

ECONOMIC WATCH

Private vices, public virtues



■ BY TILAK ABEYSINGHE

IT IS human nature to seek justifications for our actions. Economists, too, provide justifications for particular modes of production, which then become accepted without question until flaws begin to emerge.

Centrally planned economies drew justification from Marxism until its eventual demise. Free-market economies draw justification from neoclassical economics. The present economic crisis and ongoing environmental degradation should lead economists to re-examine the theoretical toolkit they use to justify free-reigning market capitalism.

The current paradigm seems to have reached its limits and a paradigm shift or a substantial modification of the current paradigm is in order. Crises are the times when new paradigms emerge. In the wake of the Great Depression, for instance, John Maynard Keynes, one of the greatest thinkers in economics, proposed a new line of thinking that subsequently came to be known as macroeconomics.

The basic economic dictum of neoclassical economics holds that when selfish, self-interested individuals try to maximise their own welfare in a free market environment they unknowingly bring about a "virtuous" world where everyone becomes materially better-off. Although it is true that free-market capitalism has produced an unprecedented amount of material wealth in the world and lifted many out of poverty, the overall outcome has not been all that virtuous.

Two assumptions underlie the basic dictum: The first is that humans are selfish. And the second is that when selfish individuals engage in their rational optimising calculus they can ignore the larger social, cultural and natural environments that surround them. As in all other disciplines, assumptions, however obvious they seem, are not always innocuous and need to be re-examined.

The first assumption – that humans are selfish – raises a philosophical and scientific question: Are humans innately selfish? Those who align themselves with Darwinian morality may argue that

the altruism we observe all around us is an outcome of selfishness; reciprocity is needed for individual survival.

It may well be the case that societies codified certain values in the form of religions and other social norms and customs to prevent themselves from disintegrating into chaos because of the inherent drive in humans to promote their self-interest. But one may also argue that every individual possesses both selfish and altruistic characteristics and what society and the prevailing economic system promotes at any one time becomes the dominant trait.

The present economic crisis and ongoing environmental degradation should lead economists to re-examine the theoretical toolkit they use to justify free-reigning market capitalism.

Neoclassical economists have emphasised the selfish end of the scale and formulated theories that turned the traditional understanding that private virtue leads to public virtue into the notion that private vice can lead to public virtue. Note that there is a clear difference between the old and new norms. In the new, "virtue" simply refers to material well-being.

Even if one grants that the assumption of selfishness in economics cannot easily be replaced by any other assumption, the second assumption – that we can ignore the effects of individual selfishness on the macro environment – remains damaging.

When macroeconomics was born, many economists were not very happy with it because it dealt with synthetic aggregates such as gross domestic product and the price level. So they started looking for what is now called the micro-foundation of macroeconomics. Consequently, microeconomics deals ostensibly with real people. The objective here

was to eliminate the micro-macro distinction, since the macro was believed to be an aggregation of micro components. But economists have not succeeded in this unification; macro phenomena are qualitatively different from their micro constituents. This problem exists in other disciplines too, particularly physics.

The main problem here is that in the process of focusing on atomistic individuals, economists completely ignored macro-constraints. By "macro" here I mean the larger social, cultural and natural environments within which we live. The problems posed by global warming are an example of a macro-constraint that is ignored.

Although economists have long talked about "externalities" or spillover effects of private economic activities, these remained outside the basic economic dictum. As a result, economists tend to recommend solutions to market failures on an ad hoc basis, and, not surprisingly, the solutions are usually not well implemented.

In traditional societies, social customs, norms, taboos and reverence for nature acted as macro-constraints on individuals even if they were self-interested or selfish. Such macro-constraints withered away during the industrial revolution and no adequate regulatory mechanism emerged to enforce similar constraints on self-interests. The result was over-production, environmental degradation and global warming, among other things. The current economic crisis is a manifestation of over-production in the financial sector.

The solutions that economists currently offer to the problem of over-production are not likely to be effective. The usual proposal is to make producers pay for the cost of the bad spillover effects they create – like carbon emissions, say – but such rules are typically unenforceable and hence, not enforced.

In neoclassical economics, solutions are usually derived by equating marginal (additional) costs to marginal benefits. These solutions could be very different from those obtained by subjecting economic activity to macro-constraints such as the macro-constraints of traditional societies or legislative prohibitions.

Constraints are binding. In the absence of constraints, it is always possible to bring down the cost of production, including spillover costs, through technological advancements and yet still over-produce. In the production process, certain things get accumulated as stocks – for example, the stock of pollution. But such stocks, unfortunately, do not play a direct role in the "marginal analysis" of neoclassical economics.

Until new theories emerge we have to go on tinkering with the current system to resolve the pressing problems we face.

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