The Centre for Enterprise, Markets and Ethics

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Ethics and Economics:
Economics as Servant or Master?

Barbara Ridpath

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The Centre for Enterprise, Markets and Ethics
First Floor, 31 Beaumont Street,
Oxford OX1 2NP

About the Author

Barbara Ridpath has worked in finance and economics in the USA, France and the UK. She started at the Federal Reserve Bank of New York and spent most of her career in credit analysis at Standard & Poor's, rising to head the Ratings Group for Europe, the Middle East and Africa, with a short stint at J. P. Morgan. More recently she has run a think tank on financial regulation and been Director of the St Paul's Institute at St Paul's Cathedral. She chairs the Ethical Investment Advisory Group of the Church of England and sits on the ethical advisory committee of the Fondation Notre Dame in Paris. She is currently a non-executive director of Paragon Banking Group and ORX. Barbara has an A.B. degree *cum laude* in Economics from Smith College and a Masters in International Affairs from Columbia University.

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Introduction

The original premise of this piece was to consider how academic, professional and popular economics became detached from any firm ethical moorings, and whether there were ways to reacquaint the two disciplines. Since then, this thesis has been challenged by reading the American social-gospel theologian Walter Rauschenbusch, who asks why our economic system is so 'fundamentally un-Christian'.[1]

This publication presumes that the current economic system as evidenced by business and markets exists to serve society and not the other way around. It looks at how the central notion of self-interest as an assumption in economics abases and perverts traditional humanistic and Christian thinking about purpose and service in practice. It shows how a transactional approach to every activity, instead of promoting some optimum equilibrium, actually neglects and endangers values Christians and others hold dear, such as love of neighbour, community, hospitality and stewardship of God's earth.

The simplifying assumptions of economics, such as self-interest and market-clearing prices, let loose beyond the academic discipline, have come to be taken as absolute truths. This has created distortions. Rather than using economics as a tool for thinking about the organisation of society, the tools have become our organising principles. The shift from Adam Smith's concept of self-interest as being bound up in the fortunes of others, to the integration of pure selfishness into most human transactions, has actually altered how we think and behave. It has changed our behavioural responses and crowded out other, more humane responses.

The following looks at how markets actually change values. In addition, it argues that the fetishisation of the current economic system has been used, in an increasingly diverse world, to avoid making moral or value judgements among people who may not share beliefs. However, it is just this lack of such judgement that has led us to presume that the 'invisible hand' of markets will do its job without guidance. This is false.[2]

Whether intentional or unintentional, the consequences are significant. In the same way that the 'pure' sciences of medicine and technology have recognised that ethical reasoning must be at the heart of decisions about the application of many of their discoveries, so too is this necessary in economics. A restoration of a common understanding of the society in which we wish to live is also necessary. The Conclusions chapter considers ways we might try and put the economic genie back in the bottle, and if not reunite ethics and economics, at least get them back on a nodding acquaintance.

It is difficult to do all this without considering how change occurs in modern society, largely through politics and government. For this reason, the Conclusions also briefly explore the relationship between the economy and democracy, how government might better reflect its citizens' views on values, and how these views in turn might reshape our economy.

Notes to Introduction

1 Robert T. Handy (ed.), *The Social Gospel in America, 1870–1920: Gladden, Ely, Rauschenbusch* (New York: Oxford University Press, 1966), p. 362.

2 Jean Tirole, *Économie du Bien Commun* (Paris: Presses Universitaires de France, 2016), p. 17.

Chapter 1

A brief history of recent changes to economic thought

Economics is a social science that looks at the ordering of society around the production, distribution and consumption of goods and services. As originally studied and practised, it was deeply integrated with politics and philosophy, and studied as political economy. Since this holistic view of the human being in society was central to the discipline, economists and theologians were in deep and healthy conversation from the eighteenth until the middle of the nineteenth centuries. After this, in Britain (and mostly elsewhere), the two disciplines parted ways.

It is worth exploring briefly some of the reasons for this. The split occurred both because those studying the subject became swept up with the rationalism and scientific thought of the Enlightenment and beyond, and because from the English Civil War until the Victorian age the Church effectively withdrew from the sphere of economic activity.

Much of political economy as an academic discipline had its origin in natural theology (*theologia naturalis*) based on reason and ordinary experience. Adam Smith lectured on problems of moral philosophy at the University of Glasgow. At the time, moral philosophy encompassed natural theology, ethics, jurisprudence and political economy. As many others have remarked, reading his *Theory of Moral Sentiments* together with *The Wealth of Nations*, it is fair to assume that Smith believed people would bring all their moral sentiments to the invisible-hand bargain.

Economics increasingly came to be seen as a substitute for political economy.[1] The abstractions of David Ricardo began, perhaps, the claim of economics to be considered as a science.[2] Max Weber insisted on social sciences being value-neutral, and economics has become 'self-consciously non-ethical' since then.[3] It began to use methods, experimentation and reasoning similar to and consistent with other social sciences, if not pure sciences. Such a pursuit wanted hypotheses, laws and answers, which were largely inconsistent with the vagaries of human behaviour and emotion. In the 1930s, Lionel Robbins promoted economics as a value-free science that should only inform us on the choices we have rather than normatively decide for us.[4]

This divorce between values and material society is attributed, by R. H. Tawney, equally to the Church's abdication of its own responsibility for a holistic view of people in economic society, by escaping into what he calls 'indifferentism'.[5] As he put it:

> After the Civil War, the attempt to maintain the theory that there was a Christian standard of economic conduct was impossible, not only because of lay opposition, but because the division of the churches made it evident that no common standard existed which could be enforced by ecclesiastical machinery.[6]

However, others, such as A. M. C. Waterman, argue that the Church's outlook at the time was entirely conditioned by current thinking and supported changing views by 'expressing favour upon private property rights, free and competitive markets ... wage labour, and a high degree of social and economic inequality'.[7]

Of course, the supreme irony is that Protestantism stands accused by both Tawney and Robert Heilbroner, not to mention Weber, of bringing this about by coming to see work as a spiritual calling, and amalgamating the spiritual and temporal lives. Protestantism weakened both the unity of Christians and the Church's overarching structure, which took single positions on issues. As Protestantism gave more authority to local churches and individuals in their relationship with God, so too did it eventually permit parishioners to choose the aspects of faith that suited them and discard those that did not. Over a period of centuries, the explosion of Christian divisions, together with increased secularisation, has changed the nature of faith in the public square:

> Religion has been converted from the keystone which holds together the social edifice into one department within it, and the idea of a rule of right is replaced by economic expediency as the arbiter of policy and the criterion of conduct.[8]

The history of bemoaning the separation of economics from values is almost as long as the separation itself. J. S. Mill argued that economics was all about production. Distribution was in the gift of society, dependent on laws and customs. There was no 'correct' distribution, nor any economic 'laws' that dictated it. The arguments against the separation, initiated with Thomas Carlyle, John Ruskin and the Victorian reformers, tended to be written by theologians and thinkers of the nineteenth and early twentieth centuries, such as Tawney, Henry Scott Holland, Beatrice and Sidney Webb and the Oxford Movement.

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Though our focus here is largely on British thinking, important US theologians argued strongly for more just and equitable labour and distribution practices. These included, most notably, Walter Rauschenbusch, as a leading proponent of the social gospel, and Reinhold Niebuhr, with his Christian realism, in the early and mid-twentieth century respectively.

Excepting Karl Marx, very few critics bothered to learn much if any economics before engaging with it.[9] The dialogue was stilted because few theologians understood economics, and few economists cared much to understand either ethics or theology. Given that it is always essential to understand any perceived opponent before trying to argue with them, this may have been one reason why the discussions were so fruitless. Observing the ebbs and flows of the critique over time, momentum for engagement from the Church tends to rise in times of economic crisis and recede when most are prospering. Therefore, debates that occurred through the 1930s largely faded during and after the Second World War as growth and prosperity began to spread.

It is worth remembering that these days the general public often equates economics with capitalism. However, there used to be, and remain, many different schools of economics and several different world views among academic economists, with socialists and Marxists having distinctly different interpretations of the 'laws' of economics. Capitalism itself came to the fore relatively recently, and was not used to name an economic system until the late nineteenth century.

Marx wrote in the mid-Victorian age, when many social reformers were bemoaning the effects of industrialisation on equality and the treatment of labour and the poor. He saw society as a battle between those who controlled the capital and those who laboured, with the excess of labour supply keeping wages down. He looked for a rising up of the lower classes – which he called the proletariat – to take over the means of production, as a result of the conditions in which they were forced to work and live.

There is a supreme irony to the Church's reaction to Marxism. Religious leaders understandably despised Marx's atheism and his naming of religion as 'the opiate of the people'. However, what Marx called for was a system in which each produced in accordance to their ability and each consumed in accordance with their needs. Such a system resembles very closely the early New Testament Church and the teachings of Jesus.

The two World Wars and the intervening Great Depression had a dramatic effect on the working out of economic theory, resulting in several trends that shaped the post-war development of economics.

First and most important was the introduction and dominance of Keynesianism. The promulgation of John Maynard Keynes's policies led to 30–40 years of fiscal-policy dominance, during which government spending was used to regulate economic growth rates. For much of the Western world, this period resulted in the most even income and wealth distributions of modern times.

Second, during this time some principles of economics were proved not to be immutable. Notably, it became apparent that not all consumers expressed their preferences in the same way. Third, in the post-war era, economic science became ever more specialised, working on very specific issues within macroeconomics (how whole economies function) and microeconomics (how firms, households and individuals function), holding as an assumption that the overall economic model continued to function well. Fourth, Milton Friedman's monetary policy – using interest rates and the supply of money to ensure price stability – became a popular alternative to fiscal policy. In addition, issues pushed aside by defining them as 'externalities' came to be critical, notably pollution and climate change. Regulation became the solution for such elements of the material world that economics could not price or fit into its system, as well as for the economic propensity of companies towards concentration and monopoly.

As early as the 1970s, Paul Baran and Paul Sweezy recognised that ever-smaller subdivision of academic disciplines was often ineffective, as it abstracted from the interactions across disciplines. A holistic view of issues is often necessary to understand a problem, its causality and its resolution.[10] This is particularly true when economics is used to make policy, as discussed in the section on behavioural economics below.

1.1 Neoliberal economics

Neoliberal economics, here defined as the resurgence of nineteenth-century ideas associated with laissez-faire economic liberalism and free-market capitalism, was born in the aftermath of the post-

'Profit maximisation by companies should not be pursued by wilfully harming others'

Second World War stimulus of Keynesianism, as a reaction to growing government deficits, expanding public-sector employment and an increasing role for government regulation. Both Margaret Thatcher and Ronald Reagan felt that the encroachment of government into economic life had gone too far, and that interest and repayments of existing government debt would impose too high a burden on future generations. They believed that in almost every instance the private sector could accomplish goals more effectively and efficiently than government. On both sides of the Atlantic they sought to institute their own version of laissez-faire economics, with the markets as the most effective regulator. In the UK, this included the privatisation of almost all nationalised industries and many utilities, and the deregulation of the City of London. In the USA, moves included tax cuts, a shift in fiscal responsibilities to states from the federal government, and a dramatic decrease in regulation.

These policies were strongly supported by Friedman and his oft-quoted article stating that the only purpose of business was the maximisation of shareholder returns.[11] However, as we will see, almost any argument in business or economics can be quickly misused or taken to extremes. According to Jeffrey Sachs, the point of Friedman's statement was to make business less harmful. Profit maximisation by companies should not be pursued by wilfully harming others, such as through financial trickery, shadowy tax practices, environmental destruction, unsafe workplaces, bribery or self-serving lobbying: 'Friedman failed to enunciate clearly the standard of "Do No Harm" and thus wittingly or unwittingly gave licence to relentless corporate abuses in the name of shareholder wealth maximisation.'[12]

The initial perceived successes of this market fundamentalism in terms of deficit reduction, growth and declining interest rates turned many people into believers. This is partly because the less attractive aspects of these policies – notably increased income and wealth inequality and decreased savings and public-service provision, with its effect on social care and homelessness – took longer to become apparent. Over the decades of the 1980s and 90s, this translated into blind faith that private markets and rational decision-making were a fair description of how ordinary people faced with risky alternatives actually went about making choices. That leap of faith had at least one obvious implication for the sort of advice economists gave to political leaders: 'It tilted everything in the direction of giving people the freedom to choose and leaving markets alone.'[13] The belief in the effectiveness of markets drove government policy towards free-market solutions on issues such as public housing and private finance initiatives. Government decision-making increasingly tried to harness people's self-interest to pursue policy goals, and used tools such as cost-benefit analysis to evaluate policy options.

Unintentionally, this period of emphasis on private markets and shareholder primacy enabled unchecked growth of corporations and their power and political influence, enormous expansion of financial markets and financial intermediation, and 'empowered the market to erode social institutions, eventually creating a backlash against citizens being downgraded to mere consumers'.[14] Together with the reduction or elimination of barriers to flows of money (capital flows) across borders, this period sowed the seeds for financialisation and globalisation as we know them today.

1.2 Enter behavioural economics

Rather than question or rethink existing theory, patches were introduced to economics in areas where theory proved ineffective. The most prevalent of these are game theory and behavioural economics. Game theory is the study of strategic interaction between economic agents, which helps examine, among other things, human conflict and cooperation within a competitive situation. Behavioural economics examines the effects of psychological, cognitive, emotional, cultural and social factors on the economic decisions of individuals and institutions, and how these vary from those implied by classical theory. Both reintroduce the element of psychology into the economist's lexicon, to understand how and why people really behave in certain situations. These approaches enabled economics to address some of the vagaries of human behaviour unexplained by economic principles. At government level, in 2010 the UK famously created a Nudge Unit – now independent – for just this purpose.

'A huge range of factors determine our economic behaviour'

The integration of game theory and behavioural economics as a means to incorporate more complexity into economic models – particularly around human behaviour – is a welcome and important development. Both techniques enable economists to think about why people choose to cooperate and collaborate instead of compete. They can also help model policy changes that encourage people to improve their behaviour. Here the central London Congestion Charge – unlike the extremely successful 5p plastic bag charge – presents an ineffective example of such a behavioural nudge.

Not only do a huge range of factors determine our economic behaviour but our choices and priorities change in the course of a human life. Economists recognise this. But society's choices also change over time due to changing human nature and social conditions. For this reason, economics never could or should be treated as immutable and separate from social considerations. As Mill wrote two centuries ago, most elements of the economy, such as taxes, inheritance, labour conditions, perception of wealth and wealth taxes, are subject to the highly mutable determinations of the socio-political order in which we live. Mindfulness that we both shape our economic system, but that it also shapes our behaviours and us, may be a first step towards understanding what needs to change.

A short diversion on academic economics (I)

While Ricardo was the first to make economics abstract, the introduction of mathematics to economics began in the Victorian era with Francis Edgeworth, Johann Heinrich von Thünen and Léon Walras.[15] Today, there is no alternative to using mathematics in its various forms to elucidate many of the analytical purposes for which economics exists.[16]

Today's economies are infinitely more complex and inter-dependent than they were in the time of Adam Smith's pin factory. As that complexity and interdependency grow, so too 'do both the quantity of, and the demand for, information on a wholly new scale'.[17] This has led the study of economics to split into two types of quantitative investigation. The more traditional is commonly known as mathematical economics, which is used for the solution of theoretical problems. Such work creates elegant but arguably often unworkable solutions. The alternative approach is more correctly named economic statistics, which uses the enhanced capacity of modern computers to analyse huge swathes of data. Much current policy analysis, such as by Angus Deaton and Anne Case, tends to come from the statistical direction, the aim being to give the best estimation of one effect or another.

While arguably useful, this maths domination creates several difficulties. First, it makes outcomes hard to understand for the non-mathematician, which is a problem when solutions are being used to solve real-world issues. Second, it gives the impression that mathematical solutions explain the real world. While they may be elegant, they may not accurately describe human reality.