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**Keywords:** Economics, Efficiency, Rationality, Tastes, Virtue Ethics

**Résumé :**

L'article propose une analyse critique des fondements éthiques de la théorie économique contemporaine, en adoptant comme perspective l'éthique des vertus.

**Mots-clés :** Économie, Efficacité, Éthique des vertus, Préférences, Rationalité

*JEL Classification: A11, A13*

# The moral layer of contemporary economics: a virtue ethics perspective

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**Abstract**
Despite the apparent unsuitability of utilitarian ethics to guide appropriate human behaviour through the labyrinth of real-life situations, economics – defined as the science of efficient resource allocation – is often evaluated in the light of this outdated ethical perspective. This paper takes a different point of view: it questions whether the contemporary science of economics and its recommendations are built on sound moral foundations as assessed from a virtue-based definition of ethical behaviour. We argue that the model of man underlying economic analyses can correspond to the model of a virtuous person, and that economics, by advocating reasoned choice and careful resource utilization, makes a positive contribution to the moral development of individuals.

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> It is sometimes said that economists regard it as "natural" or "normal", and in some sense even right, that man should be governed only by selfish motives; this opinion may however be dismissed at once as a popular error, which finds no support in the teaching or practice of the best economists. (Alfred Marshall, *Principles of Economics*, 1890: 79)

## 1. Introduction

As pointed out years ago by John Maynard Keynes, the influence of economics on the global ideology of capitalism should not be underestimated.[1] Economics, like any other social science, is built on moral foundations which shape its development, guide researchers' choice of topics, and structure their recommendations. The main goal of this paper is to present some inquiries into the moral foundations of economics, with special focus on the recent developments in this field. As the analysis takes a virtue-based ethical perspective, the main question addressed here is whether the economic model of man is consistent with the model of a virtuous person.

Broadly speaking economics studies how society produces and delivers goods to its members. Over time several paradigms struggled to provide a rigorous explanation for this process of resource allocation. In this text we will stick to the perspective provided by what is known as the neoclassical school of thought, which has been the dominant paradigm for over a century. From this standpoint, 'economics is the study of how societies use scarce resources to produce valuable commodities and distribute them among different people' (Samuelson and Nordhaus, 1998: 4). The tension between the scarcity of resources and the limitlessness of needs thus lies at the heart of neoclassical economic theory. This tension is an overwhelming fact of life. In many developing areas of the planet, basic human needs (food, housing, public health, etc) are still unsatisfied. In the developed countries that no longer suffer such deficiencies, the supply of more sophisticated products is still rationed. It is beyond the scope of this paper to provide an analysis of the other paradigms, which occupy only a small part of the contemporary landscape. In the rest of this paper, the term 'economics' actually refers to neoclassical economics.

[1] He wrote: "…the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slave of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back." (Keynes, 1936: 383).

In the neoclassical paradigm, economics is a theory of human actions undertaken by intelligent people, who understand the world they live in, can evaluate their options, and are able to decide wisely. As a study of human interaction, economics focuses on voluntary agreements or trades between individuals. This perspective was reinforced after the collapse of socially planned economies and the communist ideology in the late 1980s, and free allocation of resources through voluntary exchange became the dominant economic model throughout the world.

As Thomas Kuhn argued, a scientific paradigm needs one set of axioms on which the specific constructs of the field are developed. One important principle of neoclassical economics is *methodological individualism*: the key element of the social nexus is the individual, and society must have the characteristics of its member individuals, rather than the reverse. Another distinctive principle is that of *rationality*: the human being is assumed to make use of reason in evaluating the various courses of action open to him, and choose the best. While economics focuses on reason-driven choices, it does not deny that sentiments and instincts can also be major drivers of human action. Yet what economists believe - and hopefully they are right - is that reason plays an important role in a substantial number of human actions. The emphasis on rational behaviour drove economics towards what Williamson (1993) called ‘calculativeness’, a concept that he does not define explicitly, but from his examples appears to be characterized by a strong focus on analytical thinking, formalism, measurement, etc. A third essential principle is that of *predetermined tastes*. Economics takes human goals (tastes) as given, and, in general, would not make any value judgement about those tastes. However, economists also agree that ethical principles guide human actions at the higher level, helping individuals to define their higher goals. The economist, that theoretician of the ‘dismal science’, is first and foremost a human being: he can only agree that human values such as honesty, fairness, fellow-feeling, kindness, and so on must be taught and instilled in a civilized society.

This paper is organized as follows. The next section reviews the basic principles of economics, then sketches an outline of the main contemporary developments. Section 3 introduces the ethical perspective of this paper. Section 4 comments on the concept of rationality in contemporary economics and presents its ethical foundations. We analyse the ethical implications of the quest for efficiency in Section 5. Section 6 addresses the paradigmatic frontier of taste predetermination from an ethical perspective. The final section presents the conclusion.

## 2. What is economics today?

### *2.1. Economics in historical perspective*

For many years, the main quest of positive economics was to find an explanation for the determination of prices in free-market economies. A milestone was reached with the analysis of an individual market by Alfred Marshall (1842-1924). He showed how the market price of a given commodity can be found at the intersection between an upwardly sloping supply curve characteristic of producers' decisions, and a downwardly sloping demand curve characteristic of consumers' tastes. In this framework, single market equilibrium or *partial equilibrium* is defined as a situation where the optimal plans of all agents in the market are mutually compatible.

As supply and demand in a market naturally depend on the prices of other goods, it makes sense to analyse the simultaneous equilibrium in all markets: this is the concept of general equilibrium. In 1776, in his famous treaty *An Inquiry into the Causes of the Wealth of Nations*, Adam Smith claimed that a decentralized economy, where each economic agent pursues his own interest, can achieve a highly efficient allocation of resources, as if an 'invisible hand' carries resources to the place where they are the most highly valued. This powerful allocative efficiency is the key to prosperity for society as a whole. The facts have corroborated this intuition, in that over more than two hundred years Western economies grew extremely rapidly, while the same period has seen the birth and collapse of all planned economies. Yet it took years for economics to provide a convincing explanation for this seemingly puzzling situation. In the late 19$^{th}$ century, Léon Walras expressed the problem of resource allocation via the market mechanism in a rigorously mathematical form, providing intuition for the solution finally worked out in 1956 by Kenneth Arrow and Gérard Debreu. Their analysis highlighted the restrictions needed to guarantee the existence of the general (or Walrassian) equilibrium, a set of prices consistent with the simultaneous equilibrium of all markets. The set of restrictions required by the general equilibrium is referred to as perfect competition. It was demonstrated that under these restrictions the equilibrium (a) is single and (b) allows for extremely efficient allocation of resources.

This understanding of a hypothetical, perfectly competitive free-market economy led to valuable policy recommendations. Economists observed how real-life economies (or industrial sectors) deviated from the competitive model, and calculated the welfare losses that come with firms' excessive market power or various externalities. Following their analyses, governments all over the world set up laws and institutions designed to contain market concentration, limit abuses of market power by big firms and promote competition between firms.[2]

Contemporary economic theory continues to pay great attention to these inefficiencies, which originate in the market architecture. Yet in the last thirty years, a new path of research tracking 'informational inefficiencies' has provided a catalyst for renewal of economics through an ambitious research programme.

### *2.2. Contemporary advances in economics*

As early as 1961 George Stigler pointed out that the production of information in decentralized economies is a critical process that deserves close scrutiny[3], and tried to model the mechanism whereby people spend time and effort to find out the characteristics of a given commodity (price, quality, location, and so on). The studies carried out in this field showed that even very small informational costs may put at risk the allocative efficiency of decentralized economies as imagined by proponents of the spontaneous emergence of the Walrassian general equilibrium.[4] Although this path of research came to a standstill in the late 1980s, it very clearly indicated the need for economics to incorporate a more rigorous analysis of imperfect information, a fundamental characteristic of real-life economic systems. The analysis of 'imperfect information' required a new approach to 'expectations', since people who decide on the basis of imperfect knowledge of reality must base their choices on their subjective perception of that reality.

Making extensive use of the concept of equilibrium specific to Game Theory[5] and importing elements from statistics and probability, in the 1970s economists developed the New Theory of Expectations, built around the key concept of the rational expectation

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[2] Economics advocates competition between firms, and not, as is sometimes claimed by uninformed critics, between individuals.

[3] Before Stigler, Friedrich Hayek also emphasized the role of market interactions as an efficient way of producing and conveying information.

[4] Diamond (1971) produced a fundamental paper in this field. He shows that by introducing a small search cost into a seemingly competitive economy, firms become able to impose the abnormally high monopsony price on consumers.

[5] Game theory analyzes individual strategic choices in view of the reaction of competitors. In a game theoretical framework, equilibrium is often seen as a situation of no regret. In equilibrium, the individual has no incentive to deviate, and would not regret his past choices.

equilibrium.[6] The basic idea was that over a long period, intelligent individuals should be able to eliminate all systematic biases from their perceptions. They may still be unsettled by exceptional events: indeed, random shocks are an intrinsic feature of real-life economies (tastes, technology, terms of trade, etc. do often change in unpredictable ways). Proponents of the rational expectation principle acknowledge that individuals are moving in an uncertain environment, but argue that they are not fully ignorant of the world they live in: they will utilize all the available information in order to reduce expectation errors as far as possible.

Given these developments, economic equilibrium (that is, the rational expectation equilibrium) was reinterpreted as a situation where individuals' actions and individuals' beliefs are mutually consistent. This is not just a cosmetic change: in contrast to the Walrassian equilibrium, these types of economic equilibria are not necessarily single. The economists' understanding of expectation-based systems with multiple equilibria (where, to put it simply, there is an equal chance of either a good or a bad situation occurring) allowed them to provide relevant explanations for notorious episodes of economic instability. For instance, the financial crises that hit emerging economies in the 1990s could be explained by emphasizing how the loss of trust had exaggerated the true scale of economic difficulties, with the resulting downturn confirming such pessimistic beliefs.

The new theory of expectations revealed its full potential in analysis of asymmetric information situations, where one of the participants in a trade has more information than the other. Economists have shown that in such situations, which are quite common in real life, the better-informed agent can set up information manipulation strategies with the aim of extracting an informational rent from the less-informed agent. These attempts to manipulate information strategically can lead to significant dysfunctions in a decentralized economy.

All in all, the concepts of rational expectations and the rational expectation equilibrium endowed economics with a method for analysing the formation of beliefs. This more nuanced understanding of the interaction between actions and beliefs in turn strengthened the internal consistency of existing economic analyses, and encouraged development of new approaches. The new emphasis on beliefs and interactions fostered development of more complex models of human decision making, which even when they do not incorporate an explicit ethical dimension have the merit of acknowledging that

[6] The new principles were first applied in the work of macroeconomists as Robert Lucas, Robert Barro, Edward Prescott, Finn Kydland, Thomas Sargent, etc. or microeconomists as Joseph Stiglitz, Bruce Greenwald, George Akerlof, Michael Spence, etc.

individuals' economic choices are subject to a wider set of constraints than is assumed in standard analysis of the Walrassian equilibrium.

## 3. Choosing the appropriate ethical perspective

Everyone would agree that, in the realm of philosophy, ethical issues provide for the most controversial topic. Textbooks often state three main approaches to morality that compete on some dimensions and are mutually complementary on others: utilitarian ethics (emphasising consequences), teleological ethics (emphasising goals) and virtue ethics (emphasising character).

There is a tendency for social science scholars to evaluate economics within the paradigm of *utilitarian ethics*. In a nutshell, the utilitarian moralist would argue that an action (or rule of action) is right if it brings about the greatest balance of pleasure over pain for everyone.[7] What ultimately matters are the consequences of an action: right actions are presumed to bring about pleasure, and wrong actions pain. Although there is nothing to prevent the utilitarian thinker from connecting pleasures to the achievement of higher human goals, this perspective has little to say about how these higher human goals emerge. Yet if we go back to Socrates, ethics is primarily about 'how one should live'. The emergence and definition of these higher human goals is thus a key question for the moralist. Even John Stuart Mill, a famous proponent of utilitarian ethics, appeared to accept this criticism:

> If no more be meant by the objection than that many utilitarians look on the morality of actions, as measured by the utilitarian standard, with too exclusive a regard, and do not lay sufficient stress upon the other beauties of character which go towards making a human being lovable or admirable, this may be admitted. (Mill, 1863, Ch. 2)

I will not argue further here on why utilitarian ethics suffers from too many shortcomings to be seriously considered as a suitable moral theory. But are the moral foundations of economics utilitarian? I believe they are not.

Economists agree that when it comes to satisfying basic needs, the individual's actions are indeed guided by an assessment of costs and benefits (or pains and pleasures in the old-

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[7] It should be emphasised here that many utilitarian philosophers give a much more nuanced account of what should be understood by pleasure, pain and utility than Jeremy Bentham (see Mill, 1863). See also Solomon (1993), Chapter 9 on Mill's broad conception of utilitarianism.

fashioned vocabulary). But this is not the same as saying that all human actions should in fact be driven by utilitarian considerations. Few contemporary scholars in economics would deny that ultimate human goals may go far beyond the simple goal of wealth accumulation. The point was clearly made by Stanley Jevons, one of the fathers of neoclassical economics:

> The calculus of utility aims at supplying the ordinary wants of man at the least cost of labour. Each labourer, in the absence of other motives, is supposed to devote his energy to the accumulation of wealth. A higher calculus of moral right and wrong would be needed to show how he may best employ that wealth for the good of others well as himself. But when that higher calculus gives no prohibition, we need the lower calculus to gain us the utmost good in matters of moral indifference. (Jevons, 1871: 27)

In no way does the logic of utilitarian decision-making as a theory of individual choice imply that modern, neoclassical economics actually advocates utilitarian ethics.

Microeconomic theory defines the individual's preferences in an axiomatic way, given the set of choices and his ability to rank outcomes from the most to the least desirable. A utility function is a compact way of representing the individual's preferred ordering, a tool that gives up some generality for the sake of analytical simplicity. Yet microeconomics does not assign any role to the level of utility associated with a given consumption bundle, but only to the ability to rank consumption bundles as representative of the individual's ability to make choices.

True, one branch of theoretical microeconomics, welfare economics (Bergson, 1938; Samuelson, 1947), aimed to provide a formal analysis of distributional justice, and tried based on social justice criteria to build a social welfare function (SWF), a utility function representative of society's preferences. Note that such a construct could be made consistent with various degrees of inequality aversion, going from the extreme principle that social decisions must aim at improving the situation of the worst-off individual (Rawls, 1971), to pure Benthamite utilitarianism where all individuals are given equal weight. In recent years, this static approach has been generalized to take into account the fact that status can change along an individual's entire life, so problems of utility inequality are placed in a dynamic perspective (what matters for an individual and society as a whole is not only instant equality but the probability of individuals improving their position over time).[8]

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[8] Not all the existing theories of distributional justice are consistent with a formalized SWF. For instance, Nozick (1974) argues that the market economy is just because it rewards the most able and the hard worker.

Yet the validity of the concept of a social welfare function has never been fully established. First of all, all these functions involve explicit or implicit interpersonal comparisons of utility, a principle that could never receive empirical or theoretical support.[9] Further scepticism on the meaningfulness of social welfare functions was contributed by Arrow (1950) who proved that given a few almost common-sense restrictions, it is mathematically impossible to determine a democratic procedure able to aggregate individual preferences so that the preferred ordering of alternatives is respected for all individuals; in other words, given alternatives $\{x, y, z, w, \ldots\}$, if all individuals prefer $x$ to $y$, (but do not all prefer $x$ to $z$ or $w$) there is no social choice mechanism involving that $x$ is clearly preferred over $y$.[10]

When it comes to welfare analysis, studies out of the field of welfare economics generally take the most elementary stance and resort to a elementary utilitarian social welfare function. But, in all these papers the main focus is on efficiency, or how to obtain the best allocation of resources. The choice of a utilitarian SWF is probably driven by parsimony rather than a strong belief in the positive virtues of this construct. When social choice is brought into the picture, economists very often become cautious in their recommendations, since they do not trust simple SWFs, have no idea of what the actual SWF might be, and doubt that the actual social decision process can be captured by any SWF.

To sum up, economics aims at removing inefficiencies, which is quite straightforward in situations where economic advice can improve the situation of at least one person without harming everyone else. When policy choices involve trade-offs, economists can point out the consequences for various groups, but will be cautious about advocating one solution, even though they can agree that choices involving social trade-offs should build on higher ethical values. This does not imply that economists, as members of society, do not have a personal position with respect to ethics. Taking a random sample of studies from a large database in economics (such as EconLit), we see that economists tend to follow the Rawlsian, rather than Benthamite, distributional principle: they will on the whole advocate decisions that protect the least favoured group of people (the unemployed rather than employers or insiders; consumers

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[9] Long ago, Stanley Jevons (1888, I20) wrote: ‘The reader will find, again, that there is never, in any single instance, an attempt made to compare the amount of feeling in one mind with that in another. I see no means by which such comparison can be accomplished. The susceptibility of one mind may, for what we know, be a thousand times greater than that of another.’

[10] There must be more than two alternatives. One important restriction is that social preferences between any two alternatives depend only on the individual preferences between the same two alternatives (independence of irrelevant alternatives).

rather than large firms; small competitive firms rather than the monopoly; developing countries rather than developed countries, and so on).

If the foundations of contemporary economics are not utilitarian, are they then virtue-based? Virtue ethics places full emphasis on character; it acknowledges that outcomes and actions cannot be dissociated from the person him/herself. The origin of this approach can be traced back to Aristotle (384-322 BC) who, in his *Nicomanchean Ethics*, argued that since virtuous people can take only good action, ethics is primarily about defining virtues, those traits of character which allow the person to respond appropriately to the situation. In general, a virtue is characterized by moderation; the same trait of character pushed to extremes becomes a vice. (For instance, courage is a virtue, while cowardice and temerity are both vices.) [11]

Over the years, many lists of significant virtues have been drawn up by various thinkers, from Aristotle and St. Thomas Aquinas to Jane Austen. In the realm of economic life, certain virtues come under the spotlight. Solomon (1993) argues that in modern market economies, basic business virtues are honesty, fairness, trust and toughness which should be accompanied by friendliness, honour, loyalty, a sense of shame, competition, care and compassion.

What should be emphasised here is that the virtuous person will be educated in and cultivate *all* virtues (honesty, for example, may require courage and helps develop fairness, and so on), while it is enough to give way to a single vice to become a bad person.

The main thesis developed in this paper is that economics trains people to oppose several vices, in particular *silliness* (unreasoned actions) and *prodigality* (wasteful spending of resources). No economic analysis would advise people to steal, lie or manipulate others in order to get rich. On the contrary, since contemporary economics is above all an inquiry into voluntary exchange, it will quite naturally call for transparency, honesty and loyalty in future trades. There is no guarantee that behaving in keeping with the principles of economics is sufficient to become a good person, but ignoring those principles raises the chances of behaving wrongly.

[11] Philosophy's interest in Aristotle's view of ethics is rather recent compared to the established utilitarian and deontological ethical perspectives. Special credit should be assigned to the work of Anscombe (1958) and MacIntyre (1981). These scholars pointed out that the quest of both utilitarian and deontological theorists for universal rules of action might be void, since no rule can be consistent with the huge variety of real-life situations. Several scholars have argued that virtue ethics might provide the most suitable lens for analysing ethical issues pertaining to business situations, since it is able to strike a subtle balance between determinism (the external constraints on the individual's behaviour) and human character (Koehn, 1995; Murphy, 1999; Solomon, 1992, 2003).

## 4. Ethics and the principle of rationality

### *4.1. Reason as a virtue*

The Greek philosophers taught us that what distinguishes humans from animals, and thus defines the human species, is rationality. In his comprehensive analysis of rationality, Robert Nozick states:

> Copernicus, Darwin, and Freud taught us that human beings do not occupy a special place in the universe, they are not special in their origin and are not always guided by rational or even consciously known motives. What continued to give humanity some special status, though, is its capacity for rationality. Perhaps we do not consistently exercise this valuable attribute; yet it set us apart. Rationality provides us with the (potential) power to investigate and discover anything and everything; it enables us to control and direct our behaviour through reason and the utilization of principles. (Nozick, 1993: 1P).

We also know that in Aristotle's view, acting with reason is a fundamental virtue. He wrote:

> For the good man judges in every instance correctly, and in every instance the notion conveyed to his mind is the true one. (Aristotle, *Nicomanchean Ethics*, Book III: 42)

In this respect, Athannassoulis (2004) makes an important remark:

> Aristotle then observes that where a thing has a function the good of the thing is when it performs its function well. For example, the knife has a function, to cut, and it performs its function well when it cuts well. This argument is applied to man; man has a function and the good man is the man who performs his function well. Man's function is what is peculiar to him and sets him aside from other beings, and that activity is reason. Therefore, the function of man is reason and the life that is distinctive of humans is the life in accordance with reason. If the function of man is reason, then the good man is the man who functions well, i.e. reasons well, this is the life of excellence, the life of eudaimonia. This means that eudaimonia is the life of virtue, as virtue is activity in accordance with reason, man's highest function.

Economics builds on the postulate that people do think, in other words, they do exercise their fundamental virtue of reason. In this, economics is deeply in line with the concept of a virtuous person (in the Aristotelian tradition). What economics teaches us is that people reason when making choices: they weigh up the alternatives and decide as well as possible. Contrary to the popular interpretation, calculation is not the result of selfish behaviour, but of the natural decision process of a good person.

Of course, acting with reason is a necessary but not sufficient criterion for behaving well. A person with vices may be rational: the criminal may rationally choose the best method to carry out his immoral plans. All we want to emphasise here is that a person driven by the highest interest cannot be considered a virtuous person if he behaves irrationally, that is in a foolish way. The virtuous person cultivates all the virtues, and one of those virtues is well learned through economics: to act with reason.

### *4.2. The model of man in economics: ethical implications*

Nozick (1993) argues that the requirement of most efficient decision-making, what he calls 'instrumental rationality', is the overwhelming guide to human action at a basic level.[12] Economics has developed its full range of analyses on the basis of decisions taken by people under the banner of instrumental rationality. Although these mental processes are important, they do not apparently provide us with a comprehensive theory of human action. Emotions and instincts may also play an important role. The fact that economics studies a limited set of human actions does not however mean that understanding this reality is a meaningless exercise.[13] The fact that economics acknowledges that the individual is an optimizer does not mean that the goals of the individual should be simplistic or basic. While economics accepts the idea that a person evaluates actions and consequences according to his own references in order to maximize something called 'utility', it does not claim that the individual is or should be selfish, and that utility is strictly related to a personal gain. The concept of utility is very abstract and can accommodate very different partial goals (such as protecting animals or

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[12] He does not rule out that a higher level of rationality can guide individuals in their more substantive actions, and that there are bridges between the two levels of rationality.

[13] Hirschman (1981) called for a research programme where emotions become part and parcel of economic analyses. The task proved to be extremely difficult. See Rabin (1993) for a decision model that incorporates some form of emotions.

making a collection of mugs).[14] Economics can therefore deal with multiple objectives, including altruism, social status, cultural factors, environmental protection, etc. (Becker, 1976; 1996; Hirschelfer, 1977; Altman, 2005). An individual may be a good, generous person, and, because of this make good use of resources by making choices based on rational calculations.

Some experiments in behavioural economics have fuelled a debate on the merits or otherwise of economics teaching. Frank et al. (1993) claim that people educated in economics tend to be less cooperative in social dilemmas (strategic interactions), which might have morally adverse consequences. It is too early as yet to tell whether their result is robust. Yezer et al. (1996) contribute some evidence that it is not.

One important topic in economics is: what is the most appropriate way to describe the mental processes and goals of flesh-and-blood human beings? Jensen and Meckling (2005) consider this issue within a comparative analysis of competing contemporary models of human behaviour. Two of them are relevant to our analysis: the Resourceful, Evaluative, Maximizing Model (REMM) and the model known as the Economic Model.[15] The REMM model describes the individual as an intelligent, creative being, who pursues a wide range of goals in the most efficient way possible. The authors argue that individuals evaluate and make trade-offs within a very broad range of 'goods', such as 'oranges, water, air, housing, honesty or safety'. Many economic analyses however depict the individual as caring only about 'money', or more precisely a monetary evaluation of the utility to be achieved from given actions. The Economic Model (or money maximizing model) therefore appears as a reductive version of REMM; Jensen and Meckling (2005: 90) deplore the fact that 'while economists profess fidelity to REMM, their loyalty is neither universal nor constant'.

The Economic Model is clearly not consistent with the virtue ethics approach, whereas REMM is. The fact that individuals can trade off 'a little of almost anything we care to name, even reputation and morality, for a sufficiently large quantity of other desired things' tells us nothing about the sizes of the marginal substitution rates. What the practice of virtue may teach the individual is that he should not give up the pursuit of higher goals, whatever the short-term benefit may be. The relative weights assigned to various objectives are what makes the difference between the virtuous and the non-virtuous man.

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[14] See also Hausman and McPherson (2006).

*4.3. Rationality and imperfect information*

Section 2.2 underlines the revolution in economics brought about by new analyses of information. In this context, the concept of rationality utilized in contemporary economics by no means assumes that people are in possession of perfect information when they decide on their desired course of action. According to the new theory of expectations (the rational expectation hypothesis), people are assumed to do their best to form their expectations. This does not mean they can never be wrong. In fact since life is full of random events people will be wrong most of the time, but clever people will strive to make these errors as small as possible and try to eliminate all systematic biases (Sheffrin, 1983). Hence the new perspective on rationality in economics comes with a more nuanced image of the acting man, who struggles to understand the world where he lives, and succeeds in this endeavour. This is no doubt a humanist perspective on the human being, since man is assumed to be able to take charge of his life through reasoning.

The new perspective on rationality was accompanied by a renewed logic of strategic human interactions which built on advances in Game Theory. Combined with the logic of imperfect information, these analyses can provide powerful explanations for contracting situations, rivalries and races, which all build on non-cooperative attitudes, but also ways to increase sharing within a cooperative framework. In so doing, economics acknowledges that while the individual is solely responsible for his own decisions, he may be aware of the consequences of his decisions for his fellow beings, and the reaction of others to his own actions. This opened up a path of research into analysis of trust, honesty, loyalty, and reputation-building which highlights the role of human values in shaping human interactions.

In general, economists carrying out analyses of trust, honesty, fairness and altruism have worked within the framework of the standard model for decision-making under uncertainty. According to this model, set up by John von Neumann and Oscar Morgenstern in the 1940s, an individual who must make a decision without knowing the exact outcome but is able to assess the probabilities of various possible outcomes is supposed to choose the action which will bring about the highest expected utility. Economists thus applied this logic in assessing the benefits of telling the truth, or helping others, or comparing their status with a control group.

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[15] The three others are the Sociological (or Social Victim) Model, the Psychological (or Hierarchy of Needs) Model and the Political (or Perfect Agent) Model.

In recent years, behavioural economics has pointed out several contradictions between the standard (von Neumann-Morgenstern) model of decision-making under uncertainty, and actual individual choices (in very particular cases). Some researchers concluded rather hastily that the concept of rationality so dear to neo-classical economists is meaningless; others inferred that the standard decision model should be generalized in order to account for these idiosyncratic reactions. As Smith (2005) notes, the first conclusion seems to be inconsistent with the observed domination of the planet by the human species over several millennia; he embraces the second view, and suggests that economists should pay more attention to the role of contexts in mental processes as shortcuts for decision-making. There is no doubt that ethical values have an important role in context definition and selection and thus should have a bearing on the choice of the course of action.

One of the major strengths of neoclassical economics is its ability to incorporate valuable concepts from other sciences (Vranceanu, 2005). As Altman argues (2005: 752), 'conventional economic theory can easily accommodate altruistic, ethical, and moral behaviour as part of its standard rational agent maximizing framework, when such behaviour has no impact on the survival of the firm'. If ethical considerations become more prominent in practice, there is no doubt that economics will be able to provide valuable insights. In other words, if the business world becomes more ethical, economics will reflect this change in its analyses.

## 5. Ethics and the quest for efficiency

We have defined economics as the social science that analyses how scarce resources are allocated. In this setup, the immediate goal of economics itself is to guide human action so as to eliminate inefficiencies in the resource allocation process. Contemporary economics puts additional emphasis on the informational origin of various inefficiencies, while traditional economics deals essentially with material inefficiencies related to the market architecture.

Yet waste and inefficiencies are abstract concepts. In practical terms, economists have long been concerned about such issues as growth and development, fighting poverty, reducing unemployment, stabilizing the macroeconomic and financial environment, or improving consumer welfare by containing firms' market power. The moral foundation underlying their quest is deeply humanist – it is the duty of the social scientists to help people live as well as possible.

The important practical contribution of economics to the development of the Western World in the last two centuries cannot be denied. Either directly, or transposed into user-friendly advice by management scholars, applied economic wisdom has helped eradicate waste in many sectors and activities and therefore sustained the economic development of the West. What should be emphasised here is that output growth comes with many moral and political benefits, clearly presented by Benjamin Friedman in a recent book. He writes:

> Economic growth – meaning a rising standard of living for the clear majority of citizens – more often than not fosters greater opportunity, tolerance of diversity, social mobility, commitment to fairness, and dedication to democracy. (Friedman, 2005: 4).

The flourishing of moral values is no doubt stimulated in an environment where basic needs are satisfied. Many human conflicts are built on quarrels over an extremely scarce resource.[16] Arrow (1970: 26) states that ‘among properties of many societies whose economic development is backward is a lack of mutual trust’.

So economics’ chief concern with growth and development goes far beyond a narrow-minded goal of wealth accumulation. While economics promotes growth as an immediate objective, this does not imply that the ultimate goal of economics is growth itself. All good economists take a broad perspective on human wellbeing. What responsible person would seriously argue that wealth accumulation is the only thing that matters for happiness? Yet the problem of growth itself cannot be overemphasised. Robert Lucas, observing that some countries tend to grow much faster than the others for reasons not yet clearly understood, wrote (in 1988):

> ‘Is there some action a government of India could take that would lead the Indian economy to grow like Indonesia’s or Egypt’s? If so, what exactly? If not, what is it about the “nature of India” that makes it so? The consequences for human welfare involved in questions like these are simply staggering: once one starts to think about them, it is hard to think about anything else’ (Lucas, 1988: 5)

Economics is at its most useful when it has to deal with situations where the policy decision can make (at least) one person better off while not deteriorating anybody else’s

[16] Empirical analyses suggest that crime is often concentrated among those living in poverty (Oxoby, 2004).

wellbeing. Yet in many real life situations, the solution to economic dilemmas involves trade-offs; some persons will be better off, and others worse off as a result. In general (neoclassical) economics redistribution is considered as a second order problem; one should firstly bake the pie, then share it. The dramatic experience of centrally-planned economies is relevant in that respect: in those countries, the focus on fair (read egalitarian) redistribution of an ever-shrinking pie did not bring people satisfaction, and in the end all these regimes collapsed under a tide of strong public unrest. Economists agree that redistributive decisions should be taken at a higher decision level, where social trade-offs can be exercised in keeping with the agreed social rules.

In his *Nicomanchean Ethics,* Aristotle praised the liberal person, the man who knows how to give his wealth rightly: to the right people, in the right proportions and at the right times. By providing a rigorous theory of prices, economics sheds light on what constitute 'right' or 'excessive' proportions. For instance, in a competitive market, the price is the right reward for the supplier; in other market structures, more careful analysis is needed in order to find out whether an abnormal producer's margin is the 'right' price for innovation and risk-taking, or is representative of an abuse of market power.

The good person who behaves virtuously must avoid wasting resources when pursuing his (higher) goals. Society highly values such a person, as illustrated by a modern-day example. In 2000 the founder of Microsoft, Bill Gates, and his wife Melinda created a charity foundation. In 2006, Bill Gates decided to dedicate all his time to running this organization. The surprise lay in the huge flow of external resources attracted by the organization (about 10.5 billion dollars): the generous donors said that if Bill Gates, one of the most successful entrepreneurs of the past century, was running the foundation, they were sure the funds would be utilized in the most efficient way, to the highest benefit of those who need aid. We trust efficient persons in all matters, including for helping the most disadvantaged persons. Economics makes a positive contribution to human development, since it teaches us how to manage resources in an efficient way. Again this is by no means an indication that efficiency alone is sufficient to define virtuous behaviour. All we are saying is that prodigality, or careless spending, is a vice that should be opposed by educating people to behave efficiently.

## 6. Ethics and the principle of predetermined tastes

In the 18$^{th}$ century, economics and ethics were closely related. Classical economists – to mention only Adam Smith, John Stuart Mill or David Hume – were at least as concerned about how people should behave within the economic interactions as about how these interactions were actually organized.[17] This normative focus required judgment regarding the fairness of distribution, and more generally the ultimate goals of society.

Yet the dominant paradigm of neoclassical economics takes individuals' tastes as given, in the sense that it makes no judgement on why people choose one goal or another (Hirschleifer, 1977; Sen, 1987). This choice was probably motivated by a concern for efficiency in their own analyses: economists were not yet comfortable with models where constraints and goals interact, given the high complexity of such structures. Since goals probably change only slowly over time, while constraints and incentives may vary rapidly, economists opted for simplification, considering goals as predetermined. Yuengert (2002: 331) argues that this separation between ethics and economics may come with a risk: 'If the researcher's ends are separated completely from the higher ends which direct it, he will either substitute the goals of economics for those higher ends, or risk conducting research that has no intelligible principle guiding it'.

One important question is whether the object of research in economics is determined by the method (assumed to be invariable), or whether the method itself can evolve so as to increase its analytical power over a given subject. If economics is about studying human choice for given tastes, the former applies, because in that case the method defines the science and not the reverse. But in the introduction we defined economics as a theory of rational human action. Changing tastes should then be seen as a worthwhile generalization of the given tastes paradigm.

This idea is given stronger emphasis when placed within a virtue ethics perspective. As observed by Aristotle centuries ago, in the long run human action also has a bearing on human character. A person's character (preferences) is the engine but also the result of the ongoing battle against scarcity. In other words, choices may also have a bearing on tastes, and not only the other way round.

In recent years it has become only too obvious that the predetermined taste paradigm has reached its limits. Buchanan (1992) foresees that in the world of economic reality where people discover their preferences through their choices, the static (predetermined tastes) general equilibrium model will become less popular as a research programme, and its normative implications might well fade away.

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[17] For instance, during that period Adam Smith became famous for his *Theory of Moral Sentiments* (1759) well before writing the celebrated *The Wealth of Nations* (1776).

In order to renew their analyses, economists should become more open to ethical dilemmas, and try to keep in mind that proposed solutions should by no means support the development of unethical behaviour. They should pay more attention to situations where the goals themselves may change, depending on actions and beliefs. The call for such a research programme within the neoclassical paradigm is not new, and can be traced back at least to the writings of Albert Hirschman in the 1970s. Today, there is some optimism that neoclassical economics will address these issues adequately (Altman, 2005; Hausman and McPherson, 2006). The embryos of such studies include analyses of addictive behaviour (*inter alia*, von Weizsäcker, 1971; Pollak, 1971; Cowen, 1989) on the interactions between social status and individual welfare (*inter alia*, Frank, 1985; Scitovsky, 1992; Cole et al., 1992; Corneo and Jeanne, 1998; Oxoby, 2004).

## 7. Conclusion

In the last thirty years, the science of economics has been totally restructured, driven by the implementation of a research program in the economics of (imperfect) information. The renaissance in economics was facilitated by the progress made in its tools and methods. In particular, advances in game theory and statistics made it possible to extend and generalize the principle of rationality, for more rigorous examination of decision-making under uncertainty and imperfect information.

Yet contemporary economics does not only consist of broader topics and better techniques. One outstanding feature of contemporary economics is a return to the ethical quest of the early neoclassical writers: with their modern awareness of how to analyse imperfect information situations, economists are beginning to focus once more on fighting waste, in order to contribute to improving the welfare of individuals and society. The raging ideological conflicts of the 1970s have almost vanished, since all economists now agree that imperfect information lies at the origins of most disruptions in decentralized economies, and that fluctuations are a built-in feature of such systems.

By focusing on informational inefficiencies within a comprehensive research programme, economics has provided helpful policy recommendations, able to stabilize and support growth in both developed and developing economies. In turn, as Friedman (2005) notes, economic development is an important factor for moral development.

By emphasizing rational decision-making, economics promotes a model of man acting wisely. In this context, calculative behaviour should not be seen as representative of a selfish person, but a responsible and prudent one. Responsibility and prudence are important virtues in the Aristotelian ethical perspective. Of course, this is only one side of the story, as efficiency is a necessary but not sufficient requirement for appropriate action. The choice of the broader goals that guide one's action is another important factor.

Although economics has so far said little about how human goals are defined, it certainly does not advocate selfish and aggressive behaviour. On the contrary, most economists would agree that human values like trust, loyalty, honesty, fairness in dealings and truthfulness are very much needed to oil the wheels of the market-based economic system, and that reneging on those ethical values would entail major economic costs in the free economy.[18] What narrow-minded economist would argue against this idea? It is clear to everybody that unethical behaviour brings about significant long-term costs, starting with the loss of reputation, an important asset in the free economy.

By taking human goals as given, economics has been able to make and is still making substantial progress in analysing human action. Yet human character and actions are interdependent. A major challenge for 21st century economics is therefore to take into account the possibility of changing tastes, while maintaining the requirement of rationality.

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[18] See Arrow (1974), McKean (1975), Becker (1976), Noreen (1988).

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