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Moral Misunderstanding and the Justification of Markets*

The free market system is seen by many as morally inferior because it seems to value the pursuit of self-interest over the interests of others. As Paul Heyne writes, however, organizing society according to the Golden Rule—"doing what's best for others"—requires more knowledge about what other people want than any individual possesses.

The level of economic literacy among Americans is low in large part because we college and university teachers do an ineffective job of presenting the introductory courses in our subject. Far too few students leave our courses with a genuine understanding of how commercial societies work, societies in which everyone specializes and lives by exchanging. Even at the end of the course students find the processes of supply and demand that coordinate activities in such a society baffling or boring or both.

It isn't entirely our fault. We deserve sympathy, not blame, for having to teach a subject that is by its very nature extremely abstract. Economic theory generalizes about activities and relationships, such as economizing and exchange, that can't be shown in pictures. That's why we lean so heavily on graphs. It's also why no one has yet been able to make a good film to teach economics and why the best of the ones that have been made are filled with "talking heads."

On the other hand, it *is* our fault that we persist in teaching the first course as if everyone enrolled were headed for a Ph.D. in economics. That's not an effective way to introduce students to any subject and it's a particularly poor way to introduce someone to a subject as abstract as economic theory.

But I want to use my space to discuss another reason why economic theory may be so difficult to teach effectively, a reason less often commented on. Really learning economics requires "getting into" the economist's way of thinking about social phenomena. I suggest that many of our students, including some of our most thoughtful ones, are reluctant to let themselves be captured by the economic way of thinking because they see economic theory as at bottom an elaborate justification for an immoral society.

The Defense of Commercial Society

Most economists will insist that anyone who views economic theory in this way is totally mistaken. Economic theory merely describes; it does not justify or defend anything at all. Economists who teach economics as a defense of commercial society, they will claim, are not scientists but ideologues. While I agree that those who perceive economic theory as a system of thought that defends an immoral society are mistaken, I maintain that their mistake is only in supposing that the society it defends is immoral.

Economic theory is in large part an elaborate justification of commercial society. To say that it merely describes, it does not justify, is to ignore what it's describing. It's describing the cooperative and positive-sum aspects of the supply and demand process to people inclined to see the process as zero-sum at best and more often as a negative-sum game. Copernicus' description of the heliocentric system was a description, not a defense, of that system because the system required no defense. People may have thought it was impious or immoral to *believe* that the earth revolved around the sun; but no one thought that Copernicus was suggesting wicked behavior on the part of the earth and the other planets. Many people today do believe, however, that the activity of pursuing one's own interests, which generates supply and demand functions and through them the prices that coordinate production, is, if not wicked, at least somewhat immoral, and if not immoral then at least morally inferior.

Inferior to what? Inferior to activity that aims at promoting the interests of others rather than one's own interests. We in the Western world have inherited a religious tradition that tells us we should do for others what we would like them to do for us and that we should give without expecting anything in return. That's not how commercial society functions. In commercial society the rule is: "I'll do this for you if and only if you do that for me." Maybe that's the way it has to be in an imperfect world, say the critics. But it's not *good*. It would be far better morally if people produced to satisfy the needs of others than to enrich themselves. In a commercial society, everyone uses others as means to their own ends. And that is basically immoral.

The abject failure of the socialist vision that became so obvious with the collapse of the Soviet Union has turned a lot of people into realists. The critics of capitalism admit that socialism does not work—unfortunately, they add. People are basically selfish. They won't live by the Golden Rule. And so we must, regrettably, turn to capitalism. Capitalism works. It may stunt the spirit and corrupt the soul; but it does feed the body. We must go on living in a world of self-seeking and competition, at least until a New Age appears in which human nature will be transformed and all swords and spears will be reshaped into plows and pruning saws. My language is deliberately religious because I believe that religious misunderstanding has greatly contributed to the depth and pervasiveness of the error I want to criticize.

Commercial Society and the Golden Rule

The fundamental error lies in supposing that the reason the Golden Rule won't work is that human beings are basically selfish. I submit that the Golden Rule won't work *as an organizing principle for a commercial society* because human beings are not omniscient. We simply do

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* This article, by the late Paul T. Heyne, is reprinted from, *The Region*, The Federal Reserve Bank of Minneapolis, v. 12, no. 4, Dec, 1998. Mr. Heyne was senior lecturer in economics at the University of Washington in Seattle.

not know enough and could never know enough to organize social life in a commercial society on the basis of the Golden Rule. Running a society by the Golden Rule requires comprehensive social planning, and that just cannot be made to work except in very small societies, societies not much bigger than a family.

I am not denying that some human beings are selfish most of the time or that all of us are selfish some of the time. I am making a different kind of assertion altogether, namely, that the Golden Rule could not effectively organize a commercial society even if every single individual in the society were like St. Francis of Assisi. It is possible, even probable I suppose, that in a society made up entirely of people like St. Francis, a commercial society would never have developed. People everywhere would have remained poor, at least by our standards, living always on the edge of subsistence, though presumably in peace and contentment. There would also be far fewer of them, even if these St. Francis-like people differed from him in preferring marriage and procreation to celibacy, because the economic systems that prevailed prior to the evolution of commercial society could not have maintained one-tenth the number of people that inhabit the earth today.

However much some people may suppose (do they *really* believe it?) that a poorer and simpler world of far fewer people would be a better world, we do not have the option of going back. If all those who now grow the food that feeds the nearly 6 billion people in today's world decided to begin producing for people rather than for profit, so that each one of them planted their crops only after determining which particular people wanted the product, most of the world's population would die of starvation within a few years. Contrary to the slogan that long filled the window of local Communist Party headquarters in my neighborhood, production for profit is production for people.

Those who find commercial society morally repugnant are capable of conceding that production for profit delivers the goods without granting that this describes a moral society. Selfishness may work, they say, but it's still wrong. But it is not selfishness that motivates people in a commercial society, although some undoubtedly are in fact selfish. Participants in the supply and demand processes that animate modern society are motivated by love for family, the desire to do a good job, anxiety about the opinions of others, the satisfaction of overcoming challenge, a wish to avoid boredom, a determination to act always so that they can respect themselves, sadistic urges, masochistic urges, or lust for sex, drugs, domination, or more toys than owned by anyone else in their acquaintance—just to give a sampling of what motivates people.

Selfishness and Self-Interest

Economists have done a great deal of damage by failing to make clear the distinction between selfishness and self-interest. Some economists, even some who have earned Nobel prizes, mistakenly claim that economic theory presupposes selfishness and greed. That just isn't so. It presupposes that people act in their self-interest. But whether pursuing one's self-interest is selfish depends entirely on what one's interests are. Adam Smith never made this mistake. He never once claimed that selfishness motivates activity in a commercial society, but rather self-interest, self-love, concern for one's own advantage. And as his book on moral philosophy makes clear, he did not identify self-love with selfishness and held open the possibility that self-love would inspire some people to acts of courageous sacrifice for others. A major source of misunderstanding and moral confusion might be removed if economists simply stopped saying that economic theory describes a society running on greed and selfishness. I would prefer that we even stop saying that it presupposes the pursuit of self-interest, because this still lends itself to misunderstanding. Economic theory assumes only that people pursue the projects that interest them. That was true of Mother Teresa, Jack the Ripper, Henry VIII and Augustine of Hippo.

"I have never known much good done," Adam Smith observed, "by those who affected to trade for the publick good." He thought that people usually promoted the interest of society most effectively when they tried to promote their own interests. This paradoxical result was the work of the invisible hand, by which Smith did not mean any magical or supernatural intervention but simply the process he attempted to describe throughout *The Wealth of Nations* and that we teachers should be trying to explain in the introductory economics course: Market interactions in a well-governed society, a society in which government protects people against theft and robbery, provides a system for the peaceable adjudication of disputes, and assures its citizens that government itself will not engage in predatory behavior.

The Golden Rule is irrelevant or even mischievous in its effects when people attempt to apply it in the context of market transactions. The reason, once again, is that we usually do not know enough. A city bus driver who waits in the morning commute for a late passenger whom he sees running to catch the bus cannot know whether the good he does for this one passenger outweighs the harm he does to all others on the bus by delaying their trip. He delays each of them just a little; but that little might be enough to make some miss a transfer connection. The passenger for whom he waits might be on an urgent mission of mercy; or he might be meeting an accomplice in order to rob a liquor store. The point is that the driver does not know, and because he does not know, he has a moral obligation to follow the rules that have been established by the bus company with the aim of maximizing the general welfare. The driver who waits, in violation of company rules, is not so much virtuous as arrogant.

Appropriate Rules

The ethical rules of the marketplace are different and must be different from the ethical rules that can guide action in a family or another small, face-to-face society. Because the Golden Rule tells us to do to others what we would like them to do for us, it presupposes a condition of personal knowledge and directness or immediacy of action that is typically missing in market transactions. In market transactions something like the Silver Rule ought to reign: "Do not do to others what you would consider unfair or unjust if they did it to you."

The Silver Rule is not a rule of expediency or a watering down of ethics or a double standard. It is a difficult and demanding rule. It does indeed demand too little if we take it to express what parents owe to their children or what members of a religious community owe to one another. It is not a rule, however, for the governance of relations among family members and friends, but a rule for the governance of relations among strangers. Once that is recognized, the truly noble and challenging character of the imperative contained in the Silver Rule becomes much clearer.

The transactions that economic theory explains are almost entirely transactions among strangers. Would it be better in some sense if fewer of our transactions were with strangers, if we lived our lives more than we do in the company of friends, if we specialized less narrowly so that we could trade primarily with people whom we know personally? It might be better in some sense. But in what sense? It would also surely be worse in many ways. Extensive specialization and anonymous trading has created for us all sorts of trivial goods. But are classical CDs, antibiotic medicines, high-speed dentist drills, fresh fruits and vegetables in all seasons of the year—are these all trivial

goods? They would not be available in the absence of very extensive specialization and its corollary, numerous transactions with anonymous others.

I have no simple advice to offer here at the end to teachers of economics. If my hypothesis is correct, that some good students do not learn economics from us because they are never captured by its perspective, and they are never captured because they perceive economic theory as an elaborate justification for an immoral society—if this is correct, then we will certainly not remedy the situation by talking about the positive-normative distinction or by insisting that ethical considerations are irrelevant in scientific inquiry. We can begin to overcome this obstacle only by being more attentive to the questions and convictions that our students bring with them when they come into our classrooms. But in order to respond effectively to the misgivings and misunderstandings that I have attempted to analyze, we will ourselves have to reflect more carefully on the nature of economic theory and of the society whose workings it explains. ❑

IT'S OFFICIAL

The Business Cycle Dating Committee of the National Bureau of Economic Research has determined that a peak in business activity occurred in the U.S. economy in March 2001, ending the longest expansion in U.S. history at exactly ten years and marking the starting date of the tenth post-war recession. Whether this recession will be extraordinarily long or deep remains to be seen.

In last month's *Research Reports* we noted that the National Bureau of Economic Research (NBER), the official arbiter of business cycle peaks and troughs, was reportedly considering selecting March 2001 as the peak month of the last expansion and the beginning of another recession. The NBER's Business Cycle Dating Committee has now made it official: the expansion that began in March 1991 ended in March 2001. At 120 months, the 1991-2001 expansion surpassed the 93-month peacetime expansion of 1982-90, and the 106-month expansion of 1961-69.

Although recession is commonly defined as two consecutive quarters of decline in GDP—and most do include of two or more of such quarters—the NBER focuses on four monthly indicators to gauge the strength of business activity. These are employment, industrial production, constant-dollar income, and wholesale-retail trade. Other measures are sometimes considered, but no steadfast rules apply regarding their contribution to the appraisal. The committee gives relatively little weight to GDP because it is only reported quarterly and is subject to continuing, large revisions.

To determine whether reported decreases in the data series that they monitor warrant the label "recession," the committee asks itself, hypothetically, what conclusion it would reach if a turnaround in the economy were to begin immediately, *i.e.* if all the new data for each series were increases for the next several months. Only if a recession would be indicated despite such a hypothetical immediate turnaround, will the committee date the peak. According to the NBER, "it is is possible that the decline in the economy would have been too mild to qualify as a recession. The [September 11] attacks clearly deepened the contraction and may have been an important factor in turning the episode into a recession."

Choosing the peak in overall economic activity is difficult because the major indicators tend to peak in different months. (See Table 1.) This time was no different. Although industrial production peaked in October 2000, growth elsewhere in the economy offset the decline in manufacturing through March, when employment began contracting. Income has yet to peak.

AIER's Chronology

Our leading indicators began signaling recession late last year. In December 2000, the percent of leaders expanding dropped to 33 from 57 a month earlier. However, our cyclical score, AIER's purely mathematical analysis of the leaders that we use to confirm the outlook suggested by the percent expanding series, did not fall below 50 until May. (Subsequent revision of the cyclical score indicates it dropped below 50 in February.) Unless both indexes decrease to less than 50, there is no clear statistical warrant to reckon that recession is more probable than not.

To reduce the incidence of "false signals," the overall cyclical score provides for a heavier weighting of increases than decreases among the individual series. This served to restrain us from calling for a recession in 1995 when the percent expanding series dipped below 50, but prevented us last December from asserting that a recession was imminent. Since 1946, only two other recessions (1954 and 1981-82) began when the cyclical score was above 50. Of the postwar occasions when the score decreased to 50 or less, seven were followed by recession, four were not.

In any event, it should be understood that the dating of expansions and contraction is quite arbitrary, and NBER's findings are not universally accepted. For example, some consider the recessions of 1980 and 1981-82 as one long recession, and refuse to categorize the 12-month period from July 1980 to July 1981 as an expansion. Others recognize so-called growth recessions, which are periods during which the economy does not contract outright but instead grows at a rate that is significantly below its long-run trend.

An "Average" Recession?

No two recessions are exactly alike. Nevertheless, a review of the depth and breadth of past recessions provides some insight into what might be expected from this recession. A statistical summary of various indicators for the nine previous postwar recessions as well as data for the first seven months of this recession appears in Table 2. Data for the Great Depression of 1929-33 are also shown.

None of the nine post-war recessions were remotely similar in magnitude or duration to the Great Depression. The widespread belief that a contraction comparable to the 1929-33 is unlikely, given the changes in the structure of the U.S. economy and our understanding of its functioning since then, is probably correct. However it would be folly to rule it out completely. Even to this day, economists remain far from agreement on the reasons, but there is a consensus that it was man-made. It may well be that today's politicians are somehow less likely to adopt bad policies or fail to correct them than their predecessors, but it might not.

The average postwar recession lasted 11 months and, with the current recession now in its ninth month, some analysts pre-

Table 1
Indicator Peak Relative to Business-Cycle Peak
(In Months)

Peak	*Industrial Prod.*	*Employ -ment*	*Real Sales*	*Real Income*
1960	-3	0	-3	+1
1969	-2	+3	-2	+8
1973	0	11	0	0
1980	-7	+2	-10	-1
1981	0	0	-6	+1
1990	+2	-1	1	+1
2001	-6	0	-7	*

Lead (-) or lag (+) in months from business-cycle peak. * Has not yet peaked. Source: NBER.

Table 2
A Capsule History of Business Recessions
Selected Economic Measures

— Month of — Peak	Trough	Duration (Months)	Real GNP* (% Chg.)	Real Personal Income* (% Chg.)	Industrial Production* (% Chg.)	Nonagricultural Payroll Employment* (% Chg.)	Unemployment Rate† High (%)	Unemployment Rate† Increase (% Pt. Chg.)	Percent of Industries with Employment Decrease**	Average 12-Month Inflation Rate††
Great Depression:										
Aug. 29	Mar. 33	43	–33	–27	–53	–32	24.9	21.7	100	–6.6
Postwar:										
Nov. 48	Oct. 49	11	–1	–3	–10	–5	7.9	4.5	na	0.01
Jul. 53	May 54	10	–2	–1	–10	–4	6.1	3.6	na	0.9
Aug. 57	Apr. 58	8	–3	–2	–14	–4	7.5	3.8	na	3.3
Apr. 60	Feb. 61	10	–1	–1	–9	–2	7.1	2.3	80	1.5
Dec. 69	Nov. 70	11	–1	–1	–6	–2	6.1	2.7	80	5.9
Nov. 73	Mar. 75	16	–4	–5	–15	–3	9.0	4.4	88	10.7
Jan. 80	Jul. 80	6	–3	–6	–6	–1	7.8	2.2	63	14.2
Jul. 81	Nov. 82	16	–3	–2	–9	–3	10.8	3.6	72	7.7
Jul. 90	Mar. 91	8	–2	–2	–5	–2	7.8	2.4	70	5.7
Mar. 01	?	9	–0.3	–4	–7	–1	5.4	1.4	64	2.9

na Not available. * Percentage decrease from high month or quarter to low. † Highest monthly figure reached and increase from low to high. ** Percentage of industries that experienced a decrease in employment over a 6-month interval. The figure shown is the highest percentage reached during the recession. †† Average 12-month increase in the Consumer Price Index during the recession. Sources: U.S. Department of Commerce, Bureau of Economic Analysis, *Business Conditions Digest*; *Business Cycles, Inflation, and Forecasting*, Geoffrey H. Moore, 1983.

dict it will end soon based simply on that fact. However, recessions have varied widely in length, lasting as short as six months (1980) and as long as 16 months (1973-75 and 1981-82). The data offer only mixed evidence that recessions have become, on average, shorter. If the current recession runs through the first quarter of 2002, it will be the third longest on record in the post-war period. At present, the only positive signs of recovery among our leading indicators are confined to the monetary series, which is a reflection of the persistent expansionary policy adopted by the Federal Reserve.

During the postwar period, four recessions have been relatively mild (1960-61, 1969-70, 1980, and 1990-91) and five were comparatively sharp (1948-49, 1954, 1958, 1973-75, and 1981-82). Thus far, the recession has not been extraordinary in terms of employment or output changes. Employment has dropped 0.6 percent from its March peak, less than one-fifth the average of prior postwar recessions. The number of unemployed has increased 2.2 million to 7.7 million and the unemployment rate has risen from a low of 3.9 percent to 5.4 percent.

Although GDP growth in the third quarter of 2001 was revised downward, to an annualized rate of –1.1 percent, vs. the -0.4 percent previously reported, the percentage decline since the first quarter peak is a modest 0.3 percent. The average drop is 2.2 percent. Except for a slight uptick in July, industrial production has declined each month since October 2000, and has dropped a total of 6.5 percent since its peak. Weakness is not confined to a few sectors: the percentage of 276 manufacturing, mining, and public utility industries reporting increased production (over six month spans) stands at just 34 percent. Almost one-quarter of industrial capacity sits idle.

The Outlook

Despite the 4.5 percentage point cut in the Federal funds rate by the Federal Reserve since January, no appreciable impact is evident among the economic indicators other than the monetary series themselves. According to the Fed's survey on bank lending practices, half of all banks have tightened standards and terms on commercial and industrial (C&I) loans over the past three months. Almost three-quarters reported weaker demand for C&I loans, citing a decline in customers' need for credit to finance capital expenditures as an important factor. At this point, adding further liquidity to the banking system to spur borrowing and lending may be tantamount to what some economists refer to as "pushing on a string."

Whether a fiscal stimulus package will have its desired effect depends on its timing, size, financing, and bureaucratic structure for delivery, as well as whether it has any displacement or spillover effects. Beyond possibly bolstering income-stabilizing programs such as unemployment benefits, food stamps, and the like, policymakers may cut tax rates, initiate new spending programs, bailout industries, or impose tariffs to protect new jobs. The main problem with counter-cyclical policy—aside from being motivated by politics as opposed to economics—is that it cannot be easily timed or used with any degree of precision. There is no convincing evidence that officials will be able to reliably "jump-start" the economy.

Not all the news is bad. Low interest rates and falling oil prices, dormant price inflation, an uptick in consumer sentiment for the past two months, a better than expected increase in construction activity, and a recovery of stock prices are encouraging signs. However, they have yet to become evident among the primary indicators, and it is premature to assert that a recovery is imminent. ❑

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