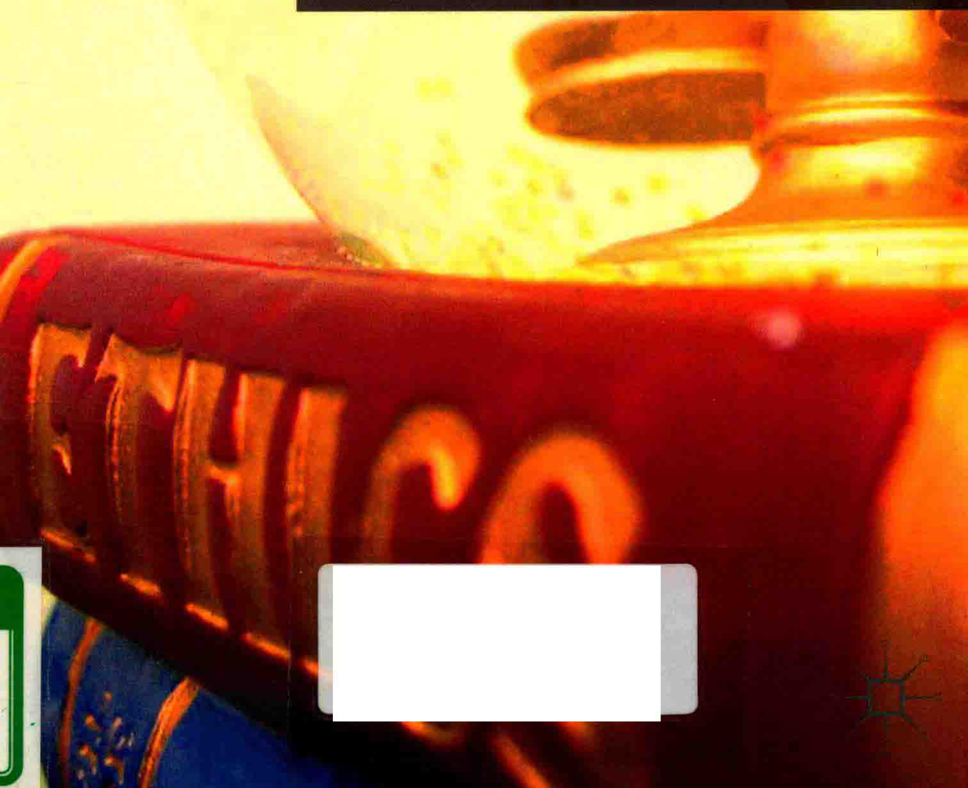
Economics and Ethics

An Introduction

Revised Edition

Amitava Krishna Dutt
and Charles K. Wilber



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Economics and Ethics

For Harolyn and Mary Ellen

Preface

This book focuses on the relation between ethics and economics, both in economic analysis and economic policy. To do so, it makes three simple points. First, economics necessarily involves ethics, and economists cannot engage in economic analysis or giving advice on economic policy without making value judgments. Second, individuals have ethical values that shape their behavior and affect what happens in the economy as a result of their interactions. Third, ethical values are involved in evaluating how an economy is doing and in choosing and appraising economic policies. The rest of this book develops these three points.

Our aim in writing this book is to encourage people who are interested in economic issues – including students and professional economists who are not familiar with ethics – to take ethics more seriously in thinking about the economy. We believe that many people interested in economics, including professional economists, pay insufficient attention to ethical and moral issues, and economics is the worse for that.

Ours is not the first book that deals with the relation between ethics and economics. There are a few excellent treatments of the subject, including a short book by Sen (1987) and the longer work by Hausman and McPherson (1996, 2006). While we have drawn heavily on these and other works, we have tried to make this book different from them in several ways. First, we have tried to provide a fairly comprehensive coverage of the main issues that relate economics and ethics, rather than focus on some key foundational ideas. Second, we have tried to avoid surveying the field with all its complexity and detail, focusing instead on what we believe are some of the central issues relating economics and ethics. Third, we have tried to relate ethical issues closely to economic analysis more narrowly defined – such as microeconomic and macroeconomic analysis and income distribution theory. Our purpose in these decisions is to make the material more accessible to a wider audience than professional economists and philosophers.

The gestation period for this book has been long. The final result has been much enriched by discussion and debate with, and comments from, many colleagues and students. We particularly wish to thank

David Betson, George DeMartino, Georges Enderle, Ronald Hoksbergen, Ken Jameson, Alasdair MacIntyre, Kali Rath, Jaime Ros, Jim Sterba, Jonathan Wight, and many undergraduate students in the economics and ethics course offered at Notre Dame.

We are also grateful to the production staff at Palgrave-Macmillan for their speedy and efficient work in seeing the book to its completion. This paperback edition is a revised version of the first edition with some corrections and a new chapter on the ethics of the global financial crisis. We thank our readers of the first edition and several reviewers for prompting these changes.

Finally, we would like to thank our families for their understanding, good humor and support, and for occasional discussions on the subject of this book and suggestions on the manuscript.

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Part I

Introduction and Background

1 Introduction

The purpose of this book is to provide a short introduction to the relationship between ethics and economics. It is written by two economists and is meant mainly for readers who are interested in economic issues. In addition it may be of use to those who are interested in ethics, but who have no more than an elementary knowledge of economics.

It is widely believed by economists and noneconomists alike that knowing about and "doing" economics does not involve ethical and moral issues. Economics is sometimes called a science – indeed, the Nobel Prize in Economics is called the Nobel Prize in Economic Sciences[1] – which is interpreted as being based purely on empirical observation and logical analysis for understanding the truth about how the economy works (just like natural scientists do with the natural world),[2] and is sometimes thought of as a form of engineering – engineers learn about how to build bridges and have them built, while economists learn about how to intervene in the economy and then help design policies to actually intervene in it.

It is, of course, well understood that economic activity and policies may have some ethical consequences. For instance, the economy can experience high and growing levels of inequality of income between people, or economic policies may involve giving away money to those who do not work for it, both of which may be considered ethically unacceptable. However, it is believed that economists can only investigate whether inequality is high and growing and, if it is, explain why, and that they can analyze what giving money away to people will actually do, and politicians, other government officials, ethicists, and people in general are the ones who will make ethical judgments about what is going on and what policies should be pursued. This is similar to the argument that scientists can do nuclear physics without deciding whether their country should develop nuclear weapons and nuclear energy, and engineers can build underground railroads without deciding whether a particular city should have it in the first place.

However, it is increasingly being recognized that ethics and economics cannot be kept separate and many economists and philosophers have begun examining their interaction. Before we examine the relation between ethics and economics, however, we need to say a few words about what we mean by ethics and by economics. We do this, in turn, in Sections 1.1 and 1.2. Section 1.3 discusses neoclassical economics, the dominant approach to economics. Section 1.4 then provides a brief introduction to the relationship between economics and ethics. The final section presents a brief outline of the book by stating what is covered in each of the following chapters.

1.1 Ethics

Ethics refers to the study of what is morally good and bad, what is right and wrong. It is concerned with questions like the meaning of the good life, what are good and bad actions, who is a morally good person, and how society ought to be structured. Sometimes three concepts central to the subject matter of ethics are distinguished: good (which refers to the ideal, or the thing that is desired); right (what is not wrong); and ought (which refers to obligation, duty, or responsibility, both of the individual and of the society).

Ethics and moral philosophy are often considered to be synonymous in the study of philosophy.[3] For our purposes, however, we may take moral philosophy to be a subset of ethics, where ethics also refers to religious ethics. Thus, moral philosophy or ethical philosophy can be thought of as the study of ethics using reason and arguments, whereas, at least in the Western tradition, religious ethics refers to what is considered good in terms of religious faith, that is, due to divine revelation. It is not necessary to have religious faith to study ethics. In this book we will discuss primarily moral philosophy and not be explicitly concerned with religious ethics as such. We will therefore sometimes use the terms ethics and moral philosophy interchangeably. However, since people's ethical views are frequently shaped by their religious ethics (in fact more so than moral philosophy for most people), in our discussion of how ethics shapes behavior we will examine the role of both philosophic and religious ethics.

It is often believed that ethics and morality are matters of opinion, that arguments about ethics cannot be resolved, and that these issues are relative and subjective, rather than absolute and objective. Thus, examining ethical questions may be useless. It may even be harmful, because it may lead to some people intolerantly imposing their ethical views on others. There may be some truth to these charges. Ethical questions may be relative to what the facts are: for instance, it may be considered ethical to lie to someone if telling them the truth would lead the person to locate his victim and kill her. Well-reasoned debates about ethical issues may lead good and ethical people to disagree with each other. Sometimes the "morality police" can breed intolerance and oppression. But all of this does not make a valid case for rejecting the study of ethics. It does not mean that whatever a person or society believes is right. The issue is not just *what* a person believes but, more importantly, *why* the person believes it. One can formulate arguments, examine premises on which people can agree on, and try to use logical reasoning to come to some conclusions about disputed issues. It even seems to be the case that there is more agreement regarding ethics than there is disagreement, even among people from different backgrounds and parts of the world. There seems to be general agreement that to kill and to torture is bad (especially for entertainment), that an ideal of good behavior is to be kind and charitable to others (especially those who are more disadvantaged than us) even to the point of being selfless, that it is not good to be selfish,[4] and that it is wrong to be intolerant of people with different views.

1.2 Economics

A very brief overview of what economics is concerned with and what issues it examines is useful to provide some background for the rest of the analysis of this book. Providing this overview can also make most of this book accessible to readers who have not even read a book on introductory economics. In what follows we first define economics; then discuss its major branches, microeconomics and macroeconomics; and then describe some of its major subfields. Most economists and introductory texts follow what is called the neoclassical approach, and we will make some comments about this approach to economics and its main alternatives in the next section. These sections are somewhat long to provide a reasonably self-contained outline of economics.

It is useful to define economics as studying some activities or some system. The activities definition is used by the British economist Alfred Marshall (1842–1924), who popularized the use of supply and demand curves for studying markets and was a major figure in the professionalization of economics (as a separate scholarly discipline). He defined economics as "a study of mankind in the ordinary business of life" (Marshall, 1920, Part I, Chap. 1, §4). Marshall did not specify what he meant by the ordinary business of life, but we can presume that this business refers to activities such as consuming, producing, working, buying and selling, saving, investing (that is, installing new capital goods for future production), and holding assets such as financial assets.[5] The system definition is used by the American economist and Nobel laureate Paul Samuelson (1915–2009) in his extremely popular introductory economics text (Samuelson, 1948) which has gone into 18 editions at the time of this writing. He defines the economic system as one which answers the following questions about the production of goods and services: what, how, and for whom.

Economics is almost universally divided into two parts, microeconomics and macroeconomics. Microeconomics examines the behavior of individual economic agents or actors (such as producers and consumers) and how they interact with each other, and studies the operation of individual markets (for instance, the market for coffee) and their interaction. Macroeconomics studies the behavior of aggregates, aggregating over both economic actors and markets. Thus, while microeconomics is concerned with the level of production of a firm, and the consumption of apples by an individual consumer, macroeconomics is concerned with the level of aggregate production of goods and services of the economy as a whole and the level of aggregate consumption of all people in an economy without necessarily examining individual actors or individual markets.

Microeconomics studies the behavior of individual consumers and firms and the interactions of these individuals. It examines how consumers choose what and how much they buy, and how their buying plans are affected by the prices they pay and their incomes. It explores how firms decide how much to produce of what goods, and how they produce them under different types of market conditions – for instance, if they are one of a very large number of firms in a market all producing an identical product (what, with some additional conditions, is called perfect competition), if they produce slightly differentiated products, if they are one of a few sellers (what is called an oligopoly), or if they are the only seller in a market (called a monopoly). It also examines how firms change their plans depending on changes in their environment, for instance, in perfectly competitive markets, how their production plans are affected by changes in the price. Interaction between buyers and sellers is used to examine how market prices of goods and services and factors of production, such as labor (that is, the wage), are determined, and how the interaction of different markets in the economy, in what is called general equilibrium analysis, determines the prices and quantities of all goods and resources. Sometimes individual interaction is examined without having markets and market prices, but simply by examining how these individuals affect each other using specified rules of interaction. In all this analysis of behavior, it is almost always assumed that individuals are self-interested maximizers of their profits or well-being (as measured by what is called their utility levels which reflect their preferences). Microeconomics also examines whether the outcome that markets and other forms of interaction may produce[6] – called the equilibrium – is desirable in some sense, usually in the sense of being efficient. Efficiency is defined as a situation in which no individual can be made better off without making someone else worse off (that is, there are no costless – in the sense of making someone worse off – ways of making anyone better off). It finds conditions under which market equilibrium is efficient, and explores how what are called market failures can prevent an equilibrium from being efficient. Market failures include such things as follows:

1. Monopolies and other departures from perfect competition. Monopoly producers may produce less than what is efficient for the economy, because they want to create an artificial scarcity and keep the price of their product high in order to make high profits.
2. Externalities, in which people and firms affect others adversely or positively without either paying or being paid. Firms may emit too much pollution which makes other firms and people worse off because the latter, rather than they, bear the costs of pollution.
3. Public goods which no private firms will want to produce because they cannot make people pay for them. Public goods are those which can be enjoyed by all at the same time (like listening to radio programs off the air) and which the producer cannot prevent people who don't pay from consuming it (for instance, national defense – a producer of this service cannot selectively protect some people from foreign invasion without protecting others who do not pay).
4. Imperfect information, in the sense that buyers and sellers do not possess all the relevant information to produce efficient outcomes. Imperfect information implies that at least some individuals in the economy do not have complete information that allows them to make appropriate decisions: for instance, if consumers do not have complete information about the properties of medicines, they may

buy those which do not work, or not buy those which actually work but which they think do not (in the latter case, both the consumers will be better off by using the medicines, and the firms would make more profits if they did).

If market failures do occur, microeconomics analyzes how markets can be made to operate more efficiently, for instance, with governments breaking up monopolies, imposing fines for pollution, supplying public goods, and by certifying whether medicines work. Microeconomics is also concerned with the determination of income distribution between people, and if the distribution is considered to be unfair, of how it can be made fairer without creating or exacerbating inefficiencies.

Macroeconomics is mainly concerned with trying to understand how the level of aggregate production in the economy is determined, why aggregate production frequently fluctuates through recessions (and sometimes depressions) and booms to result in business cycles, what determines unemployment (that is, the number of people who want to work but who are not employed), what explains the level of inflation (that is, the rate of increase of the average price level of all goods and services), and what determines the rate at which the level of production of goods and services (at constant prices) grow over time. It examines how financial markets function, for instance, what determines interest rates and stock and bond prices, and how these affect output and inflation. Macroeconomics also examines the trade balance of a country (its exports minus its imports) and its balance of payments (its overall receipts of foreign currency through, for instance, exports and foreign capital inflows due to borrowing and foreign investment less its overall spending of foreign currency through imports and foreign capital outflows) and how these affect the economy as a whole. Macroeconomics examines not only why unemployment exists, why inflation can be high, and why growth can be low, but also how government policy can be used to overcome problems, if and when they occur, through monetary policy (by controlling interest rates and the supply of money) and fiscal policy (by changing government expenditures and taxes). There are differences of opinion within macroeconomics about whether involuntary unemployment exists and what causes it, and what policies to adopt when unemployment is high. Macroeconomics is also sometimes concerned with income distributional issues, for instance, looking at the relative income of the rich and the poor (as broad groups), and examining the relation between income distribution and growth.