

## On the Purpose and Aims of the Journal of Contextual Economics

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“Exact science must always tolerate a different explanation of things as its equal, one shaped by an image of the whole and premised on the value of the past that seeks to understand and interpret individual phenomena in their context and organize the material through reflective judgements according to a general point of view.”

Gustav Schmoller,  
“On the Purpose and Aims  
of the Journal” (1881)

It is widely acknowledged today that the economy and the discipline of economics are in a state of flux. The collapse of socialism, the shift of the world economy’s center of gravity back to Asia, recurring financial and sovereign debt crises, and growing inequality – among other things – have shaken conventional understandings of economic and social processes. Familiar economic theories and policy convictions have been reexamined and found wanting, and economists have been forced to reintegrate society into their conceptions of economy. As editors, we wish to elaborate in this introductory statement on why we have chosen to give the venerable journal *Schmollers Jahrbuch* the new subtitle *Journal of Contextual Economics*. We will also try to define “contextual economics” and what approaches toward contextualized economic thinking are emerging within the discipline. At the same time we will make a

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case for why we believe a journal of contextual economics is not only timely but urgently needed.

### Isolating and Contextual Economics

Mainstream economics as we know it today is a child of what Karl Polanyi (1944) called “The Great Transformation” and what may be described in more sober terms as the functional differentiation of an economic subsystem out of a wider social system. As Polanyi argued:

A self-regulating market demands nothing less than the institutional separation into an economic and political sphere. Such a dichotomy is, in effect, merely the restatement, from the point of view of society as a whole, of the existence of a self-regulating market. It might be argued that the separateness of the two spheres obtains in every type of society at all times. Such an inference, however, would be based on a fallacy. ... Neither under tribal, nor feudal, nor mercantile conditions was there ... a separate economic system in society (Polanyi 1975 [1944], 71).

Regardless of whether we date the emergence of a boundary between the economy and other component areas of society in the eighteenth or nineteenth century, the problem happens to be as old as economic thinking itself. Aristotle differentiated between an *oikonomia* embedded in the household and conducive to the cohesiveness of the *polis*, and chrematistics, the art of making money, which followed its own laws and could potentially dissolve the social and political bonds of the *polis*. The question of how economic activity was related to other social systems also played a central role in the work of Adam Smith. His complete system – comprised of the *Theory of Moral Sentiments*, the *Wealth of Nations*, and his never completed jurisprudential work – was most concerned with the “cohesion question” (Evensky 2005), the problem of how social order comes about in society. At the same time, Smith saw that the question of the overall order of the wider social system in a highly differentiated society could only be answered by considering the differing ordering mechanisms prevailing in the component subsystems. Thus Smith posed two questions of broadly equal status: the older question that predominated in antiquity and the middle ages of the interrelation *between* the economic sphere and the wider social system (particularly in a normative sense), on the one hand, and the newer question of the laws operating *within* the economic system, on the other.

As we understand it, contextual economics relates mainly to the first question: it is mostly interested in the relationship between the economic sphere and the wider social system. By contrast, isolating economics concentrates on those processes that operate within the economic system. Both approaches are legitimate and valuable, and while it is true that the isolating approach dominates today’s mainstream economics, it is not the case that all economists did so in the past or do so in the present. While contextual questions were an important

pillar of analysis until the mid-twentieth century, thereafter they were neglected as disciplinary specialization narrowed the field of vision to the purely economic. Claims to scientific legitimacy were bound up increasingly with ever greater formalization and abstraction. Thus the development of mainstream economic theory, which led from classical political economy to neoclassical economics and then to the neoclassical synthesis of Paul Samuelson, was attended by an ever greater concentration on processes occurring *within* the economic system. Contextual economic questions were outsourced to sociology, economic sociology, and economic history. As a result, the primary focus of today's mainstream economics is isolating.

There is nothing to criticize *per se* about this narrowing of focus. The complaint that “a view of the whole” has been lost is off the mark – after all, even Adam Smith understood that one could not understand functionally differentiated societies without analyzing their component orders. We are not at all interested in an “either-or” debate, of asserting the superiority of one over the other. Rather, we are interested in the question of the proper balance between isolating and contextual approaches. What we do criticize is the tendency of many contemporary mainstream economists to claim the field of science exclusively for isolating approaches, while contextual approaches are dismissed as “unscientific” or even “esoteric.” This is an unfortunate and counterproductive development because the history of economic thought shows very clearly how the relationship between contextual and isolating approaches has been altered time and again by changes in economic reality. We believe that the current dramatic changes in economic reality require readjustment of priorities away from isolating toward contextual approaches. Unfortunately, entrenched convention in the market of economic thinking is such that mainstream economics prevents adaptation of the discipline to an altered economic reality. As such, economic science is under threat of losing its relevance to reality. In that sense, scientific realism is a substantial challenge to economics (Mäki 2011).

### **The Historical Roots of Contextual Economics**

To reiterate: our basic argument is that recent changes in economic reality require changes to economics as a discipline, leading to a readjustment between isolating and contextual perspectives in favor of the latter. The history of economic thought offers many examples of past episodes when economic change brought about shifts between isolation and context within the discipline and will help illustrate and support our claim.

It is hardly coincidental that the first protests against isolating economics were initiated in the United States and Germany in the nineteenth century, as both countries were among the first nations to engage in “catch-up industrialization” vis-à-vis Great Britain. More concretely, when classical political econo-

my was introduced to Germany and the United States in the early nineteenth century, both countries were still in the midst of a “Great Transformation,” that is, in the middle of that process at whose end point a differentiable economic subsystem emerged. The existence of such an economic subsystem was implied as given in classical political economy, particularly in the Ricardian variant. For that reason it had little to nothing to say on the problems with which these countries were confronted. After all, “catch-up economic development” deals above all with the changes between the different social realms and thus asks a genuinely contextual set of questions.

Before and during Adam Smith’s time, British economic policy was shaped strongly by the ideas of “Whig imperialists” like John Cary, which helped bring about the British colonial division of labor and spark industrialization through mercantilist policies that bore uncanny similarity to the ideas later propagated by the fathers of “catch-up economic developmental theory,” Alexander Hamilton and Friedrich List (Reinert 2011; Pincus 2012). By contrast, Smith’s *Wealth of Nations* viewed the economic reality of the British Empire’s division of labor in the 1770s as a given rather than the outcome of that transformation process. From Smith’s perspective, the economy of the British Empire was the outgrowth of “natural” forces being hindered and distorted by the remnants of mercantilist regulation and monopoly rather than the (often unintended) outcome of such “visible hands” as the Navigation Acts, Royal charters, export bounties, and import duties (e.g., Calico Laws) that rewarded the risks of productively developing colonial territory, engaging in overseas commerce, and inventing industrial machinery (see esp. Smith 1976 [1776], vol. 1, bk. IV, 474–95; vol. 2, bk. IV, 83–181). In any case, it is today widely acknowledged that aggressive mercantilism and overseas empire were among the prime movers that led to Britain’s export boom, rapid urbanization, and high wages in the eighteenth century, which in turn made industrial mechanization of cotton profitable in England (Pomeranz 2000, 189–201; Allen 2009, 110–11, 117–18; Beckert 2014, 47–48).

That Smith’s perspective was too narrow to take this into account – even if Smith was well aware of the significance of institutions (Sturm 2010) – is understandable given his aim of seeking to understand the mechanisms of the market division of labor in an isolated fashion. But a pitfall of that isolation was that Smith missed the single most important contextual economic development of his time – the industrial mechanization of cotton spinning and iron production – and so he continued to prioritize agriculture over manufactures in his analysis (Smith 1976 [1776], vol. 2, bk. IV, 195–207). Not surprisingly, Hamilton took Smith’s analysis to task precisely because Smith largely overlooked the productive importance of industry to a national economy, underestimated the practical harm of imperial prohibitions on colonial manufacture, ignored the role of industrial policy in creating manufactures, and disregarded the real trade discrimination that American goods faced in British and Continental

markets (Hamilton 2001 [1791], 650, 659, 660–61, 668, 689–900). Latecomers like the United States faced structural changes and upheavals in the interface between economy and society, and it was precisely with regard to these problems that contextual economic analysis had a comparative advantage.

The incongruity between British classical economic theory and economic reality in the United States and Germany that provoked the critiques of Hamilton and List later inspired both the American School (“American System”) and German Historical Schools of political economy (Tribe 1995, 32–65). These must be seen as contextual reactions to classical political economy that built on similar critiques and which were later eagerly taken up by other countries also confronted with the problem of catch-up development, such as Japan, Italy and Russia. “Economic nationalism” and “historicism” were thus hardly American and German intellectual peculiarities but rather much wider phenomena bound up with “latecomer” status (Grimmer-Solem and Romani 1998; Pearson 1999; Caldwell 2001; Chang 2005; Reinert 2007). Both in the original American variant of institutionalism (Carey, Veblen, Mitchell, Commons) and in the German Historical Schools (Roscher, Knies, Hildebrand, Schmoller), a radical rearrangement of the relationship between isolating and contextual modes of analysis was affected by the different economic conditions that prevailed in the two countries compared to Britain.

With respect to Germany, Gustav Schmoller and his colleagues in the “younger” German Historical School were responding to the massive upheavals that had been brought about by rapid industrialization, urbanization, growing inequality, and the rise of social democracy and trade unionism. In the 1860s and 70s the isolating Ricardian-Malthusian classical political economy offered neither insight (the labor theory of value and the wage fund doctrine denied that trade unions could raise wages, as wages were thought to be bound to the level of profits) nor policy guidance (interventions in the economy or redistributions of income would only make poverty worse). It was only with contextual analysis that these and other shopworn classical theories were disproven and ground-level theories were developed that justified a program of social reforms tailored to these new conditions (Grimmer-Solem 2003). For Schmoller, economics was understood as a concrete and practical discipline where a turn toward the object (confronting actual economic conditions), the acting agent (and her or his perceptions), as well as problems (the social question) were what really mattered. These priorities were followed by clear political conclusions, which included such things as progressive taxation, legal recognition of collective bargaining, higher public investment in schooling and vocational training, factory legislation, and social insurance schemes. In important respects, this journal – which Gustav Schmoller edited from 1881 until 1917 – was the organ of this contextual research program and its social reform policy.

Both old institutional and historical schools can rightly be accused of having neglected core areas of economic theorizing, and much evidence suggests that

in both cases the pendulum did indeed swing too far in the direction of context. The other common accusation that these strands of economic thinking contributed nothing to economic theory is, however, only true if one narrows the concept of “economic theory” to what we refer to here as “isolating economics.” Methodologically speaking, the institutional and historical schools pursued a different goal. From their perspective it was insufficient to view individual parts of economic life in isolation to investigate general patterns and economic laws (e.g., business cycles, wage laws, price movements). Rather, they were convinced that all economic phenomena were closely tied to social, legal, and political forces. Thus it was the declared goal of Gustav Schmoller to bring into his analysis “the nature of customs and of law, the power of customary feelings and cultural ideas which also govern whole economies” (Schmoller 1874, 264). Even if we do not wish to go as far down the contextual path as Schmoller did in his day, the implication is nevertheless that a contemporary contextual economics must be open to different methodologies. In that sense we do want to make a contribution with this journal toward a more pluralistic reorientation in economics, acknowledging how important but also how difficult methodological debates are within the discipline of economics. As John B. Davis observed recently, “... pluralism does not operate in a significant way in economics but not because there are differences between economists regarding methodological values; pluralism does not operate in any significant way in economics because of certain forces operating in economics that push methodological debate to the side” (Davis 2014, 496; see also Hands 2001).

### **Why a Readjustment Toward Contextual Economics is Needed**

In light of what has been said so far, if we understand the concept of “transformation” in the sense of Karl Polanyi as a general phenomenon pertaining to the changing relationship between economy and society, then it is possible to argue that contextual economics is always first and foremost *transformation research*. Processes in which profound changes in the relationship between the economy and other social subsystems are underway are best analyzed with contextual approaches. Conversely, in those instances where the economy has differentiated itself out of society and/or where the relationship between economy and society is somewhat stable, an isolating approach has advantages.

This quite simple insight illuminates not only why contextual approaches were dominant in Continental Europe and North America in the nineteenth and early twentieth century, but also helps to explain the triumph of isolating economics after the end of the Second World War. From today’s perspective, we know that the period from 1945 until approximately 1990 – relative to the time period before and after – was above all a phase of “deglobalization,” or at most

a time of only very slow global economic integration. The stalemate between the two superpower blocs throttled the pace of institutional change and assured that there were very few changes in the relationship between the economy and society in developed industrial countries. In short, in the economic reality of the Cold War all the conditions were met to give an advantage to an isolating approach in economics.

All of this changed fundamentally with the collapse of “real existing socialism,” and it is hardly coincidental that the deficits of isolating economics would be brought into sharp relief when its practitioners were tasked with analyzing the “transformation processes” in Central and Eastern Europe in the early 1990s. With some parallels to earlier episodes of transformation discussed previously, nearly all economists assumed as given that which was in fact then just coming into being, that is, an economic subsystem that could be clearly differentiated from the rest of society. For example, in their seminal book *Russian and Soviet Economic Performance and Structure*, Paul A. Gregory and Robert C. Stuart define transition as “the replacement of one economic system by another economic system; in the 1990s, the replacement of the planned socialist economic system of the former Soviet Union and the countries of Eastern Europe with market economies” (1998, 18). Underlying this definition is the utterly mistaken idea that both in socialism and in capitalism there existed something like an “economic system” that could be distinguished from the rest of society. And from this assumption it followed that reforming the system was viewed as “changing the economic system.” In fact, however, in socialism the political and the economic system had formed an inseparable unity so that reforms were first and foremost about changing the *relationship* between economy and polity – a prime example of a contextual problem (for a contextual perspective on transition, see Zweynert and Goldschmidt 2006; Zweynert 2006). The empowerment of the “oligarchs” in the course of a process of state capture in many of the countries of the former Soviet Union can certainly not be attributed directly to the recommendations of Western economic advisors. Nevertheless, this was to a noticeable degree a phenomenon involving the co-evolution of economy and society representing a critical blind spot of isolating economics.

The transformation processes in Eastern Europe, however, represented only a starting point for a newer wave of profound change in the economic and institutional structure of developing and emerging economies, and increasingly also of developed industrial countries. The forces unleashed since the end of the Cold War include changes in the world economy driven by new technology, wage arbitrage, the emergence of China and the shift of the center of gravity of the world economy to East Asia, rapid shifts away from manufacturing toward services in many advanced developed countries, and the challenges posed by aging populations. They have resulted in much more widely shared prosperity, but also in large global imbalances, rising inequality in developed economies,

and recurring financial instability (Stiglitz 2002; Piketty 2014; Shiller 2015). War, terror and political instability in the Middle East, Africa and South Asia; the emergence of a number of “failed states;” and massive human migration add to the burdens of these challenges. Climate change, the loss of arable land and biodiversity, and acute shortages of fresh water promise to add additional ingredients of instability that are only likely to reinforce political, social, and economic upheaval in the twenty-first century.

One way or another, these changes will result in a rebalancing between isolating and contextual economics (as well as in the intersection with neighboring disciplines). As a matter of fact, this process has already started. Despite the apparent rise of contextual problem fields, the demise of modern isolating economics is neither to be expected nor would it be the least bit desirable. But it could well be that future historians of economic thought may identify the relative failure of prevailing economic theory to grasp the transformation problem, or offer sensible policy recommendations, as the starting point of a readjustment of the relationship between contextual and isolating approaches that led to a significant reevaluation of the latter. This would likely not have been the case if the transformation processes that occurred – and continue to occur – throughout the former Soviet Union had been a singular phenomenon, an “accident of history,” for which the neoclassical synthesis built on its equilibrium model was simply ill-prepared. But as already noted, that is certainly not the case.

One crucial insight that has emerged is that a Continental European or Anglo-Saxon understanding of the market economy cannot simply be transferred to any society; on the contrary, its operation is bound up with very specific historical, social, and political contexts (Bates 2010 [2001]) and thus barriers to regulatory convergence remain (Falkner and Gupta 2009). This insight may seem obvious today, but it was precisely the failure to acknowledge this fact that comprised the blind spot of the predominant isolating economic paradigm twenty years ago. Since then much has changed. For one, it was recognized once again that institutions are of central importance to growth and developmental processes. Likewise, economic development will alter institutions (Chang 2011). While property rights were once listed in last place in the Washington Consensus, the significance of institutions was not only successively emphasized over time, but the concept of institutions was widened.

This has resulted in an ever broader analytical frame of reference beyond the field of economics and ever stronger knowledge-interest in the co-evolution of political and economic orders. Daron Acemoglu and James Robinson (2012) have written an expansive book on this topic, which in light of the overabundance of historical material and absence of high theory would have made even Gustav Schmoller blush. The core thesis of their book is that the creation of sustainable growth depends upon inclusive political institutions, particularly on a double sequence that first enables the centralization and execution of state power and then effectively checks that power.



A similar line of argumentation had earlier been developed by Robert Bates based on very extensive fieldwork in Africa (Bates 2010 [2001]; 2008), as well as by Douglas North and his colleagues based on analysis of the historical evolution of institutions in Britain, France, and the United States (North et al. 2009). This framework was later applied to a number of developing and newly industrialized country case studies (North et al., 2013). The core idea developed in the latter writings is that wherever the state lacks a monopoly on violence, economics and politics are bound up inseparably. If the state is ruled by a “dominant coalition” of groups prepared to exercise violence, stability can only be achieved by offering these groups privileged access to very specific markets whereby they secure rents (termed “Limited Access Orders”). This fosters peace within the governing coalition because disputes could lead to the loss of those rents. Just as restricted access to political power and economic resources are reciprocally conditioned in Limited Access Orders, more open access to politics and the economy reinforce one another in market economy democracies (termed “Open Access Orders”): institutionalized competition for political power (elections) over a state with a monopoly on violence prevents the generation of rents through open market access, while economic competition prevents the emergence of potential concentrations of economic power that can be transformed into political power – examples of such absent competition include the limited access order dynamics of the oligarchs in Russia and the Chinese Politburo.

As editors, we have no desire to prescribe a specific program for the kind of contextual economics that will find a place in this journal. It should nevertheless be clear that we do share a certain skepticism about theorizing arrived at by thought experiments with the aim of building and testing models according to a reductive logic of explanation. Even new institutionalism, while inclusive of many aspects of the wider social context (property rights, social norms, bounded rationality), sometimes tends to operate within a rigid neoclassical “iron cage” that leaves little room for human agency or change (see Hall 2007, 140). We agree with Geoffrey Hodgson that new institutional economics must give more room for “social preferences, cooperation, altruism and motivation, albeit alongside greed and opportunism” (Hodgson 2014, 605; see also Hodgson 2013 as well as Bowles and Gintis 2011). Here reorientation toward the original institutionalists can offer fresh impulses (Hodgson 2001).

A contextual economics of the sort we wish to encourage begins with the recognition that economic life is continually evolving and driven by changes in the human context and environment. The approach assumes that the economic system is a social subsystem that cannot properly be understood dynamically by excluding habits of thought, cognitive constraints, webs of meaning, values, and “knowledge regimes” (Campbell and Pedersen 2015). Likewise, social hierarchies, social learning (e.g., Mobius and Rosenblat 2014), laws, and the exercise of power always shape economic activity, just as the economic system as a whole cannot be understood unless the physical environment, biological

and ecological systems, and resource constraints of a living, finite planet are part of that picture of economic activity. In short, we wholeheartedly agree with Neva Goodwin that “[t]he starting premise for Contextual Economics is that an economic system is embedded within a social context that includes ethics, norms and human motivation, and the culture that expresses them. It also includes politics – that is, the development of economic and other kinds of power – as well as institutions, and history” (Goodwin 2010, 3).

As in anthropology, contextual economics is sensitive to the specificity of cases. It is interested in thick description, but it is also committed to comparison with the aim of both a better understanding of the singular cases and the arrival at contextual generalizations, typologies, or grounded theories that apply to several or all the studied cases (Mjøset 2009, 48–50; Goldschmidt and Remmele 2005). The contextual approach is also theory-driven, but it is more pragmatic and less focused on equilibria than on processes of change and transformation. Ultimately, it is the problem at hand that determines what methods are appropriate and what ultimately counts as useful generalizations or insights. High-level formal theory, if it is used, is only ever a tool of analysis, not an end in itself. This is a point that the rhetoric of economics literature has been making for some time: “being able to assert statistical significance of a coefficient implies very little regarding its substantive significance” (Klaes 2012; see e.g., McCloskey 1985 as well as Ziliak and McCloskey 2008). One might add that statistical significance does not even imply the existence of any real relationship. In this sense, too, Schmoller’s insights have a continued relevance. As he argued in 1897, when abstract models become the end, addressing human problems can fall by the wayside: “not people, their actions and institutions are investigated but the ‘magic’ of the technological-capitalistic production process is demonstrated via the enchantments of dialectics and allegedly irrefutable mathematical formulae” (Schmoller 1897, 1396). Among other things, contextual economic analysis attuned to specific social reality holds the promise of offering more relevant policy solutions, especially in those instances where the economic conditions and developmental paths diverge from what high theory would posit or what is observed in, for example, advanced developed countries (Reinert 2007; Rodrik 2007; Altmann 2011).

Strengthening contextual thinking in economics also holds the promise of altering the way economics is taught. Steps in that direction have already been taken by Neva Goodwin, who has shown what contextualizing existing theory means for teaching economics (Goodwin et al. 2014; Goodwin et al. 2013). At the same time, contextual economics offers the possibility of giving plural approaches a legitimate place in teaching (Dow 2009; Garnett 2009), thus addressing the stifling predominance of quantitative methods by introducing qualitative approaches and affirming their equal validity and usefulness (Klaes 2012; Piore 2006; Schlüter 2010; Starr 2014). If in a methodological sense contextual economics is about reflexively tying economic processes back to the social and

physical processes in which they are embedded, pluralism in pedagogy aims to “equip students to exercise their own professional judgement as economists” (Denis 2009).

As was shown earlier, fruitful examples of a contextual approach have been part of the history of economics and the social sciences since Adam Smith. Additional examples might include (but are hardly limited to) the Chicago School of urban sociology of the 1920s and 30s, the work of Walter Eucken and F.A. Hayek in exploring the interdependence of social, political and economic systems, the case study method of Alfred Chandler and others at Harvard Business School, and Herbert Simon’s pioneering work in human decision-making. Many other examples could be listed, but the main point to be made is that our notion of contextual economics is pluralistic and pragmatic. It is, borrowing from the philosopher of science Otto Neurath, a “situated” social science (Neurath 1983 [1913]; 1973 [1921]) without foundational theoretical conceits, aiming at a mosaic of insights that build to a rational understanding of economic life and its inherent processes of change. It is our hope that these insights will enable informed individual and collective action to improve human welfare in the face of the challenges of ongoing societal transformations. In this respect we hope to continue in the long and venerable tradition of *Schmollers Jahrbuch*.

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