Modern Economics as Social Psychology: Escaping the Moral Dilemma of the Invisible Hand
-by Garrick R. Small
University of Technology, Sydney, Australia

Modern economic theory is fundamentally a behavioural interpretation of market events, however, its common evaluation is in moral terms. The tension between these two aspects of economics is explored along with the underlying moral threads that haunt the positive science.

The causal foundations of the market are reviewed. Supply and demand are both positively evident in the marketplace, however their theoretical explanations are unsatisfying. By taking the analysis no further than the positive behaviours, this problem disappears. The advantages of this strategy are assessed in terms of popular tendency to assert that economics and morals are totally separate sciences. Against this, it is shown that moral thought remains the central foundation to positive economics.

The paper concludes that there are two possibilities for economic science. One accepts that there is no moral basis for the market, but studies common practice within it. This is generally what is commonly understood as economics today. The other is an exploration of the moral content of economic action within a free commercial environment. The latter accepts the market as amoral and seeks to explore the moral content of various economic strategies. Despite the practical usefulness of the former, only the latter direction can be shown to be fully consistent.

Introduction

The predominant development of economic science in this century has followed Marshall’s prescription for the discipline to be a positive science of behaviour. As such it is quantifiable and capable of interpreting the likely outcomes of policy initiatives. Currently it exists as a discipline dominated by observation and interpreted using the tools of mathematics. Despite this, economic science has never completely shaken free of its earlier roots in philosophy, particularly metaphysics and morals. Economics grew out of political economy, a moral science that is "the study of appropriate relations between intelligent persons with respect to material things." Before Marshall, most contributors to economic thought were primarily philosophers. Adam Smith, the father of modern economics, studied economics as part of his activities as professor of moral philosophy. St. Thomas Aquinas, whose
economic thought summarised the medieval position, was writing economics as part of moral theology. Other writers in political economy, such as David Hume and J. S. Mill, are also known as least as well for their philosophical writings as for their economics. Aristotle, the Philosopher, identified the key elements of political economy that have been debated down to the present day, although his economics is predominantly found as parts of his investigations into ethics and politics.

Today, positive economics claims the success of being able to interpret and predict human economic behaviour, yet its critics object on two grounds. Firstly, that as a positive science its objective successes are not commensurate with expectations, and secondly, that its prescriptions are often bereft of adequate moral content.

The purpose of this study is to evaluate the claims of positive economics with a view to locating its value to the community by evaluating its characteristics as a behavioural, not a moral, science. In this way it is proposed to demonstrate that both the claims of its supporters and the criticisms of its detractors may be simultaneously upheld.

**Market Behaviour**

Economics is focused on the market. Without trade there is no content for economics. Controlled economies are no more than markets where critical processes have been suppressed. The aberrations in behaviour that result from socialist controlled economies are well documented and do more to support the essential theory of market behaviour than to detract from it.

When persons freely meet in the marketplace to exchange goods and services, certain behavioural realities are evident. Suppliers are attracted by higher prices and they tend to multiply as prices improve, giving the characteristically upward sloping supply curve. Similarly, purchasers are prepared to pay higher prices when quantities are limited, but reluctant to pay high prices when the market is flooded with goods.

Despite the market being the prime focus for observation, both supply and demand are not fundamental but understood to be themselves the outcomes of causal explanations. The theory of the firm is used to generate the supply curve, while demand is the outcome of a utility maximisation calculus that is somehow carried out by purchasers.

Jones outlined several examples of the successes of market theory and similar examples abound in most standard texts on economics. In particular cases, such as urban economics, the impacts of market controls have been well examined, often as the result of observations of the outcomes of state interventions. Generally, these have been unanimous in finding that artificial controls result in distortions that manifest as various disincentives, the
encouragement of black market activities and over-compensations when restrictions are removed.

Consequently, market theory can be considered to have been empirically validated by the evidence of economic behaviour. However, despite a degree of empirical support, several areas of economics still resist the positivist approach. Macro policy appears to be an area where theory follows behaviour, rather than predicting it. Three decades ago stagnation and inflation were found to coexist despite the theoretical impossibility of such a union and today the move towards deregulation appears to be creating as many problems as it solves. It is also evident in the continuing existence of economic recessions and the failure of mechanisms such as government and Federal Reserve policy to control them. Grieder's study of the Federal Reserve's decisions during some of the most critical years of the post-war period illustrates the gulf between the major theories, practice and effectiveness.6

Economic Theory and Causal Explanation

Various lines of empirical evidence exist supporting the demand curve. A major part of the success of advertising can be attributed to the fact that by enhancing the consumer's perception of a product's utility, its demand function will be elevated. Since advertising and marketing expenditure is justified on the basis that it produces a net increase in revenue, its continued use must indicate its success.

Some aspects of evaluating demand are less straightforward. Some time ago Wickstead noted that statistical studies of demand for specific goods were usually flawed by the violation of their assumptions. For example, the generation of demand curves derived from observations of prices and volumes traded relied on several impractical assumptions. These studies assumed a fixed demand function over time and virtually removed supply behaviour. Wickstead even asked why the data acquired was not evidence of the supply curve and concluded that some of the anomalies reported were more due to methodology than to genuine aberrations, such as giffen goods.7 His critique does not appear to have been answered.

Boland considered in some depth the assumption in economic theory that the consumer is a utility maximiser. At the very least, this axiomatic assumption that consumers maximise utility is a metaphysical assertion concerning the nature of consumers. Perhaps consumers are not very effective at performing this maximisation. Except for the market itself, there appears to be no definitive evidence of how consumers evaluate their maximum utility, making utility as a justification of the market a tautology. You cannot explain market price using utility if the only evidence of utility maximisation is the market or experimental models of it. The existence of giffen goods suggests that consumers are significantly influenced by additional factors, amongst which ignorance and
emotion must feature prominently. The rational, utility-maximizing consumer is not a creature found in real markets, which makes it a dubious premise for a supposedly positive science.\textsuperscript{8} The question of objectivity must be also considered. Obviously, the objective merits of a product are not changed through advertising, yet it influences demand. It seems hard to justify this expanded demand through the pleasure experienced subjectively as a result of advertising imagery. The practical lack of substitution opportunities further limits consumer utilisation calculus, as does whim.

Economic utility maximization must also consider the difficulties experienced in moral utilitarian theory, as it is no more than a specific application of it. One of the well-recognised shortcomings of utilitarianism generally is the impracticality of the computation of maximum utility. While utilitarianism is a powerful rhetorical tool, its outcome in ethics has been moral anarchy. It can be used by the individual actor to estimate apparent personal optimal outcomes, but this is not the same as the common good, and even for the individual it is highly questionable whether its determinations constitute genuine optimums. Most troubling are instances where ignorance, or disordered self-interest, have resulted in utilitarian determinations that are objectively deficient. These problems appeared to have been well recognised in the nineteenth century. One of Durkheim's motivations to establish the discipline of sociology came from his perception that moral philosophy had failed to deliver adequate guidance for Western culture.\textsuperscript{9} Likewise, developments in twentieth century moral thought have been interpreted as outgrowths of the inadequacies of nineteenth century moral theory.\textsuperscript{10} If utilitarianism generally cannot provide robust determinations of the greatest good for the greatest number, how much more difficult must it be for consumers to reliably determine their utilitarian optimum in the economic order?

On the supply side, the problems of causal explanation are even more pronounced. Jones recognised that the supply function rested on the theory of the firm, which explains the upward sloping supply curve in terms of the rational optimization behaviour of the firm. The theory, also known as marginalist theory, suggests that firms set their operating points at the intersection of their marginal cost and the marginal revenue curves. It yields a rational, or marginalist, price through the interaction of these two functions.

Marginalist pricing has the advantage that takes market behaviour into account. The marginal revenue curve is derived from the demand function and the marginal cost curve relates to the production constraints encountered on the supply side. In this way it provides a superior pricing theory to the older labour theory of value that is the implicit foundation of full cost pricing. Full cost pricing is the practice of applying a markup to factor costs to set price. Because full cost pricing does not have any explicit connection with market conditions, especially demand, it is not useful for explaining supply behaviour.
Unfortunately, Jones failed to find a single case of marginalist pricing in practice. Further, the literature on the absence of the practical application of marginalist theory now reaches back about two-thirds of a century. Other recent studies have encountered related problems. Langholm compared the two pricing theories, using a simulation approach, and found marginalist pricing less efficient.\textsuperscript{11} Seton rejected both pricing theories for reasons similar to the above and attempted to formulate yet a third pricing theory\textsuperscript{12}

Boland explored the related matter of the assumption of the upward sloping marginal cost function. The explanation of this function is usually done using examples where limited short-term productive capacity means that an increase in production can only be achieved at significant cost. He noted that in the real world this condition only applies in the very short term, hence the marginal cost curve, and the supply function that is derived from it, is only applicable in cases of rapid changes in the market.\textsuperscript{13} It therefore cannot contribute to the formation of market equilibrium as required by market theory.

Moreover, the upward sloping supply curve suggests diseconomies of scale that would provide no incentives towards larger organisations. Yet, the real world reveals an almost universal trend towards massive productive capacities and is filled with examples of corporate aggregation. There is an obvious contradiction between the supply function as found in economic theory and the complaints of ever growing corporations that in order to be profitable they apparently need to operate at immense scales of production, necessitating access to global markets.

Apart from inferring a supply function that is the inverse of that adopted for market theory, the reality of widespread economies of scale is upsetting for marginalist pricing. Marginalist pricing assumes that marginal revenue (MR) is a diminishing function that follows the diminishing demand function, while the marginal cost (MC) function is an increasing function, at least in the vicinity of its intersection with MR. If MC is also a decreasing function, as is the case with economies of scale, then its intersection with MR will be considerably less determinate. It is therefore no surprise that it is rare in practice.

The evidence is therefore not favourable to marginalist theory. The retention of marginalist theory, despite its absence from the real world, is contrary to positivist methodology. Its only merit is its implicit validation of supply behaviour in a moral sense. Supply behaviour is evident, yet it would be no more than a \textit{greed function} if it was not for the theory of the firm asserting that suppliers have no other commercial choice. Its retention is therefore an indication of the importance of moral validation in the enterprise of economic theory. The positive science of economics has very sensitive moral roots.
Perfect Competition and its Moral Assumptions

Market theory can be morally validated directly however, under conditions of perfect competition. VonKettler, amongst others, described the way that a perfectly competitive market achieves a moral goal when price is honed down to normal levels (pricing that just covers the cost of production plus normal profit). An immature or imperfect market does not pass this moral criterion and its moral failure, also termed market failure, can be related directly to the amount of economic rent that is left in the price. Economic rent is the gap between normal price and market price and leads to super-normal profit. Monopolies, and other examples of market failure, are all characterised by perennial economic rents.

Samuelson noted the way that the characteristic negative gradient of the demand curve was purely an artefact of market failure. He argued that since perfect competition assumes full knowledge, a plurality of suppliers, and defines normal profit as sufficient to provide suppliers with a sound income, suppliers would always be found who would be willing to supply under terms that would return normal profit. Prospective purchasers, knowing both the costs of production and the fact that numerous potential suppliers existed who could frictionlessly enter the market, would therefore be reluctant to offer super-normal prices for goods, regardless of quantity traded. Under perfect market conditions demand should therefore have a zero gradient (or, more precisely, should follow the normal cost of supply).

A similar argument could be mounted for supply. The monotonic positive gradient has been shown to be a practical phenomenon, not a theoretically supported one, given the problems with marginalist pricing. Under perfect competition, new suppliers coming into the market would cap supply once normal pricing was exceeded. Therefore supply in a perfectly competitive market would also follow normal costs.

Along this vein also lies the problem of perennially imperfect competitive situations due to other causes. Under perfect competition, revenue to the producers is sufficient to cover costs, risk and provide a normal level of profit. Normal profit is that level of profit that supplies sufficient dividends to maintain share price. Insufficient profit will cause share prices to fall while super-normal profits cause growth in share prices.

A perfectly competitive market should therefore be characterised by stable share prices. Moreover, if revenues are stable and super-normal, finance theory, such as the capital asset pricing theory, suggests that share prices should rapidly adjust upwards to absorb the excess profitability in a one time adjustment. Hence, stable super-normal profits capitalise into higher stock prices that effectively normalise returns for subsequent stock purchasers. However, the realities of the equities markets are that stock prices tend to appreciate in real

288 Catholic Social Science Review
terms over the long term. Hence, not only are the markets imperfect, but the degree of imperfection cannot be adjusted out at any single point in time.

The conventional explanation of growth in stock prices is that it is the result of necessary reinvestment of a part of profits as retained earnings. While this is a significant part of the mechanism of stock growth, the real component of growth (above inflation) is not accounted for and even when supplied through retained earnings indicates that the latter are derived from super-normal earnings. Moreover, new capital investment often results directly in a form of economic rent. Barlowe demonstrated how new technology earns a rent governed by its marginal productivity over the least productive machinery in use. As old technology is taken out of service the rent dissolves. 16

In addition, the entire discipline of finance appears to stand in opposition to the notion of perfect competition. The object of finance has been defined as being "... to maximise the shareholders' wealth" 17 yet the only tool that is conspicuously absent in the technology of finance is attention to increasing productivity.

Necessarily, if profitability is improved, especially when not attended by greater productivity, it can only be the result of the generation of super-normal profit. The on-going success of the finance function is testament to the absence of any real trend towards perfect competition at that level. Some tools of financial management, for example pricing and credit policy, can be interpreted as techniques to manipulate the market to maximise revenue to a point just short of the onset of market adjustments. Tackling the moral issue headlong Gilder depicted economic rent-taking as the dynamo of development and Wilken sought to validate entrepreneurial rent-taking by noting that without the entrepreneur the other factors would not be productive. 18, 19 While rent-taking is undeniably a practical incentive, it does not follow that humans cannot be motivated without it. Likewise, the notion of normal return to management (entrepreneurs) does not exclude a reasonable reward for innovative contribution.

Hence, the positive realities appear to be that supply and demand do constitute actual and quantifiable tendencies in the behaviour of parties engaging in trade. However, the causal explanations for both supply and demand are highly problematic and the accepted theories are demonstrably lacking. Once it is recognised that our usual rendering of the market functions relate to actual behaviour within imperfect markets all that follows in economic theory is consistent.

Positive economics is therefore in a curious position. While it can justly claim substantial empirical success, its causal underpinnings are less than satisfactory. This can be resolved most effectively by recognising that market behaviour is simply behaviour and dropping the morally inspired (but problematic) causal justifications. The gap between the market supply curve
and the medium/long-term cost of production curve is simply economic rent and firms act to maximise their collection of economic rent.

The demand curve is also a simple behavioural reality. In the practical order, purchasers lack adequate market knowledge; they cannot easily substitute alternate goods and suppliers are not sufficiently mobile. As purchasers evaluate the cost/benefit performance of goods it should come as no surprise that as net utility is eroded by increased price, purchasers on limited budgets will progressively choose to go without.

The market is therefore a behavioural reality and positive economics stands up very well as a sub-set of the study of group behaviour, i.e., social psychology. Scan through the methodology and methods of social psychology and much is familiar for the economist. Experiments in social psychology involve setting up situations and observing behaviour. Demand studies do the same. Listen to any commentary on any finance market and you find that it bristles with psychological overtones, such as market confidence or uncertainty. Marketing uses an explicitly psychological methodology to achieve financial objectives and the sub-discipline of behavioural economics appears to be well developed. Hedonic analysis in econometrics, and real estate appraisal research are no more than specialised and well-developed branches of social psychology.

Social psychology and modern economics are methodologically compatible, both are positivist and amoral. Psychologists are just as likely to study the tendency of people to avoid giving help when others are in great need, as the dynamics of friendship. This frees the discipline to study any culture and to simply describe its behaviour, regardless of its ethical merit. Its goal, like economics, is simply to model and predict human behaviour, especially in the short run. Having found that nine out of ten people will walk past an automobile break-in in progress, one can anticipate future behaviour and make informed decisions regarding security. The fact that the major part of economic theory is built on the foundation of actual (imperfect) market behaviour explains its successes as a well-developed branch of this type of study.

The construction of human nature that follows is not the morally inclined notion of nature that gives rise to the natural law and hence normative behaviour directed at the good, but rather the positive, Enlightenment, notion of human nature constructed empirically and inductively from observed behaviour. The former leads towards human perfection, while the latter, containing as it does all the imperfections of particular persons, leads only to short run behavioural predictions within what is historically evident as a long run self-referenced downward spiral of erosion of what constitutes civilised humanity.

Although positive economics is generally divorced from morals, it does retain certain significant vestiges of moral thought. The utilitarian assumptions at the very roots of economics are derived explicitly from the moral thought of
Bentham and Mill and some of the shortcomings that carry over from moral utilitarianism have been discussed. In addition, other moral issues are normally accepted as part of modern economic thought, despite not being a necessary part of the positive science. For example, there appears to be a generally held belief that monopoly situations are to be discouraged and that economic distribution should evidence some level of distributive justice.

Concepts of distributive justice have a long history in Western thought, beginning with Aristotle, evident to some extent in scripture, expounded by great Christian thinkers such as St. Augustine, St. Thomas Aquinas and St. Bonaventure and most recently championed in the last century of social encyclicals. Even Islamic economic thought is founded on moral principles that closely parallel Christendom. The movements that have given rise to modern positive economics also have a strong moral strand. The ordinary person still relies on economics to provide morally sound prescriptions for the appropriate relations between persons with respect to material goods and this was exactly what Marshall argued would come from a positive science of economics. In no small degree is the popular criticism of economics a criticism of its failure as a moral science, and hence the empirical failure of Marshall's assertion.

For this reason, economic inquiry is still popularly expected to provide the best outcome for society and a level of justice for all participants. These are moral goals. Even Pareto's optimality hypothesis is a moral optimum, though it is less evident if real markets can achieve it.

History appears to be studded with examples of failures in the economic endeavour. Almost a century ago Rogers used sound historical methods to study six centuries of work and wages in England. His conclusion was that over the period of his study, the highest level of real wages occurred at the close of the fifteenth century and up to the first quarter of the sixteenth. Although Rogers was no friend of the Catholic Church, his observations placed the high point of wages at the very close of the Catholic era in England. His observations also challenge the relevance of GDP per capita as a measure of the success of an economy. If GDP per capita is increasing while wages are falling in real terms, it must be the result of a significant polarisation in the distribution of wealth. The seventeenth and eighteenth centuries saw England a world economic leader. However, the establishment of New South Wales, Australia's first white settlement in 1788, was not stimulated by economic opportunity. It was rather necessitated as a sink for destitute Englishmen, Scots and Irish who were forced into lawlessness through lack of participation in the massive wealth generated in their own economy. At the close of black slavery in North America, Negro slaves enjoyed a significantly better standard of living than did free working people in Britain. Despite the current tendency to ignore the reality of Dickens's portrayal of English life for the common person, it stands as but one tiny, though highly visible indication
of the moral failure of the economics that Adam Smith championed half a century earlier.

Adam Smith’s economic theory was self consciously moral, but its moral system was based on Enlightenment foundations. His biographers proudly point to the well known fact that he wrote little in his *Wealth of Nations* that was not first discussed with his friend David Hume. Although Smith wrote on morality, his philosophical position is essentially a reflection of Hume’s. Hume was very clear in asserting that human nature was knowable by observing what humans did. Hume's moral system was premised on the assumption that humans are guided by an internal moral sense that interprets events as experienced, that "crime or immorality . . . arises entirely from the sentiment of disapprobation." This was essentially adopted by Smith when he asserted that it was "the sentiment or affection of the heart, from which all action proceeds and upon which its whole virtue or vice depends." Smith observed self-interest as the mainspring of commerce and concluded that it was not only a part of human nature, but that it mysteriously guided commerce towards the optimum outcome in his metaphor of the invisible hand.

That Smith could have made such a statement in the face of a massive rupture in distributive justice is not nearly as extraordinary as the way that it has been repeated down to the present day. Distributive justice is part of the common good. Smith asserted that the common good was best served by individuals pursuing their own self-interest. The criterion of the common good makes this a moral assertion, though many have found its validation of self-interest quite extraordinary. Self-interest, or more plainly *greed*, is normally considered to be a vice. At best, there appears to be an argument based on Aristotle’s Golden Mean that would suggest that excessive self-interest is vicious, but moderate self-interest may be virtuous. Virtue here relates more to the strict moral definition that links virtue to those actions that benefit humanity. Indeed, a deficiency of self interest, say in terms of self preservation, can be hazardous, making both deficiency and excess vicious and completing the familiar pattern *virtus stat in media*.

Virtuous self-interest relies on its ability to achieve the common good. Smith left the economic actor free to subjectively assess this moderate position through direct perception of personal moral sentiment. The failure of Hume's moral sentiments as a moral system are extensively recognised, effectively freeing persons to pursue any desire; the bank robber and the rapist both consider their acts to be most attractive, hence their moral sentiments are aligned to what are generally held to be objectively immoral behaviours. Moderation with self-interest is therefore unlikely if the test is sentiment and even the notion of moderation is not prominent in Smith's text itself. Rather, by stressing the virtuous aspects of self-interest, Smith tended to portray it as an

292 *Catholic Social Science Review*
absolute good and paved the way for the eventual popular adoption only a decade or so ago of the notion that greed is good.

Smith's metaphor of the invisible hand asserted that the common good followed from individual self-interest. Given the evidence of his era alone, even the empiricist should have been wary. However, the decision makers and theorists tended in large measure also to be the beneficiaries of the resultant maldistribution and their perception in this area was deadened somewhat.\textsuperscript{25} If self-interest is virtuous and is the foundation of the market, then the market becomes the natural moral floor for economics, and no further enquiry in this direction is necessary, thereby freeing economic theory to develop in other areas. This is the position that is generally held today.

Smith's invisible hand can be interpreted more successfully as a behavioural reality, rather than a moral or metaphysical one. Self-interest does provide a stimulus for movement between market positions. The best market positions are those affording the greatest economic rents and this will tend to result in a distribution of suppliers roughly according to a community's needs. However, this distribution of supply does not necessarily mean the elimination of economic rents, neither theoretically nor in practice. It has been shown that market failure indicates moral failure and is indicated by the existence of economic rent. Pareto optimality, while stressing optimized utility, is likewise silent on economic rent, as is the utility-maximizing consumer at the end of the economic process.\textsuperscript{26, 27}

The split between economics and morals is now well accepted. The neoconservative position is largely based on the assertion that economics provides tools that inform the moral decision-maker, implying that the former has negligible native moral content. Neoconservativism asserts that it seeks a "... synthesis of free-market economic science and the science of moral theology ... "while striving"... to maintain the rightful autonomy of both..."\textsuperscript{28} The suggestion of autonomy would seem to be an acceptance the economics is behavioural science only, despite popular expectations. Since it is a practical science, the lack of moral structure within the discipline of economics creates the necessity for external review by something like moral science. Michael Novak is perceived by the community more as an economist than a moral theorist, and although his audience is usually from the commercial sector, his work is primarily not economics but morals. Rourke's comparison of the essential elements of the neoconservative position with the more conventional philosophical understanding of the key issues has demonstrated serious difficulties.\textsuperscript{29} Much of this problem originates from the attempt to graft Enlightenment thought onto a philosophical position that the Enlightenment explicitly rejected. More generally, O'Neill has collected and reviewed a very wide range of moral defenses of the market, well beyond the Catholic parameters of the neoconservatives. His work concluded that the market did not
survive analysis under any moral system, even utilitarianism. Behavioural economics may minimise its moral element, but it has been shown that this is still its most sensitive fundamental component.

Curiously, none of this constitutes a rejection of the market as a social institution, it merely indicates that one needs to look elsewhere for the moral content of economic action. Enlightenment man is a soulless machine that understands morals subjectively. Given an opportunity to legally gain at another's expense, he will, and historically has. Man can be something more, a creature that chooses self-restraint rather than self-interest, who can will to act for higher goods, for charity and solidarity. Such willing must be conscious to be truly human. Enlightenment thinkers looked no further than their own countries and class for positive data on human nature. Had they looked further afield, to the ancient guilds, to the family and tribal bonds of customary peoples, or even to classical Greece or Rome in their ascendency, they would have found consistent evidence of a different nature. That nature enables men to act in the free market place, but not following the profit maximisation of modern economics. Parts of the neoconservative project point to such a moral economics and its principles appear to be the more interesting to pursue.

This suggests two directions for economic science. One is to continue the study of self-interested man in the marketplace, which is the behavioural science of current mainstream economics. This can only be consistent and reliably socially beneficial when it is pursued under the awareness that it is built on a morally indefensible institution. The other is the exploration of how deeply economic behaviour is penetrated by moral issues. This study is directed at illuminating the moral content of the various relationships found in the economic universe, with a view to civilising the market place. While both are worthy of study, only the latter would appear truly human.

Notes