobs among themselves and those closely related to them.

In section 2.3.2, I explained market power as one party having the power to influence the market price in its advantage. This section will take a more fundamental look at power and markets. Here, I will explain that the market itself can generate power in an economy, and hence, inequalities between groups in an economy. Let's start at a higher level of abstraction of describing the economy. As we have seen in chapter one, the economy consists of three domains: the market, the state, and the care economy. Among these three, the market is the location of accumulation. Through labour markets, workers acquire and develop experience and expertise, which may earn them increasing incomes when they accumulate their human capital in response to labour demand. Through capital markets, investors accumulate financial capital through interest, dividend earnings, and profits made on trade in assets. Such accumulation tends to be stronger, the higher the starting position is, the more demand there is for the skills or services provided, and with some luck. Accumulation, therefore, already comes with inequality, even in markets without market power, when there are many sellers and many buyers. Of course, it is possible to grow from a poor shoeshine boy or sweets selling girl to a millionaire. But these are rare exceptions. The dominant pattern of accumulation in competitive markets exacerbates existing inequalities:

- accumulation starts with a marketable initial resource and not everyone has such a resource
- accumulation requires market demand for the goods that one produces with that resource; but for some goods demand is low and declining and substitution costs to shift to the production of alternative goods may be high
- accumulation depends partly on luck: some possible future events can be insured, but many events are simply uncertain and cannot be mitigated; those with more resources are better able to get insurances, to diversity their portfolio, and to acquire expert advise to reduce the costs of possible mishaps

But this is not all. Those who are successful in accumulation, whether it is as entrepreneurs, top executives, investors, or high skill professionals, then will try to maintain their advantaged position. Partly through developing market power (see 2.3.2) and through creating or supporting dominant institutions that defend their interests

(see 2.3.3), such as lobbying clubs, lobbying the state for lowering the type of taxes they pay most. Or they manage to forge asymmetric information situations in which they manage to shift risks to those less informed or to the taxpayer. These accumulation-induced forms of strategic behavior strengthen the market vis-à-vis the state and the care economy. Accumulation, hence, directly and indirectly increases the role of the market in the economy. And when markets become dominant, economies become less stable. The 2007 financial crisis is a good example of this. Finally, market dominance may turn citizens into market parties: consumers and investors. This leads to market-like behavior in society as a whole. Taxpayers want to pay only those taxes from which they will benefit themselves. Hence, not for the municipal swimming pool if they don't have children taking swimming classes there, and not for bus services if they drive their own car, and not for development aid if they prefer to give privately to a development NGO for small scale projects only.

From CH 3 Individuals and households

Intro

The smallest unity of analysis in economics is the *economic agent*. This is an individual, a person, acting in a social world with other persons, through exchange, redistribution, and sharing and gift giving practices. Through these interactions with the social world, economic agents perform roles: *economic roles*. The major economic roles are worker, employer, entrepreneur, consumer, producer, saver, borrower and investor.

Economic agents make decisions and act upon these in an economically meaningful way. This implies that they have ends, in line with their values, and that they try to achieve these ends in a socially acceptable and efficient way. This requires *agency*, which means making autonomous choices and acting upon these. Without agency, people may be coerced, alienated, submissive, passive, or desirous to please. Economic agency implies that the individual has decision making power: over what he or she wants and how to achieve this, using available resources, but also drawing upon collective agency and institutions through the social groups that he or she is part of. Economic agency, hence, can be weaker or stronger, and more individualistic or more social. The main factors that constrain economic agency are:

1. Limited information about present and future prices, goods, needs, and conditions (bounded rationality)

2. Limitations to the human capacity to process information, rank options, and select the best option (psychological biases)
3. Limited power to control risks and uncertainties (vulnerability and fundamental uncertainty)
4. Institutions that limit options, gains, or self-awareness (laws, regulations, routines, and social norms)

In social economics all these constraints to economic agency are fully recognized. This means that economic agents are regarded primarily as *social agents*, acting in a social world under a wide variety of constraints, including asymmetric ones, which favor members of one social group over another. But social economics also recognizes the positive side of economic agents being primarily defined at the social level rather than at the individual level. This positive side is twofold:

1. The *collective agency* of individuals as members of groups: this strengthens decision making power, for example through farmer cooperatives and labor unions
2. The strength of *pro-social norms* such as trust, fairness and cooperativeness: this increases the frequency and distance of economic interactions

Institutional economics emphasizes the fourth category of factors that constrain agency: institutions. At the same time, institutional economists not only regard institutions as constraints but also recognize enabling institutions. For example, on the one hand, laws against market power, which constrain the size of large firms, and hence prohibit certain mergers and acquisitions. While on the other hand, such a formal institution of anti-trust law enables small new-coming firms to enter a market. Similarly, a social norm which ascribes unpaid housework to women and not to men is a time constraint for women's labour force participation but a windfall gain for men's labour force participation, who can leave their daily needs to be taken care of by the women in the household.

Post-Keynesian economics also recognizes economic agents as members of social groups and emphasizes in particular the third constraint to agency, namely risk and uncertainty. This constraint to economic agency makes Post-Keynesians concerned with business cycles and the devastating effect of recessions and crises. Keynes referred even to 'animal spirits' to describe the non-rational motives that drive investors to take risks, and often many others to simply follow when uncertainty rules in volatile markets. This leads to a self-fulfilling prophecy: fear for a downturn in markets actually creates such a downturn, through the herd behavior of investors. The emotions involved in agent's

decisions lead to increasing risk taking and speculation, driving up prices to irrational heights, and after the burst of the bubble bringing markets down through collective panic sales, resulting in crashes of asset values and ending in economic recessions.

In Marxist economics, the social identity of economic agents is limited to two classes: the labour class and the capitalist class. Their interaction is framed as a class struggle over the surplus produced in a capitalist economy. Marx emphasized the need for a collective identity for the labour class, as the only way to win the power struggle against the capitalist class. This results in a class-based agency of the one class against the other in a class struggle.

Neoclassical economics emphasizes not the social but the individual identity of the economic agent. It focuses on individual choice and the maximization of subjective preferences. However, neoclassical economics does recognize limits to agency, and largely those of the first category mentioned: constraints of information. The theoretical solution to this limitation of agency is a cost-benefit analysis. Economic agents are prepared to pay for acquiring more information, up to the level where the expected benefits of additional information do not weigh up against the costs of acquiring the extra information.

This brings us to the question of rationality. If agency itself is a messy activity, full of social and psychological opportunities and constraints, is there any rationality left in economic decision-making? Well, to be honest, the problem goes even deeper: how do we understand rationality in economics? The dominant school of thought, neoclassical economics, has long maintained that rationality is self-interested goal-oriented behavior. Or, more technically, *utility maximization*: the maximization of an individual, subjective utility function with a consistent ordering of all preferences, with a given budget constraint. But: are economic agents necessarily self-interested? *Self-interest* is an individual motivation purely directed at one's own interests and requires that economic agents know what they want and are able to get it. In the real world, these two assumptions often do not hold.

First, we do not always know what we want, because our wants are influenced by advertising, by the social groups we want to keep a good reputation in, and by changes in our life course which affect our needs, identities our goals in life. Second, we are not

always clear about how to get what we want. If we want a particular consumer good or insurance today, we should ideally compare all existing alternatives with their prices and characteristics, guarantee and service offerings and estimated longevity. This is impossible. That is why we often are not *maximizers* of our goals but *satisficers*: we compare alternatives to some extent, until we are satisfied with what we found. Third, uncertainty over future states or events make it difficult or even impossible to make the right choices, in line with our self-interest. What is actually our self-interest today if we do not know that in a year's time we will lose a leg and are unable to drive that car we are just about to buy? If we would have stuck to public transport we would not be stuck with an unusable car.

The above three arguments show that self-interest is largely an impossible motive to pursue in the real world, which is full of uncertainties with limited information or, to the contrary, too much information, and in addition changing goals and psychological traps. This brings us to the next question about rationality defined as self-interested goal seeking. This is the question whether people are indeed largely or exclusively motivated by self-interest. Do economic agents, despite serious limitations, seek to satisfy their self-interest?

Let us begin answering this question by looking into the opposite of self-interest: *altruism*. We immediately face the difficulty of finding out what is good for someone else. If it is already impossible to know exactly what you want for yourself, for now and later, as we have seen above, how then can you know what somebody else wants? And even if you know that because the situation expresses a clear need – for example a colleague who rushes home for an emergency and you offer to take over his tasks and stay two hours longer at work – is this altruism? Or is your behavior concealed self-interest? Because you do it to further your reputation as a good employee and colleague in the eyes of your boss and co-workers? Or simply because it gives you a good feeling about yourself, supporting that part of your personal identity that is (supposed to be) generous? So, altruism appears just as difficult to pursue as self-interest as an exclusive motive for behavior. That is why they both are rare.

In behavioral economics, experiments in classrooms have demonstrated that self-interest is rare for economic agents. The *ultimatum game* is a good example.

The ultimatum game teaches us two lessons. First, the majority of people act in a social way, conscious of being part of a group in which interests need to be balanced. Second, the majority of people are prepared to punish those who offer unfair deals, even at their

own cost. They enforce a universally shared group norm, namely, that given resources should be shared more or less equally in a group.

Household

An important group of which economic agents are member of is the *household*. Households have three economic functions: reproduction, joint production and consumption, and risk pooling. All three functions are imbued with power relations within and between households. Power is predominantly expressed in the age hierarchy and in the households' gender relations.

A major economic function of the household is the *reproduction* of the labour force. It does so by births and raising children in a set of norms and values that prepare them for future economic roles and sending them to school. At the same time, the household also takes care of the daily recovery and support of its workers and entrepreneurs, by feeding them, clothing them and listening to their stories and perhaps giving advise on the problems they experience in their economic roles. So, households reproduce the current labour force and the future labour force, reproducing the human resources in the economy.

Households reap gains from joint production and joint consumption. For production, this is enabled by a *division of labour* in the household in which members specialize in different skills, unpaid work and paid jobs. Whereas someone specializes in earning an income through a paid job outside the household, another one may specialize in childcare at home or studying for a university degree next to doing domestic tasks. *Specialization* allows for more income earning and more total household production than is possible when people live alone. Moreover, households allow for *complementary production* processes. For example, health care provided in a hospital can be complemented by unpaid home care for the patient after the operation by household members, who also administer the medication. The combination of paid and unpaid health care, when in balance with patient's needs and care providers' skills, is quite efficient. It saves costs of public or private health care through complementary home care and it supports patients' healing through the love and affection received at home from family members.

Also on the consumption side there are gains for households as compared to individual consumption. These gains lie in the economies of scale and economies of scope of joint consumption. *Economies of scale* in household consumption are cost advantages due to an increasing scale of consumption. This is the case both for consumer durables as well as for daily consumer goods. For durable consumer goods, economies of scale are

reaped from the shared consumption of a single durable good. Sharing the fixed investment of a house among a group of people is cheaper than having individual houses per person. That is precisely the reason why students often live in groups: not because they want to substitute their home family with a surrogate family, but largely because it significantly reduces costs of living when studying in a town far away from home. A similar economy of scale occurs for durable consumer goods such as a car, tv, and furniture, because their use can be shared. For some daily consumer goods it is also possible to reap economies of scale in consumption. Groceries bought in larger quantities tend to be cheaper per unit than when bought in individual packages, thanks to volume discounts. That is why food tends to be cheaper per person in multi-person households as compared to single person households. Another form of gains from joint consumption is through *economies of scope*. This means that the enjoyment of consumption tends to be higher when shared with those you care about. It is often much nicer to have dinner with your family or fellow students than alone, or to watch the football game on TV with friends, so that afterwards you can discuss the results or celebrate your favorite team's victory.

Households are also units in which economic agents *pool risks* and counter the effects of uncertain negative events together. By sharing resources and carrying out a division of labour, households are able to better deal with risks of unemployment, price increases, and changing returns to specialized skills than individuals. But over a longer period of time, specialization may increase risks for some household members. In case of divorce, the partner who specializes in unpaid childcare and domestic tasks will suddenly have lower pension rights and low potential earnings in the labour market (due to limited labour market experience) as compared to the partner who specialized in paid work. Those who specialize only in unpaid or low paid work, in childcare and domestic work have a disadvantage in the long run if the household breaks up or when the main breadwinner dies. So, specialization helps to counter risks in the short run but may increase risks in the long run for household members specializing in unpaid work.

Gender division of labour and caring

Gender refers to the social and cultural differences between men and women, which have hierarchical meanings, often in favour of what is regarded as masculine. These differences are rooted in stereotype concepts that we also find in economics. These include ratio versus emotion; public versus private; competition versus cooperation; and paid work versus unpaid work. In these dichotomies, the first one is in many societies labeled as 'masculine' and the second as 'feminine', that is why we call them

gender stereotypes. Moreover, the first one often has higher social status than the second. Together, these two sides of gender stereotypes create unequal and contested gender relations in society and the economy. In this section, I will discuss the major ways in which gender is expressed in economic behavior of individuals and in households.

The members of a household (remember, we only refer to adults) have to decide how to spend their time between three alternative uses: paid work, unpaid work and leisure time. The invisibility of unpaid work results in a general underestimation of the hours of unpaid work that are spent in households. In particular when men are asked how many hours the women in their household spend on household chores and childcare, they systematically underestimate the actual number of hours. The gender division of labour has direct consequences for the gender division of income. It will come as no surprise that for every economy in the world, women's incomes are lower than men's incomes. This inequality has four sources:

1. Less hours of paid work by women than men and more hours of unpaid work by women than men.
2. Short periods of time out of the labour market due to maternity leave, with in addition sometimes also parental leave taken largely by mothers (much less by fathers) when the child is young; this reduces labour market experience and (rightly or not) signals low ambition.
3. Concentration of women's employment in a limited number of sectors in the labour market, associated with women's work in the household: health care, education, and secretarial work. These jobs earn relatively low wages compared with jobs taken more often by men.

Gendered beliefs about leadership, leading to very few women in top management positions in business, the civil service and NGOs.

Unpaid work clearly has economic value. First, if it would not be done, reproduction of the current and future labour force would come to a halt. Second, poverty would increase, because many goods and services produced with unpaid work are quite expensive in the market and not obtainable by most households. Think about hiring cooks or buying take-away meals three times a day, or hiring cleaning services on a daily basis and bringing your clothes for laundry and ironing services. Third, without unpaid work, consumption would suffer, because many goods consumed in households include some combination of goods obtained through the market, or from the state, and

household production. Think about preparing food, home care, and help with schoolwork of children.

A special type of unpaid work is *unpaid caring*: the positive attention and time given, without pay, to address a particular other's personal needs. Many domestic tasks are not caring tasks: cleaning, shopping, laundry. Other domestic work is caring work: childcare, care for the frail elderly and home care to a sick or handicapped family member. Caring involves a relationship between care giver and care receiver and the value of caring goes beyond the imputed market value for a service provided: its basis is the meaningful sustenance of a relationship. Therefore, it is problematic to express the value of caring in money terms. Moreover, caring is an important source of social capital, an intangible resource in the economy. *Social capital* is the value embedded in the voluntary relatedness of economic agents. This value may be captured through an economic activity by the individuals involved, as for example in a business network where relationships help to find clients or skilled workers. Or the value of social capital may not be captured by individuals but remains at the social level, for a community or economic sector as a whole. This is the case for the social values generated and sustained through these relationships, in particular the value of mutual trust, which is a lubricant for exchange relationships and for tax morale in an economy. In conclusion, we can summarize the value of unpaid caring by adding the three dimensions of what it does for the economy:

- providing attentive, personalized services (which can be expressed, as is the case for non-caring unpaid work, through the proxy measure of substitute services available in the market or supplied by the state)
- sustaining personal relationships (which can be expressed only in subjective terms, for example on a scale of 1 to 10 for how satisfied one is with the relationships in one's life, for example in the family, with friends, neighbors, colleagues, and community members)
- generating social capital through these relationships (which can be measured in terms of the effects of the strength of trust, the density of networks, and the extent of collective action on economic outcomes)

Household bargaining

The sources of bargaining power are threefold: resources, an exit option and asymmetric institutions. Resources include current income, assets such as land or a house, education (human capital), and the social networks that one can draw upon (social capital). The exit option determines the threat point in the bargaining process. It

consists of the resources that one has individual command over when leaving the household. The resources that make up the exit option, and provide a credible threat in bargaining, are the same as those determining bargaining power, with the condition that they are individually owned and recognized as such by both partners in the household. Income, wealth and other resources are not the only determinants of bargaining power. A third source of household bargaining power is *asymmetric institutions*. These are institutions, which favour one partner over the other because of the membership of a favoured social group. Asymmetric institutions are located outside the household, in a class, ethnic group, gender, community, region or country. That is why they function as a “windfall gain” for the advantaged partner, who does not need to undertake any effort in acquiring this bargaining power.

Household Production

This sub-section involves a long text with many tables and diagrams. There is not enough space to copy this.

From CH 4 Consumer behaviour

Intro

Households demand *consumer goods* and *services*. There are three categories of goods that households demand: *final consumer goods* or services, *durable consumer goods* that they use to make household tasks more efficiently (washing machines, cars, computers, coffee machines), and *intermediate consumer goods*, to which they add their unpaid labour in the household to produce final consumer goods or services. Households demand a variety of services, varying from entertainment (theater, tourism) to financial services (health insurances, pension savings and investment plans). The biggest demand by households is for housing: this involves renting at a significant percentage of one’s income.

Wants and choice

Consumers express agency in consumer markets, under the earlier discussed constraints of incomplete information, limited capacity for processing abundant information, risk, uncertainty and institutions. The agency of consumers is referred to as

consumer sovereignty: in a perfectly functioning market economy, consumers determine what is produced, and hence, the economy produces exactly what people want. In the real world, consumer sovereignty is constrained in several ways. The most important constraints are:

- advertisement: whose preferences?
- social norms: what you should want
- collusion and monopolies: what the industry decides for you
- living standards: from needs to wants
- consumer credit: more than you want

Consumer demand

Consumer demand requires purchasing power. Without money, and hence, some source of income or wealth, one cannot exercise demand in a market. But not only income matters – prices matter too. Hence, what is relevant for a consumer is *real income*, which is the *purchasing power* of income, taking prices into account. The cost of a consumer good, however is not simply the price paid for it, and hence, the reduction in available purchasing power. The cost of a consumer good is its *opportunity cost*: the value of the other goods that could have been purchased with the same amount of money.

So, the cost of a pair of sneakers may be 150 dollar at first sight. But its real cost is that you now cannot purchase ten healthy meals worth 15 euro each for the rest of the month, risking vitamin deficiency and obesity. The budget constraint for a consumer consists of income, wealth and prices. Within this constraint, a consumer can buy any combination of goods he wants: this is called the opportunity set – see diagram 4.1 for the opportunity set for a choice between two goods: sneakers and healthy meals. The blue shaded area is the opportunity set for the initial case: opportunity set 1. It allows for purchasing one pair of sneakers or ten healthy meals, each worth 150 dollar.

Demand for a particular consumer good depends on its price level and the available budget. Generally, we tend to buy more of a good when it is cheap and when we have more income, and less of a good when it is expensive and when we have less income. These are called *normal goods*. Not all goods are normal goods. A *normal good* is a good of which demand increases when income increases. An *inferior good* is a good of which demand decreases when income increases. Think about low quality flip-flops produced by underpaid home workers in Cambodia, that wear out in a few weeks, as compared to the Brazilian produced sandals from recycled tires in quality controlled factories in Brazil which last for months if not years. As soon as the income of poor people rises, they may reduce their purchase of flip-flops and begin to buy better quality footwear

such as sandals. The flip-flops are then inferior goods. A special type of inferior goods are *Giffen goods*, named after the Scottish 19th century economist Robert Giffen. People buy less of these when the price decreases and more when the price increases. The best known example comes from Giffen himself and is on staple foods. Poor people tend to consume less of staple foods like potatoes, corn, rice or cassava when the unit price goes down, because this allows them to buy some of the food they prefer more, namely vegetables and meat. This means that for a Giffen good, the demand curve is not downward sloping but upward sloping: the lower the price, the lower demand, and the higher the price, the higher demand.

The relationship between income levels and quantities consumed of a particular good is referred to as the Engel curve, named after 19th century German economist Ernst Engel. The Engel curve shows that with increasing incomes, consumption of a particular good, or basic needs, will decline as a percentage of income. Consumers will spend an increasing share of their income on more luxurious goods, durable consumer goods such as a house, or on savings rather than consumption. If we plot the Engel curve in a diagram with income on the horizontal axis and the percentage of income spent on a particular good, or on all needs together, on the vertical axis, the Engel curve is downward sloping.

In post-Keynesian economics, it is the *propensity to consume* (c) which indicates the percentage of income (Y) that economic agents spend on consumption (C). The remaining percentage goes to savings (s), because income is distributed over two uses: consumption and savings (S). In line with the logic of the Engel curve, Keynes stated that richer people, or owners of capital, tend to save more, and have a lower propensity to consume compared to poor people, or workers, who have a high propensity to consume. Following up on the Engel curve and the different propensities to consume, we can now move on to the relationship between prices and quantities demanded of a particular good. This relationship is referred to as *price elasticity of demand*. It is the percentage change in the demand for a good in response to a percentage price change and determines the shape of the demand curve. The change in demand can be negative or positive. For most goods the price elasticity of demand is negative: a price increase generally results in a decrease in the quantity demanded. An exception are Giffen goods, which have a positive price elasticity of demand. This is because a decrease of the price leads to a decrease in its consumption, while a price increase results in higher consumption.

Finally, we analyze the effects of price changes on the consumption of more than one good. Assume that we have two goods, X and Y. If the price of X falls, consumers may do two things. First, they may buy more of Y, even though the price of Y does not change, and less of X. This is the substitution effect and it results from a change in *relative prices*. More formally, the *substitution effect* is the reduction of demand for a good if the price of that good increases. Second, a price change will change the income available for consumption, or the purchasing power, of both X and Y. So, consumers may buy more of X (as well as more of Y). The effect on demand for X is the income effect. More formally, the *income effect* is the reduction of demand for normal goods if the price of any good increases.

Consumer behavior

In section 1, we have already seen that economic agents are just like people. They have a variety of motives, which lie in between the extremes of self-interest and altruism. And their agency is often constrained by too little or too much information, risk and uncertainty, and institutions. This section first zooms in on the most common characteristics of consumer behavior, which reflect both the variation in motives and the limitations to agency which consumer experience when they make their day-to-day economic choices. After this overview, this section will go into our common weaknesses in terms of status sensitivity and negative side-effects of consumption.

In general, economic agents are sensitive to *framing*. Economic agents dislike loss more than they prefer an equal amount of gain. This leads to the *status quo effect*: they rather stay with their default option, for example insurance package, than shift to another one that claims to be cheaper, but may have hidden costs or less coverage. This asymmetry in preferences for gain and loss also leads to the *endowment effect*. Economic agents tend to attach greater value to a good once they have obtained it. Commercial campaigns make use of this habit, by offering products for free for a limited time period. By the end of the period, consumers who have tried it are willing to pay more for it than consumers who had not the opportunity to try it out for free. Economic agents also have, on average, a rather short time horizon, which leads to the *immediacy effect*. They prefer a reward now over a bigger reward later.

Economic agents also let their sub-consciousness influence their consumer choices. They are sensitive to *priming*, which are invisible consumer messages, like very briefly showing images of a brand of consumer products during a film, so quick that people do not notice it consciously. An opposite psychological feature is *self-control*. Consumers use this as a counterforce against the psychological processes that seduce them into a

particular choice. In particular when they are aware of the immediacy effect, they may seek strengthening of their self-control by joining a group of similarly oriented consumers (think about Alcoholic Anonymous or a club of vegetarians exchanging tasteful recipes and restaurant addresses).

Externalities of consumptions

The fact that economic agents are social beings, and check on what others do, also leads to negative social patterns in consumer behavior. One such pattern is an increased interest in expensive goods when economic agents see their income increase. This can be explained by the *Veblen effect*: the fact that some economic agents are willing to pay a higher price for a good, which has a cheaper substitute that is quite similar.

Affluenza has *negative externalities*, which are unintended consequences of behavior. The externalities of consumption are both expressed at the individual level and for society as a whole. Externalities at the individual level are addiction (how many pairs of fancy shoes is enough?) and health effects (obesity levels in the developed world are alarmingly high, while the fastest growth rates of obesity can be found in the developing world, such as China and the Caribbean). Externalities at the societal level are lower health standards in the population (because of the aggregate individual health effects), pollution (sports cars produce higher levels of CO₂ per km) and environmental degradation (golf courses in desert areas crowd out water for agriculture and human consumption). Moreover, the Veblen effect reinforces itself in the absence of checks and balances in politics (taxation and regulation), in culture (providing a counterbalance of non-materialist values through art, sport, and community life), or in spirituality (by questioning materialism from philosophical traditions, such as stoicism, or religious traditions emphasizing the virtue of living a simple life).

Externalities are, as the definition makes clear, unintended consequences of behavior – not intentional. This implies that generally, consumers do not wish these negative effects to happen. Nevertheless, our consumer behavior makes them happen, precisely because of the behavioral reasons mentioned above, as well as a few other reasons.

Which are these?

1. No price attached to environment and society
2. Alternatives are too expensive: inconsistent pricing
3. Discouragement effect of individual behavioural change
4. Myopia: distance (time and place) between consumption and negative side effects
5. Lack of self-control

6. Framing effect
7. Say's Law: supply creates its own demand
8. Materialism

From preferences to demand to wellbeing

We need to have some idea of what goes on in the black box in order to be able to understand where demand on markets comes from.

A well-known psychologist, Martin Seligman, has summarized his decades of research into what makes people happy in five key purposes of life. I have added a sixth one from the perspective of poverty and developing country experiences. This makes the following list of six components, which can be remembered by the acronym of the first letter of each component: PERMAS:

- Pleasure: yes, this is the happiness component, referring to your satisfaction with life
- Engagement: this refers to the extent to which a person spends time on activities that provide connectedness to the world, or to a cause, that absorbs him or her
- Relationship: this refers to the importance of relationships in one's life, with family, a partner, friends, co-workers, or others
- Meaning: this is the component that people seek to realize in what they do, in order to experience that their life has a purpose
- Achievement: this refers to the human drive to excel, to develop one's talents and to become good in what one does
- Security: this refers to the basic human needs of food, shelter, care and being treated fairly by others

In social economics and institutional economics, consumer demand by individual economic agents is not understood as neatly ordered and relatively fixed. Therefore, these theories do not use mathematical methods to derive demand functions from preference orderings. Instead, they use qualitative methods to understand differences in demand between groups of people and geographical locations. Or to understand changes in demand over time. This is done through segmentation of consumers. This happens vertically, along income groups, and horizontally, along socio-cultural groups. Examples of such horizontal segmentations are age groups – the grandparents of Vladimir and Irina have quite different preferences for food, clothing, and TV channels than the young couple itself – and subcultures, such as fashionistas, vegetarians, or skateboarders. Changes in demand by these segments over time are analyzed by trend watchers but also through socio-cultural surveys which spot shifts in values, for

example, from family-based, to individualistic, to peer group values, or from materialism towards new-age anti-materialism.

In Post-Keynesian economics, individual demand differentiation and change is not the focus of analysis, because Post-Keynesian economists are concerned with the aggregate level demand and its changes. They rather look for patterns in demand, and explain rigidities in these patterns. For example, they note that in the second hand car market, there is more demand for a car with 98.000 km on the meter than one with 100.000 km, and that people are prepared to pay significantly more for the first than for the second car, even when there are no quality differences between the two cars. For Post-Keynesians, segmentation according to income groups is more relevant than horizontal segmentation. That is because of the Engels curve from which the higher propensity to consume for lower income groups is derived. This means that poorer households spend more of their income on consumption than richer households, who save and invest more.

What matters for any understanding of market demand is consistency in people's choices. If economic agents would have no consistency at all in what they want for which price and when, it would be simply impossible to derive individual or even aggregate demand functions in a market analysis. Fortunately, people are agents, who make relatively consistent choices over time, despite the constraints to their agency and constraints to rationality as were discussed earlier in this chapter. In social and institutional economics as well as in Post-Keynesian economics, this consistency in preferences and hence in demand is explained by people's underlying values. And these, of course, are quite constant.

In neoclassical economics, it is assumed that preferences are neatly ordered and rather fixed – per individual and over time. In other words, preferences are regarded as exogenous: they are given and do not change. This assumption of exogeneity of economic agents' preferences allows for a mathematical deriving of demand functions from individual preference orderings. Such preference orderings are called utility functions. The name goes back to the classical idea of happiness as more of pleasure and less of pain. *Utility* is the unit of measurement of preference satisfaction from goods and services. Consumers are assumed to maximize their utility. They do so along a utility function, which is not a straight line but a curve, therefore also called utility curve. The *utility function* shows the relationship between consumption and utility derived from that. *Marginal utility* is the utility derived from the last unit of a good that is consumed. The marginal utility derived from the last unit tends to be lower than that of a previous unit. Imagine that you are very thirsty and that a friend offers you a glass of water. If you

were asked to measure the utility/happiness/pleasure derived from gulping this glass of water down your throat on a scale of 0 to 10, you probably would rank it 9 or 10. Even if generally you prefer apple pie over water, now you probably prefer the water – it gives you maximum utility. Now suppose your friend sees the smile on your face after you have emptied your glass, and offers you a second one. How much utility would this give you? Probably not 9 anymore, but perhaps 8 or 7. Your third glass may still be useful to you, but probably only at a rate of 3 or 4, because your belly gets filled with water, whereas now you notice that you like to eat something al well. So, if your friend offers you a fourth glass of water you probably refuse, because it adds zero utility. Instead, you rather like to spend 2 pounds for a piece of apple pie rather than getting another glass of water for free. So, marginal utility goes down the more units you consume of a good. This is known as the *law of diminishing marginal utility*: the last added unit of consumption adds less to utility than previous units.

From CH 5 The behavior of firms

Entrepreneurs and management

Firms are initiated by entrepreneurs. *Entrepreneurs* are risk taking economic agents on the supply side of markets. Some entrepreneurs head their own firm, being owner and manager at the same time.

There are several parallel solutions to the principal-agent problem. First, firms may have a supervisory board which checks upon the operation of the executive board of a firm. In some countries this is even obligatory for publicly listed firms. This builds in extra checks and balances on executive management's decisions. Second, the owners may give extra rewards when managers ensure that the firm generates stable profit rates at the levels desired by the owners. This can be either done through a high fixed salary or through variable pay – a bonus – on top of a fixed salary. Third, the owners may pay part of the managerial reward in the same units in which they themselves gain from the firm, namely in shares or stock options. *Shares* (or stocks) are partial ownership claims of a publicly listed firm, and *stock options* are future claims on shares, at a pre-set time, for example two or five years.

The solutions to the principal-agent problem, however, generate an even bigger problem. This is the dominance of the interests of shareholders over the interests of all

other stakeholders of the firm. When shareholders have managed to align the interests of the firm's executives and top managers with their own interests, who will take care of the interests of workers, consumers, creditors, and society?

Whereas shareholders are mainly interested in earning the highest possible rate of return on investment (ROI), and as fast as possible because they can sell their shares on the stock exchange at any moment, firms have a longer-term and broader objective. To state it crudely, for a shareholder, a share in a firm is just a means to reap ROI, and if selling it and buying a share of a different firm will earn a higher ROI a shareholder will often do this as soon as the shares of other firms look more promising. So, if a firm is managed in such a way that it exclusively satisfies shareholder interests, having solved its principal-agent problem, its focus becomes more and more short-term oriented. Because shareholders want to see short term profits increase and are not willing to accept one or more years of low profit which allows a firm to innovate and invest, or to train its workers in new techniques or to adapt to more greener technologies to reduce its ecological footprint. Shareholders rather exchange shares of such forward-looking firms for shares of firms that are more oriented towards short-term profitability. A capitalist economy therefore runs the risk of implosion: the undermining of its corporations not by an intervening state or by angry activists, but by its own capital providers

There are several strategies that firms and governments use to prevent such an implosion. The two main strategies to counter this are the following. First, substantial government ownership of shares, to ensure stability among floating shareholders. Government shareholders are responsible for more objectives than profitability, namely ensuring levels of employment, environmental responsibility, and investment in research and development to contribute to a country's competitiveness. Examples of government shareholders are the French and German governments owning substantial numbers of shares in the car manufacturing industry like Renault and Volkswagen. Second, labour union representatives on the supervisory boards of firms, to ensure that the firm's strategy takes the interests of workers into account, as a counter-balance to the interests of the shareholders. Countries that have labour representatives on supervisory boards are, for example, Germany and the Netherlands. *Stakeholders* are all parties who are affected by the operation of a firm. They include suppliers, customers, workers, providers of capital, the government, society, and the natural environment.

Like all human resources in a firm, also management is subject to a division of labour, as a special human resource. First, management is organized in a hierarchical way: from top to the bottom of the organization (line management). Second, management is organized in staff management functions, according to the organizational units of a firm. This can be limited to functional tasks such as accounting, production, human resources, and marketing. But it can also include the management of different locations or subsidiaries, in the same countries or across the world. The coordination of a firm – management – is responsible for, and internally and externally accountable for: managing worker's motivation, accounting, production and its costs, price setting, marketing, sales, and last but not least, the relationship with the firms' stakeholders. How this is done is explained in this chapter.

Motivations and incentives

What drives workers? Do they work only for the money? In order to understand what drives employees of a firm (managers and workers alike), we need to go back to what we learned about ethics (Chapter Two), agency and rationality (Chapter Three), and the black box of what economic agents value in life (Chapter Four). Remember that economic agents generally seek the achievement of six broad goals in life: PERMAS (Pleasure – Engagement – Relationships – Meaning – Achievement – Security). In the previous chapter, we discussed how this affects agent's role as consumers. In this chapter we can apply PERMAS to economic agents' role as workers. What is striking when we examine the six broad goals is that earning an income is not part of these. Neither is money, becoming rich, or financial gain. Only the last item – security – can be related to income, because in a market-dominated economy, income is the most important way though which people find economic security. So, income is a means to one of the goals. For the item of pleasure, income seems a possible means (pleasure obtained from consumer goods, through income spent to acquire these in a market economy). While for two other items, income is a by-product (of engagement in a work task) or a reward among other rewards (of achievements in a competitive setting such as markets). For the two remaining items in PERMAS – relationships and meaning – it is not easy to find a link with income. Hence, PERMAS teaches us that workers do not work in the first place for the money, and certainly not only for maximizing money income.

When we apply our general definition of agency from Chapter Three, to workers' agency, we can define the agency of a worker as making autonomous choices and acting

upon these at work. Each theoretical perspective employed in this book contributes to the further detailing of this work agency. Marxism makes clear that workers' agency can only be effective in a capitalist economy when it is a collective agency. The socio-economic perspective teaches us that economic agents act upon and re-enforce pro-social norms. Post-Keynesian economics points at risk and uncertainty, which workers will try to minimize in their choices at work. Of course, all these theoretical perspectives also acknowledge that agency includes power seeking, if only to reduce risks (of losing one's job, or of being under-paid or over-worked). The neoclassical perspective on workers' agency, instead, assumes that workers want to have maximum benefits at minimum effort.

How are workers motivated and how can money, either as a salary, piece rate wages, or bonus, be an effective motivator? The first insight from the theories is that workers are satisfiers and seek livelihood security and expect a fair reward for their efforts. If they perceive their reward as unfair, they will try to punish their employer and seek help from a labour union or from the government who is responsible for enforcing labour laws. The easiest way to punish an employer is to reduce work effort. The second insight is that workers generally prefer fixed over variable pay. Unless their job is routine and gives them very little autonomy: in that case workers prefer variable pay, such as a piece rate.

From this theoretical background on workers' agency and motivation, we can now distinguish four broad systems of worker motivation and incentives, that are used in firms.

1. Control
2. Bureaucracy
3. Incentives
4. Intrinsic motivation

Finance & accounting

I distinguish here seven sources of financing the operations of a firm.

1. Own capital and retained profits
2. Bank loans
3. Private investment
4. Bonds
5. Equity: shares

6. Subsidies

7. Crowd funding

The *balance sheet* compares what a firm owns (assets) with what it owes (liabilities). If the difference is positive, the firm has a positive net worth, or equity. If the difference is negative, the firm has a negative net worth and has more debt than it can afford. This may be bearable in the short run but not in the long run. The solution to such a situation is either bankruptcy or a take-over at a low value by a firm interested in its potential, embedded in its production, production process, market access, brand, or other uniqueness that has market value. The *profit and loss account* shows how the result of the business operation in a year have been obtained. So, whereas the balance sheet gives an idea about the value of a firm at the end of a year, the profit and loss account shows the earnings and expenditures over a year and the difference between the two, which is the result (profit or loss).

Firms

Firms exist because innovation, investment, production, and sales can be done more efficiently and effectively through an organization, which overcomes the transaction costs and uncertainties of doing each of these processes through market exchange between a large number of individuals. The particular objectives of firms varies, depending on the type of firm, the type of market, and the stakeholder interests and the bargaining power of the stakeholders in the firm. Generally, the overall objective of a firm is its continuation over time. Firms are not set up as short-term money machines, at least, not the large majority of them. If you want to get rich fast, you better learn to play poker very well, develop a unique skill like singing and join a TV talent show, or develop a unique low-cost-behind-your-desk technology such as an innovative app or webtool, or a wet up a web-shop that addresses a want that has not been supplied for yet. Firms require investment of capital and human resources, which expect returns, and these are generally reaped over a long period of time. Moreover, the longer the time period, the higher the chances of success, through achieving intermediate objectives. The main intermediate objectives are: sufficient profit, increase of market power, and growth. Other objectives include client satisfaction, innovation, societal change, or environmental care. Profit maximization is often not listed as the number one objective by business owners and managers, except for publicly listed corporations, who thereby signal their attractiveness for investment by shareholders. Most firms do not put profit maximization at the first place because it narrows vision: extreme profit targets have

shown in the past to lead to fraud, excessive risk taking and short-term orientation at the cost of long-term survival of the firm.

The other intermediate objectives that I mentioned, next to sufficient profit, were power and growth. These two are related. Power improves the bargaining position of a firm, and hence, is a means and an end in one. Firms are concerned with keeping costs low, trying to set prices as high as possible in the market they operate in, and reduce transaction costs of managing human resources and risk. This means that they will try to have power over their suppliers, which will allow them to force down the price of inputs. Growth helps in this, because the larger the firm, the more dependent suppliers are for the sales of their raw material on a big buyer in the market. Similarly, when a firm grows, it tends to outcompete some of its competitors and take over others, so that its market share increases. This implies that consumers have less choice and the firm can use its market power to keep prices higher than they would be if the firm was smaller and operating among more competitors.

SME's, as small and medium sized enterprises are called, are the most prevalent type of firms worldwide. In the European Union, 99% of all business are small or medium sized, including one-person firms (also referred to as self-employment). They create the majority of employment in most countries in the world, more jobs than multinationals or the public sector do. Moreover, in the informal sector, SME's are the only employer, including many self-employed workers who work from home or on streets.

Large private enterprises in private ownership have limited responsibility (abbreviated to Ltd). This means that when they would go bankrupt, the owners' private assets cannot be confiscated by the firms' creditors. Large, privately owned firms become increasingly rare. That is because in good times, investors offer large sums of money to the owners to not only benefit from return on investments but also to reap the additional benefits of ownership.

Publicly listed firms are not owned by an individual but everybody who is interested and has the money available, can invest in the firm, and hence acquire partial ownership. The shares of ownership are traded on a *stock exchange*, the market for shares of stocks of firms. The shareholders together own the firm. Their influence on the firm's policy and strategy, however, is limited. They largely vote with their feet: when shareholders are dissatisfied with a firms performance, they simply sell their shares in the stock exchange and buy shares of a firm that they are more agreeable with. If a firm's net worth becomes very low or negative, the most a shareholders can lose is that the shares she has have become valueless: nobody wants to buy them anymore for any

price. But she never risks her property or other assets as a shareholder. Shareholders who hold a large part of a firm's shares generally do claim influence over the firm's strategy and policy, in particular when they own the majority of shares. They may even enforce decisions over mergers and change of management teams.

Multinational, or also named transnational, corporations, are often abbreviated to MNC's. As their name already indicates, MNC's have branches, or subsidiaries, in several countries. The main office is located in the country of origin, while the MNC's subsidiaries across the world are simply more than sales points but contribute substantially to the corporations' objectives. They do so through designing a 'global assembly line' or a 'global workshop', in which different stages of the production process are located in different countries. This includes not only physical production – think about Shell which drills for oil in many countries, at sea and under land – but this globalization of business activities also concerns design, marketing, sales, and financial operations.

Cooperative firms, or co-ops, are a special category because we find them small and big, national and multi-national, and profit and non-profit. They are special because they are not privately owned, neither publicly listed, nor state-owned. Cooperative firms are literally a cooperation of equals who are both its collective owners and capital providers, and its members, as either clients or producers. Clients have a say in the firm management, either directly through representatives on the board, or indirectly, through an advisory role to the board.

Non-profit organizations may be cooperatives, as indicated above, but are often associations or foundations. Think about a museum, a sports club, or a charity. Non-profit organizations, like most firms, require capital, labour, material inputs, and are required to be registered and to make annual reports, including financial reports. Even when they do not make profits, they are likely to pay taxes: labour taxes, value added taxes, and possibly other taxes (for example on their real estate). Non-profit organizations, as the name already indicates, have a different objective than earning money. Earning sufficient returns in the major condition for serving its objective. The objective generally reflects an ideal, such as humanitarian aid or nature conservation, or it has a more profane objective, such as preserving a family estate. Even non-profit organizations often find themselves competing with others: over donations from the public, over getting members, and getting attention for their actions through marketing efforts.

State-owned enterprises, public firms, nationalised businesses – these are all names for firms that are 100% in state hands. While such firms are managed like any other firm,

their governance is different. The company board of directors, its Chief Executive Office (CEO) and its supervisory board are all or partially appointed by the government – meaning, the cabinet, with parliamentary control. The reason for this political involvement is that a public firm's net profits and losses go into the treasury: the state's accounts. So, there is democratic control on the governance of a public firm. Some public firms have very little competition, because they operate as monopolist, for example when they operate a dam in a river to generate electricity, or when they are responsible for the cadastre or the railway infrastructure. Other public firms operate in a market with competitors and similar objective.

Inputs and costs

The costs consist of a fixed and a variable part. *Fixed costs* are the costs of the firm even without producing a single unit: costs for land, buildings, machines, and contract labour. *Variable costs* increase with the number of units produced and concern the material inputs, flexible labour, energy use, and transport costs.

Marginal costs are the extra costs when producing one additional unit of output. Insight into the marginal cost structure of production helps to decide whether the firm should produce more output (when marginal costs are low: an extra unit is cheap) or not (when marginal costs are high: an extra unit is expensive). This insight can be provided visually through a production function or a cost curve, because the marginal concept refers to the slope of a curve. Finally, we will discuss average cost as part of the production cost structure. *Average cost* is the total cost per unit of output. Two special cost concepts need to be mentioned here too. First, opportunity costs. For firms, *opportunity costs* are the benefits foregone by choosing a particular investment or production option. For example, if a private equity firm invests 100 million euro in a Finnish software company it cannot invest that money in a French telecommunications company (and may regret this later when the return on investment of the latter company turns out higher). The other type of cost, which deserves mentioning here, is *sunk costs*. These are the costs that have been incurred already and which therefore should not be taken into account in a cost/benefit decision about the future. Nevertheless, people are tempted to do so out of spite or loss-aversion.

Firms will try to minimize costs in order to survive competition and to satisfy consumers and stakeholders. One way to this and which at the same time serves their intermediate objectives of growth and obtaining market power, is through achieving *economies of scale*. These are cost advantages per unit due to an increased production size. The unit costs will decline with an expansion in production because the fixed costs

will be distributed over a larger number of units produced, lowering the costs of each individual unit. This, of course, only works in the short run. Because in the long run, continuous increases in production will at some moment require an expansion of fixed costs, through acquiring more land, constructing new factories and offices, and adding more management layers.

Input and costs in the short run

Every firm has a *production function*, which shows the relationship of inputs to outputs over a period of time. In the short run, hence, fixed inputs create a capacity constraint on production expansion. Given this capacity limitation, how can the firm know which level of production (number of outputs) is the most efficient to operate the business? Well, we first need to make an important assumption, namely, that whatever level of output is being produced in the short run, there is sufficient demand for the firm's output so that all its produces will be sold. Obviously, in the real world, this assumption does not hold, or only when additional units are sold at lower prices (think about a discount).

The total cost curve is an upward sloping curve. We can interpret the shape of the curve with the help of the concept of marginal cost. Remember that marginality refers to the slope of a line or curve. The total cost curve shows first a declining slope, reflecting diminishing marginal costs. Then follows a constant part, reflecting constant marginal costs. And finally the upper part, which is has an increasing slope, and hence, increasing marginal costs. The next diagram gives the marginal cost values for each additional unit of labour input.

Now, assume that this firm operates in a perfect market: there is strong cost competition and no market power. In that case, the optimal level of production is when average cost is at its lowest point. This counts for every individual firm in this market, and hence, represents the lowest cost for this market as a whole.

Cost and growth in the long run

In the long run, not only variable costs can change, but also fixed costs can change. This means that the most relevant type of cost for understanding the long run cost structure is average costs. Remember that average cost is the total cost per unit of output. The long-run cost strategy is then for firms to grow to the size where their average costs are relatively low. Because that is where they can be competitive, at least, in terms of cost price. The long-run cost strategy also involves substitution of production factors. That is not possible in the short run, but in the long run, a firm can substitute labour for machines, or mechanical production for computerized production. Or it may decide to

relocate to a different country where the costs of the major input for the production process are cheapest, on a world scale.

What then matters for firm's costs and profits in the long run are the constraints to growth. Here, the Post-Keynesian perspective is the most relevant approach. In this perspective, firm growth has two types of constraints. First, finance constraints. Kalecki's 'principle of increasing risk' states that firm only can and often wants to borrow limited amounts a time. The more it borrow and the greater the amounts, the higher the risks, both actual and as perceived by investors. The principle of increasing risk attached to increased borrowing implies that increased finance can both spur profits and growth, but not above a certain ratio, which is an expression of the finance frontier. The second type of growth constraint that firms face concern transaction costs for coordination, management costs for oversight, and the risks involved when accessing foreign markets. The expansion frontier increases steeply, allowing a firm to grow fast to some point. But from that maximum onwards, the constraints start kicking in and growth becomes more difficult and costly. . The maximum point R is where profit is maximized. From R to the right, the positive relationship between growth and profit turns into a negative relationship, also referred to as 'the Penrose effect', named after Edith Penrose, one of the first business economists, and who described this effect in 1959.

Pricing and profits

Firms generally seek to make profits, either as an end in itself, but more often as a condition to be able to continue over time and to achieve intermediate objectives of growth and market power. So, we refer to sufficient profits, rather than necessarily maximum profits. There are different types of profits. *Commercial profit* is the positive difference from selling something for more than it costs to purchase it. This does not need to involve any production. *Business profit* is the residual of a business operation after all production factors and inputs have been paid.

The value of output, Y , in a firm distributed over profit (R) and wages (W). So:

$$Y = R + W$$

We can rearrange the equation above to define profits as the difference between output and wages, showing that the providers of capital are the residual claimants of a firm: they receive everything of the total revenues after the wages have been paid:

$$R = Y - W$$

This gives us a variation of the earlier profit rate equation:

$$r = R/K = (Y - W)/K$$

These last two formulations of profit above make the Marxist perspective visible, because they express profit as what remains for the capitalists after labour has been paid its share. But who determines the adequate or fair labour share? In a capitalist economy, capital hires labour and not the other way around. And since many labour markets are characterized by some rate of unemployment. Capital is on the 'long side' of the market, with more bargaining power than labour to determine the wage rate. Labour is on the 'short side' of the market, with limited bargaining power. Thus, in a capitalist market economy, it is the capitalist firm's capital owners who determine the total wage sum, and hence, the amount of revenue left over as profit (normal profit and possibly more) for the capital owners. In the Marxist perspective, profit is therefore labelled *capitalist profit*, referring to the extraction of the surplus profit from labour by capital. This surplus refers to the power of capitalists, to what they earn above what they would earn in return for their risk taking as investors. In other economic perspectives, the surplus profit is referred to as *economic profit*, which is profits above *normal profits*, the profits necessary to satisfy the providers of capital. Obviously, what is normal is context dependent, social-economics teaches us. In booming times, shareholders expect profit rates of 15 or even 20%, similarly in periods with fast innovations, such as in ICT, or when outsourcing to low wage countries drive up shareholders' profit expectations. While at the same time, society's attitudes to profits versus wages and other stakeholders' interests also weighs in. The lower threshold for normal profits is the *opportunity costs* for investors: the returns on investment they can reap with alternative investments.

So, in the Post-Keynesian and Marxist perspectives, profits cannot be calculated from the cost structure and market price that a firm faces, but is also dependent on the relative bargaining power between capital and labour. In turn, this bargaining power, which determines the distribution of profit over capitalists and workers, depends on the labour market. When supply is relatively low and demand is relatively high, labour becomes more scarce and has more bargaining power over employers. But when supply is high and demand low, labour markets are characterized by high unemployment, which negatively affects labour's bargaining power.

The neoclassical perspective is applicable to an ideal market and ideal circumstances. It assumes perfect competition in markets, which means that there are many sellers and buyers, a homogeneous product, and free entry and exit for firms. This market structure implies that the price of the product in this market is determined by market forces and

cannot be influenced by any individual firm. It becomes possible to calculate the production level at which profits are maximized. We need to compare marginal revenues with marginal costs, because we need to know at which production level extra inputs no longer add to profit. In mathematical terms, this is when $MR = MC$: marginal costs equal marginal revenues.