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Ethics and Economics?

Economic Analysis, Moral Philosophy, and Public Policy is concerned with economics and ethics, but it is not about how to behave ethically when doing business or undertaking economic research. We prescribe no code of conduct and preach no sermons. Rather, in this book we try to show how understanding moral philosophy can help economists to do economics better and how greater knowledge of economics and ethics can help policy analysts to improve their evaluations of alternative policies. We also hope to show how philosophers can make progress in ethics by drawing on insights and analytical tools from economics. While we are writing mainly for those who are interested in economics and aim at helping them to think more deeply about this field, we think that economics has some important concepts and methods to offer to those interested in ethics, too.

This focus may seem a big letdown. Surely it is critically important to grapple with the moral problems that arise inside corporations and businesses, as well as in the global economy. You will get no argument from us about that. We are not proposing that people stop asking moral questions about the justification of employee and CEO compensation, the use of "sweatshop" labor, the rationale for protectionist policies, and the legitimacy of using economic boycotts to make policy change. On the contrary, we hope this book will show how important morality is in economic life. But our primary concern is with economic theory rather than directly with economic life. *Our job will be to show clearly the role that ethics has in economics and policy analysis and to demonstrate how knowing moral philosophy helps one do economics and policy evaluation better.*

In our view, the main value of moral theories does not lie in prescribing what to do in particular situations. Moral theories are not cookbooks for good behavior. Their main purpose is to help people to understand what morality is, where it fits into human life, and why people assign it the importance they do. Moral theories have a practical role in guiding people's reflection on the moral principles they accept and in thereby helping people decide what to do when their moral principles conflict with each other. Similarly, understanding ethics can help economists to think productively about the moral dimensions of policy problems, and it can bolster their confidence in recognizing and dealing with these moral issues. Knowing some ethics can help economists and policy analysts to improve their methods of policy evaluation and to understand how people's economic behavior is influenced by the moral dimensions of their lives.

Moral insights are, to be sure, more important to some parts of economics than others. Though not entirely irrelevant to any human choices, moral ideas are of little help in forecasting the price of wheat or in refining theories of exchange rate determination. Moral ideas will be more important to economists who face problems such as improving the standard of living in poor countries, increasing tax compliance, or helping citizens think through the trade-offs between environmental protection and economic growth.

1.1 Economics and Morality in Contemporary Controversies

This third edition of our book makes its appearance roughly a decade after the dramatic economic events that unfolded in the wake of the bursting of the housing bubble in 2007. Questions raised by these events, as well as the greater attention to the growing inequality between the rich and everyone else they have helped provoke, illustrate the close relationship between economic analysis and moral judgment that this book explores. Serious thinking about economic policy demands both economic and moral sophistication.

The U.S. economy (followed by those of much of the rest of the world) experienced a spectacular disruption in 2008. The value of financial assets plummeted, and unemployment soared to levels not seen since the Great Depression. The shock was all the greater because it followed a period of more than twenty years of relative stability in prices and employment sometimes labeled as "the Great Moderation." During this period of macroeconomic stability under Democratic and Republican governments, interrupted only by the intense, but brief, "dot-com" recession of 2001–2002, mainstream economists grew confident that deregulation of financial markets coupled with skillful control of the money supply by the Federal Reserve had secured stable (if modest) economic growth, employment, and prices. A great many economists regarded the great problem of maintaining a steadily growing economy as solved.

The progressive deregulation of the financial system that began in the 1980s led in the new century to a bewildering variety of financial instruments that were supposed to allow for an optimal distribution of risk among those who were best equipped to bear it. But once a housing boom (spurred by irresponsible mortgage lending) collapsed, it quickly became apparent that the entire economy had been very heavily leveraged on risky debt that no central agency was monitoring. The resulting crisis destroyed trillions of dollars of assets on the books of homeowners, businesses, and large financial institutions. The financial contraction led to rapid reductions in business investment and consumer spending, and it plunged the real economy – that is, employment and production – into the deepest recession since the Great Depression.

These rapidly cascading developments confronted legislators and policy makers with pressing economic and moral challenges. Consider these three:

1. What help, if any, should the government provide to homeowners who were suddenly unable to pay the mortgages on their homes, whether through job loss, deceptive lending practices, or because of having gambled on purchasing an unaffordable home with the expectation of reselling it at a profit? Was it fair to help those who took the biggest risks, while doing nothing for those who financed their homes more conservatively and therefore did not face foreclosure, but who still lost much of the value of their homes? Was it fair to let the victims of the housing crisis (some more "innocent" than others) suffer? Releasing them from their obligations might create what in the world of insurance is called a "moral hazard": encouraging reckless borrowing on the belief that the government would bail people out if their speculations miscarried. (In the end, federal efforts to help homebuyers proved to be limited and halting.)
2. In the event of nonpayment for most mortgages, the lender can seize the house, but the lender has no legal claim over any other of the homeowner's assets. That means that homeowners whose property is worth less than what they owe can walk away from their debts by simply stopping paying their mortgages and letting the bank seize the property (often after staying on for free for some additional months). There may be prudential reasons for homeowners not to do that, including harm to their credit ratings. But is there a moral obligation to keep the repayment promise implied in taking the mortgage?

Bankers and community leaders tended to argue that there is such an obligation, both as a fundamental moral requirement and on the grounds of the harm that abandoning homes causes to neighborhoods (White 2010).

3. The third moral challenge requires some further background. In 2008, the drop in the value of the very risky assets held by major banks and financial institutions made them illiquid (without the cash needed to maintain day-to-day activities) and in some cases insolvent (with debts they could not pay). Was it appropriate for them to receive financial assistance (a "bailout") from the federal government in weathering the storm? In letting Lehman Brothers fail, rather than finding some way to save parts of the firm (as the government had in the earlier case of another investment bank, Bear Stearns), officials invoked the principle that investment banks should accept the downside of the serious risks they chose to take. As it turned out, permitting Lehman Brothers to fail broke the confidence of the market and led to a furious effort by other financial institutions to sell off their risky investments and to try to build liquidity. This effort drove down the prices of those investments, reduced the liquidity and risked the solvency of these institutions, and nearly caused the collapse of the entire financial system.

Federal officials facing the crisis, and chastened by the consequences of their decision regarding Lehman Brothers, concluded that the risks to the financial system as a whole were too great to permit any of the remaining large financial institutions to fail. The government consequently loaned large amounts of money to the major banks and nonbank investment firms to enable them to keep operating.

This decision, made rapidly and with little public deliberation, was widely seen as unfair, if not outrageous – basically rewarding the companies and individuals that had caused the crisis. The contrast between the feeble response to homeowners with troubled finances and the lavish assistance provided to wealthy bankers and their firms sharpened the sense of unfairness. Federal officials defended the action not on grounds of fairness but of economic necessity, asserting that failure of these institutions would have caused intolerable economic hardship across society.

Were they right? In answering this question both moral values and empirical consequences come into play. Many people, not unreasonably, regarded the decision to insulate the banks and their leaders from the consequences of their high risk investment strategies as unfair. In addition, the bailouts created or strengthened a serious moral hazard. If banks believe that they are "too big to fail" – that their importance to the financial system implies that they will always be bailed out when they face large losses – then they will be more inclined to undertake reckless investments.

Thus, even if major financial institutions could not be allowed simply to collapse, there were economic as well as fairness reasons to make the terms of a "rescue" of the banks less favorable to the banks than they in fact were. The government might, for example, have pursued a federal takeover of major banks and have compelled both a change of leadership and a limit or ban on bonuses. Financial institutions could have been required to establish procedures to adjust unaffordable mortgages. Clearly, any alternative would have had pros and cons and uncertainties of its own. But the result was that tens of millions of Americans saw the government as protecting the wealthy and powerful malefactors responsible for the financial crisis while turning its back on the vulnerable.

Partly as a result of this perception, the Great Recession focused public attention on the huge gap in income and wealth between Wall Street financiers and ordinary Americans – attention spurred by the short-lived Occupy Wall Street movement with its slogan "We Are the 99%." While inequality in incomes and wealth was already increasing significantly during the last quarter of the twentieth century, those who believed that a growing economic pie offered a larger piece for everyone found that reality easy to ignore. As the Nobel Laureate Robert Lucas (2004) put it, "Of the tendencies that are most harmful to sound economics, the most seductive, and in my opinion the most poisonous, is to focus on the question of distribution… The potential for improving the lives of poor people by finding different ways of distributing current production is nothing compared to the apparently limitless potential of increasing production."

The perceived disparity in the treatment of rich and poor in the wake of the financial crisis, coupled with new findings on the distribution of income, wealth, and economic opportunity, undermined the dismissal of distributional concerns that Lucas espoused. In particular, the economists Emmanuel Saez and Thomas Piketty, in partnership with others, reported historical data on trends in income and wealth inequality for the United States and other countries that revealed that these inequalities, which dropped precipitously during the Great Depression of the 1930s and remained relatively low until the 1970s, had been increasing rapidly, with incomes and wealth at the very top expanding most rapidly, while declining or holding steady for a large majority. For example, in the 1960s, CEOs earned princely incomes roughly 25 times as much as that of the average workers in their firms. They now make imperial incomes 250 times as much. The top 20 percent of the U.S. population has seven-eighths of the wealth, and half of that belongs to the top 1 percent.

These data are of concern both to citizens and to scholars. New work has taken up the challenge of explaining the reversal of a generations-long pattern of declining inequality and providing policy suggestions for limiting inequalities. For example, Piketty argues in his best-selling *Capital in the Twenty-First Century* that capitalism has an inbuilt tendency toward increasing inequality that was interrupted by the extraordinary events of two world wars and a great depression. These exceptional occurrences destroyed enormous amounts of wealth held by the very affluent and strengthened the hand of workers and soldiers in claiming benefits from the economic system. In Piketty's view, the best solution to the inequalities that capitalism engenders lies in government intervention in the market, largely in the form of taxation at the top and benefits at the bottom.

The theoretical and empirical issues raised by inequality are far from resolved and engage challenging questions of morality and justice that are entwined with them. Here are some of the remaining points of controversy:

1. In explaining the rapid growth of inequality of income and wealth over recent decades, some analysts have emphasized changes in technology and the growth of globalization, while others have emphasized political factors, including changes in the tax-transfer system and anti-union efforts. (The "Reagan revolution," which weakened unions and cut the top tax rates by half, coincided with the beginning of the great divergence between the fates of those at the top and the rest of the population.) Who is correct? And, if growing inequality is the result of "impersonal" forces of technology and globalization, are the outcomes any less morally problematic than if the greater inequality results from political decisions? Should the source of these inequalities matter to our moral judgment of them? What is wrong with income and wealth inequality? Is such inequality a problem only for its effects on productivity and efficiency, as some have argued? Or for other reasons, including reasons of fairness?
2. Some scholars have argued that focusing on the extremes of wealth and income – the 1 percent – distracts attention from the real problems of intergenerational mobility and equality of opportunity. There is, for example, considerable evidence that growing income and wealth inequalities are systematically related to growing disparities in educational resources and students' performance in school (Duncan

and Murnane 2011). This is not simply a problem for the tail ends of the distribution: the historically high earnings premium associated with added years of schooling contributes to growing earnings gaps and low intergenerational mobility across the entire range of incomes (Autor 2014).

Should the focus be on opportunity and mobility? According to Saez and Zucman, as reported in the *Economist* on November 8, 2014, "The 16,000 families making up the richest 0.01%, with an average net worth of $371million, now control 11.2% of total wealth – back to the 1916 share, which is the highest on record." Is the problem with these inequalities the extent to which they limit opportunity for so many others, or instead should we be worried about the power that such wealth confers on a small number of individuals?

3. It is often suggested that great fortunes are less morally problematic if they are generated by an entrepreneur in his or her own lifetime than if they have been inherited. Piketty anticipates that in the twenty-first century inherited wealth will grow in importance relative to new wealth, leading to a "patrimonial capitalism" that he finds distasteful, although he does not elaborate an explicit moral view. Why might entrepreneurial wealth be less troubling ethically than inherited wealth? One reason is that encouraging the accumulation of vast entrepreneurial wealth provides incentives for innovation and investment. For example, Mark Zuckerberg might have been less motivated to develop Facebook if he had faced higher taxes. Others have argued that successful people "deserve" their returns, quite apart from any incentive effects. An opposing view grants that inequalities may be justified when they contribute to the well-being of the least well off, but argues that it is hard on these grounds to justify fortunes anywhere near as great as those the top .01 percent enjoy.

The purpose of this section has been to underline the contemporary relevance of this book's inquiry into economics and ethics by sketching the inescapable links between the ethical and economic questions raised by the financial crisis and contemporary inequalities. We have not tried to answer these questions, but rather to suggest that addressing them requires systematic analysis and reflection of the kind to which a large part of this volume is devoted.

Economic Analysis, Moral Philosophy, and Public Policy is not, however, concerned only with the interplay between economics and ethics in the assessment of public policy. It also discusses the ways in which moral assumptions are embedded in purportedly purely scientific economics, the relationship between morality and rationality (particularly as understood by economists), the moral limits on markets, some of the many moral frameworks that economists tend to avoid, and the tools that economists have provided for ethical inquiries.

1.2 What Are Moral Questions and How Can They Be Answered?

Moral questions and moral reasoning can be difficult to understand, and we have found that students often hold very skeptical or even cynical views. One hears claims such as "Morality is just a matter of how you feel." "There's no rational way to resolve moral disputes." "Moral claims cannot be true or false." "Morality is just a matter of social convention or prejudice." These views seem to have some foundation.

- It might seem that morality is just a matter of individual feeling and that moral disagreements cannot be rationally resolved, because it is hard to understand how moral claims can be tested, confirmed, or disconfirmed.
- It might seem that moral claims cannot be true or false, correct or incorrect, because moral claims are often prescriptions that concern how things ought to be rather than how they in fact are.
- It is tempting to believe that moral claims are conventional or relative, because members of different societies disagree about morality.

Yet these skeptical conclusions are exaggerated, and they yield implications that are hard to accept. To see why, consider a genuine moral question that might face an individual:

Sarah's abortion decision. Sarah is a young woman attending college who becomes pregnant and is trying to decide whether to have an abortion. Although some of her friends see no moral problem with doing so and advise her to do whatever she thinks best for herself, Sarah has moral qualms. She is in doubt about whether abortion is morally permissible.

Saying that Sarah has "moral" qualms means that she is not just asking what would please her family or conform to the norms of her community. She is asking what would be the right thing to do for *anyone* whose circumstances are in the relevant regards just the same. Sarah's problem is not a legal problem. She knows that abortion is in fact legal. But this does not tell her whether it is morally permissible. It is legal to be rude to your parents or to pretend to love a person in order to seduce him or her, but that does not mean that these actions are morally permissible. Second, notice that Sarah's question is not one that a sociologist can answer. Even if she reads that 62.37 percent of her fellow citizens think that an abortion is permissible in circumstances like hers, her problem has not been solved. Sarah still needs to decide whether she ought to have the abortion. The third point to recognize is that Sarah's question is a real question, something that she might agonize over. Whether reflecting by herself or talking over her dilemma with friends or family or counselors, she will be thinking about reasons why she should conclude that abortion is or is not morally permissible. Whether or not one believes that morality is subjective (in some sense of this ambiguous term) or that morality depends in some sense on feelings, there is unquestionably a huge potential role here for argument and judgment. It seems that some answers to Sarah's question are better than others – for example, they may be more logically consistent or better supported by evidence – and it is possible to think rationally about which answers are better and which are worse.

There are genuine moral questions about social policy as well as about individual choices. For example, the question about whether abortions should be legal cannot be decided by ascertaining what the law currently is. The moral question of what the law concerning abortion *ought to be* must also be distinguished from questions about whether laws permitting or banning abortion are constitutional. Before the Thirteenth Amendment was passed, the U.S. Constitution specifically permitted slavery. That made slavery constitutional, but it did not make it just. Questions about what the Constitution *ought to say* are moral questions. One also cannot decide whether abortions ought to be legal by means of sociological research, such as taking a poll. A poll can determine what most people believe, but it will not determine whether they are right. Those who believe that abortions ought not to be legal cannot be refuted by results of polls showing that most people believe that they should remain legal. One addresses moral questions instead by making arguments.

Once one recognizes these truisms – that moral questions have better and worse answers, and that arguments can sometimes help people find out which answers are better – one can see that the cynical or relativistic conclusions concerning morality are exaggerated and unjustified.

- It is not true that there is no method of resolving moral disagreements. There is a method: one can make arguments; that is, one can look for premises that others agree on and then use logic to try reaching agreement on the issues in dispute. To be sure, when people stand to benefit from doing evil, they may be deaf to rational argument. It took a civil war in addition to the arguments of abolitionists in order to eliminate slavery in the United States, but without those arguments (to which there were, in fact, no good responses) there would not have been a movement opposing slavery. While some moral disagreements may remain, others can be resolved through argument and evidence.

- The fact that some moral judgments are *prescriptive* – that they say how things ought to be rather than how they are – may imply that some moral judgments cannot be literally true or false, but it does not follow that one cannot sensibly consider whether moral judgments are mistaken. When people assert that "killing people for fun is wrong," they certainly take themselves to be saying more than just "I'm personally not into killing people for fun." The idea that killing is a moral wrong plays a different role in their thought and action than a mere whim or feeling would. Moreover, even if moral judgments are not descriptive assertions, the reasons for those judgments often include empirical claims that can be criticized and investigated.
- Though moral questions are not always easy to answer and though difficult questions give rise to persistent disagreement, there is also a lot of agreement in ethics. Because people only argue about those claims upon which there is disagreement, it is easy to overlook how much people agree about. Few people approve of torture for any purpose, and even fewer approve of it for the purposes of entertainment.

The claim, which is often heard, that morality is "relative" is ambiguous. In one sense morality clearly is relative: what is right to do depends on (is relative to) what the facts are. Whether it is permissible to knock over a frail old man depends on whether one knocks him over to see whether his bones are brittle or whether one knocks him over to prevent him from being run down by a truck. But to recognize that one does not have a well-defined moral prescription until one has specified all the facts is perfectly consistent with the idea that moral questions can have better and worse answers.

What people mean by claiming that morality is relative is often something altogether different: It is sometimes suggested that whatever a person (or a society) believes is right is automatically right ("for that person or society"). But when Sarah is trying to decide whether it is morally permissible to have an abortion, she is not trying to find out what her beliefs already are; she is trying to find out which answer to her question she should affirm.