L7: Ethics and Neoclassical Price Theory

[M]odern methods of **trade imply habits of trustfulness on the one side and a power of resisting temptation to dishonesty on the other,** which do not exist among a backward people. Instances of simple truth and personal fidelity are met with under all social conditions: In *Principles of Economics* by Alfred Marshall (Eighth edition) (1920/2012, p. 16), Digireads.com, Kindle Edition.

The last chapter shows why markets work better when they have ethical support that facilitates trade by reducing fraud and transactions costs and also by reducing production costs by reducing agency problems.

Lecture block 6 basically assumed that prices were known and in the settings of interest the trades and/or production generated net benefits for both sellers and buyers, and also for producers and input providers—except in the case of fraud.

Lecture block 7 shows how ethical dispositions can affect prices through effects on neoclassical demand and supply curves.

It also shows how market rewards can affect the distribution of ethical dispositions in a society in the long run and what a social equilibrium looks like when the distribution of ethical dispositions and patterns of trade are more or less stable--e.g. in equilibrium.

Possibly Unnoticed Effects of Ethics on Markets (1)

- Virtually all products, from automobiles to zucchini, have properties that cannot be perfectly assessed by consumers at the point of sale.
- Much of this uncertainty is not a consequence of fraudulent claims **but much of the variation in quality that can be attributed to nature, human error, and the cost of quality control in manufacturing processes.**
  - A given edible plant may receive more or less sunshine, rain, and grow on more or less fertile ground.
  - Machines benefit from a variety of adjustments as they are used and wear out. And, without such adjustments the average quality of their output may diminish.
  - **Workers can be more or less attentive to their assigned tasks in the sequence of productive tasks that generate products for sale.**
  - Products are occasionally damaged when transported to shops, put on display, and sold.
  - The designers of production processes and the persons engaged in overseeing the quality of the output can be more or less diligent in their oversight and planning.
- **As a consequence, the quality of many products tend to be randomly distributed at the point of sale.**

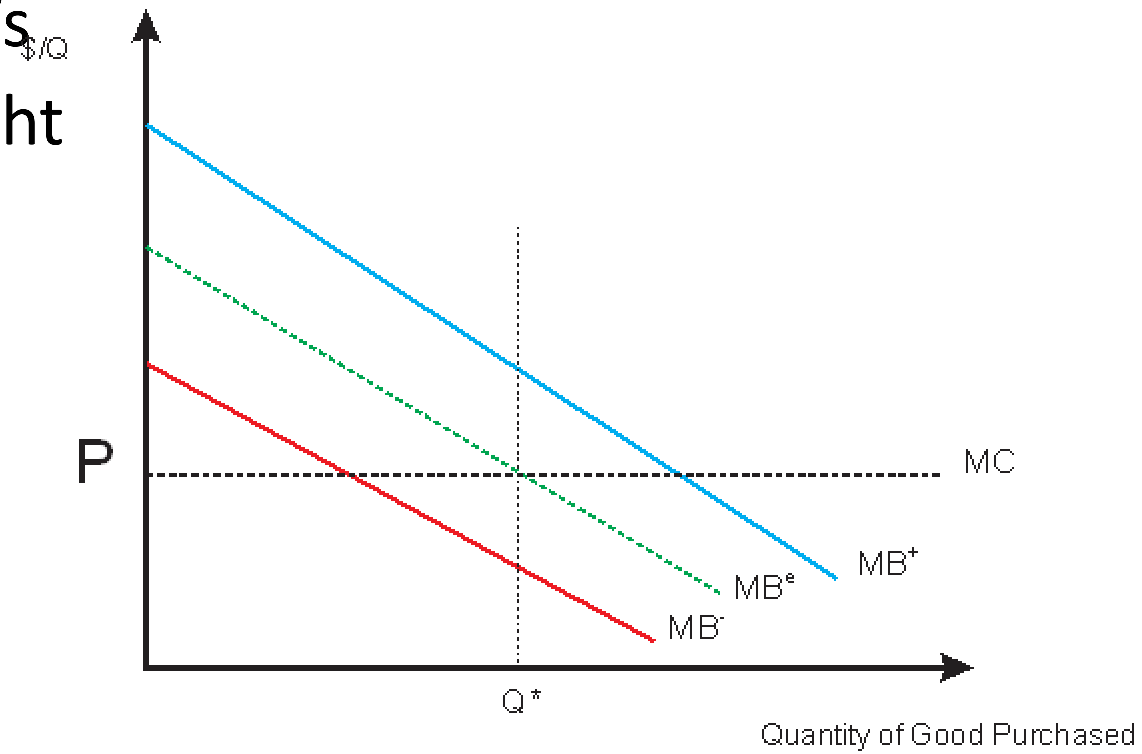
Possibly Unnoticed Effects of Ethics on Markets (2)

- At least some of this randomness is a consequence of the diligence with which workers fulfill their duties, which in turn is partly a consequence of their internalized ethical dispositions.

The probability of a defect varies with a worker's sense of duty and what might be called their work ethic.

Figure 4.1 shows how uncertainty about quality affects prices.

Figure 4.1 Maximizing Expected Consumer Surplus



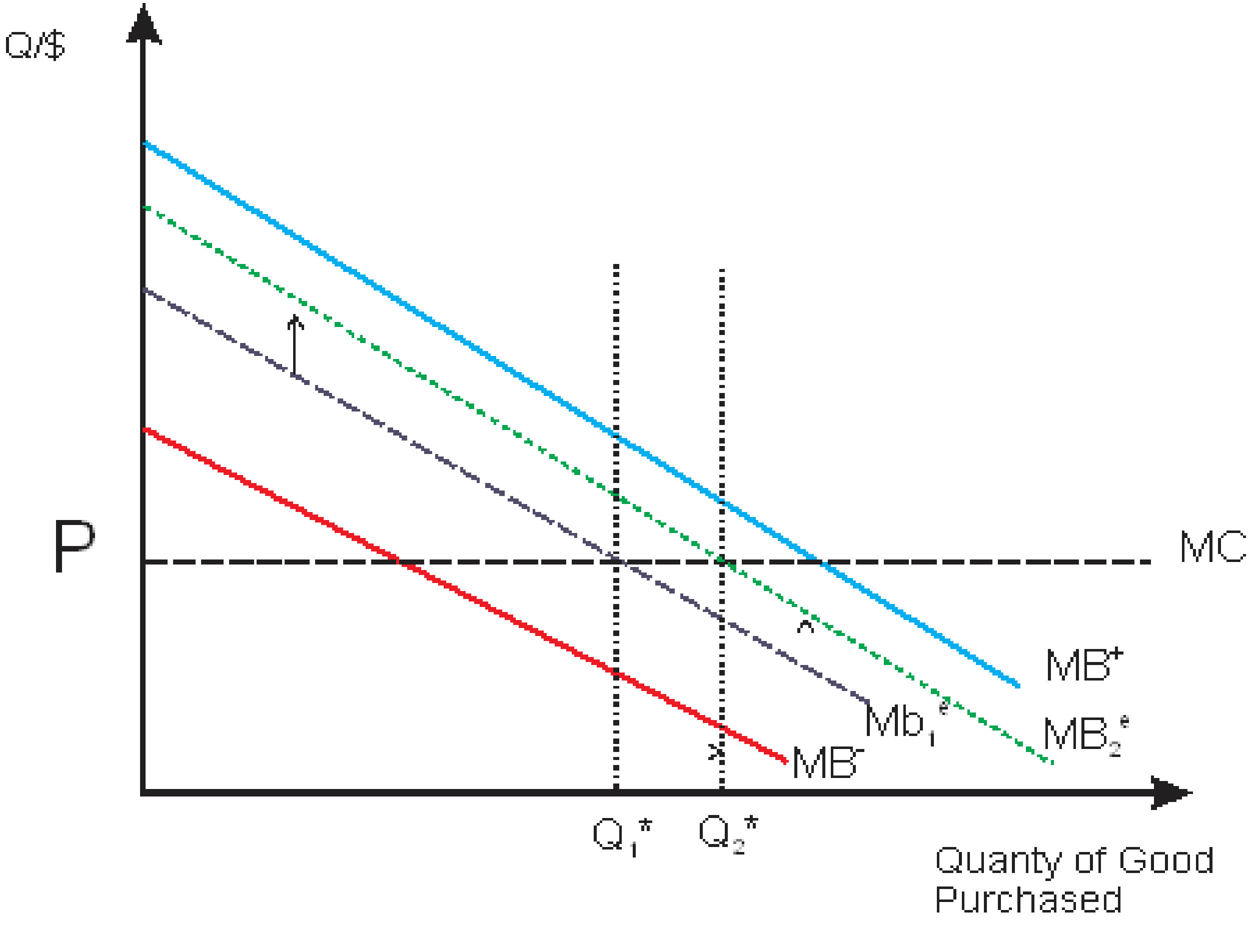
Possibly Unnoticed Effects of Ethics on Markets (2)

Figure 4.2 shows how an increase in the average diligence of a firm's workforce tends to affect quality (the probability of defects falls, so average quality rises.)

If consumers can estimate the probability of defects, they will be willing to pay more for the products of such a firm than the one in the previous diagram, because average quality is higher (the middle line) for this firm's products than for the one(s) in figure 4.1.

In this way, internalized norms can affect prices even if norms are unrecognized.

Figure 4.2 Effect of an Increase in Productive Ethical Dispositions on a Typical Individual's Demand



The Market Demand for and Distribution of Ethical Employees (1)

If, for example, differences in diligence is the primary driver of quality and profits, the quest for profits will induce employers to attempt to search for diligent employees.

And it will induce firm owners and managers to determine where best to deploy employees with particular ethical dispositions.

Not every virtue on a philosopher's list is likely to increase production, reduce defect rates, improve service, or otherwise increase the quality of a firm's products, but those that do, would be sought and out and deployed in the most efficient manner.

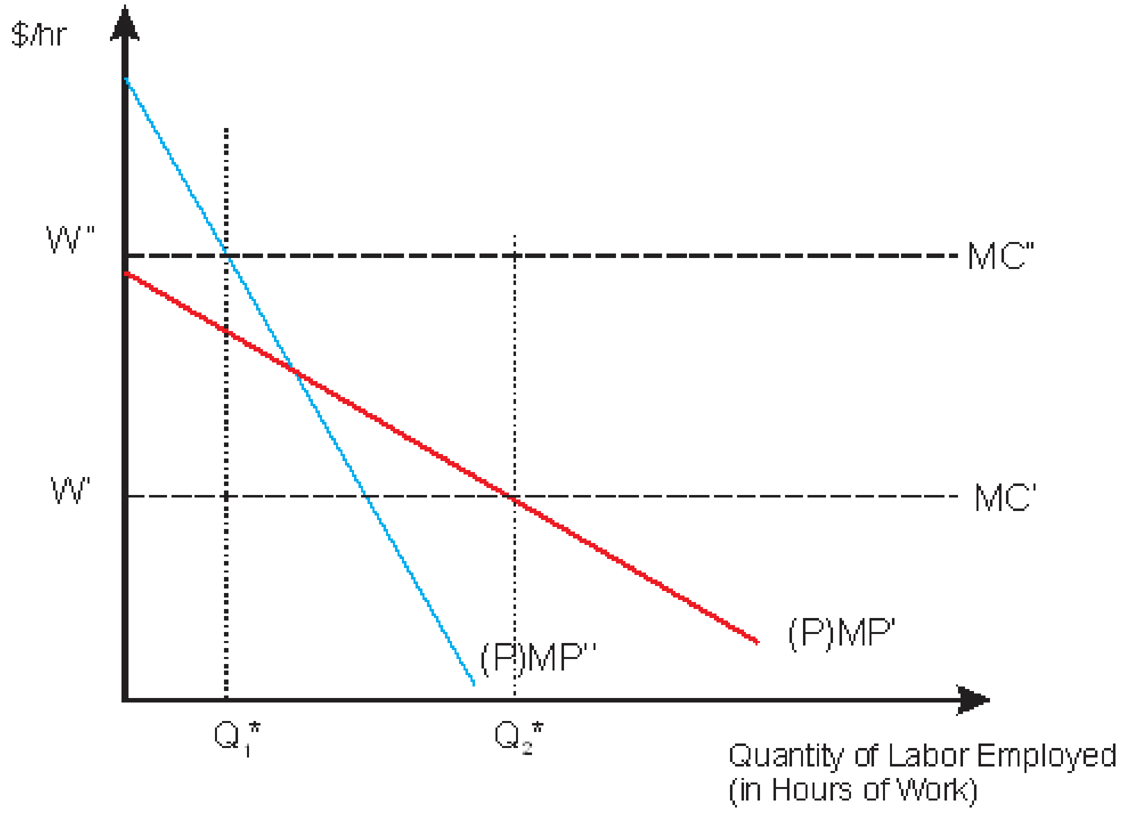
As this process takes place, it is likely that persons with productive ethical dispositions will be paid a premium because such persons have a higher marginal product.

Prices—here wage rates—will again rise for the relatively "high quality" employees relative to the "lower quality" ones, which in this case is mainly attributed to differences in ethical dispositions.

The Market Demand for and Distribution of Ethical Employees (2)

- Figure 4.3 illustrates hiring decisions for two different positions among two different types of potential employees within a single firm.
- Type (") are assumed to be relatively ethical in the sense of being relatively more honest and diligent when not closely monitored.
- Type (') are assumed to require more monitoring and more complex contracts to achieve similar results.
- The employer’s demand for the two types of individuals is based on their expected marginal revenue product—which is simply the firm’s output price, P, times their respective typical marginal products, MP' and MP" (the extra revenue produced by an additional hour of work from a type " or type ' employee).

Figure 4.3 Hiring More (") or Less (') Ethical Persons for Two Different Positions



The Market Demand for and Distribution of Ethical Employees (3)

Figure 4.3 can also be used to characterize the demand for employees with different ethical dispositions but the same skill level in different industries and markets. Interpreted in this way, the logic of labor markets implies that a subset of industries may outbid the others for most persons with particular internalized norms.

The higher salaries of what might be called the “double prime” market would attract the most ethical persons to it (and, of course, persons pretending to have such ethics who would have to be weeded out). The same sorting, of course, tends to be true for other productivity-enhancing human capital as well.

As true of output markets, the segmentation of labor markets requires reliable indicators of differences among potential team members.

Diligence, for example, might be revealed by past employment experience, reference letters from former employers, their course of study and grades at university, and reference letters from college professors or high school teachers. Other evidence might be garnered from criminal records, club memberships, and church attendance, as with Weber’s Protestantism hypothesis.

That persons involved in scandals and ex-cons are widely reported to have a difficult time finding jobs is, of course, an implication of ethics-based hiring—and it is a difference that is hard to explain without taking ethical dispositions into account. Of course, this is not entirely caused by the ethical propensities implied by arrest and conviction. Convicts have often invested less in other forms of human capital as well.

An accessible overview of the issues and evidence on the effect of a criminal record appears at: https://www.prisonlegalnews.org/news/2011/dec/15/study-shows-ex-offenders-have-greatly-reduced-employment-rates.

The Supply of Persons with Market-Supporting Ethical Dispositions (1)

- **The wage premiums paid to persons with productive ethical disposition will affect the distribution of ethical dispositions in the communities in which such premiums are paid.**
- The ethical theories reviewed in Part I of the course (Part III of the book) suggest that individuals have many reasons to invest in ethical dispositions.
  - Aristotle suggests that virtuous dispositions tend to increase lifetime happiness and contentment. Immanuel Kant argues that performance of one's ethical duties can be a source of sublime satisfaction.
  - Theology-based theories of ethics argue that internalizing particular rules of conduct increases one's probability for an afterlife or indicates divine favor.
  - Adam Smith suggests that virtue tends to attract praise and approbation from members of one's community.
  - Utilitarians such Jeromy Bentham and John Stuart Mill suggest that ethics can be a source of long-run pleasure, which increases social utility as long as it does no harm to others. Benjamin Franklin and Claude-Frédéric Bastiat argue that a subset of virtues tends to be associated with higher income and wealth.
- **Ethics are a means rather than an ultimate end in all of these theories: a means to personal happiness, to an afterlife, to praise, to wealth, and/or to an improved society.**

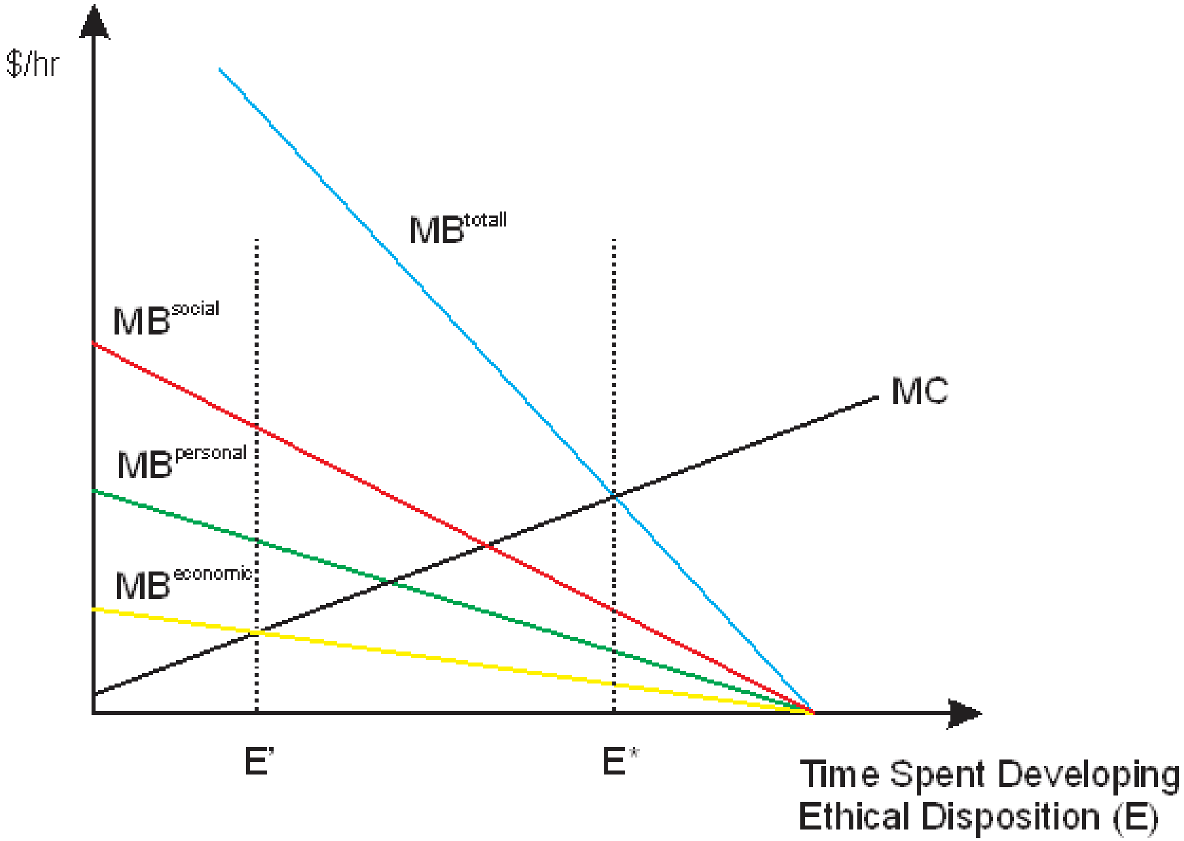
- **Suppose that all or at least a subset of these effects motivate families and individuals to invest in developing ethical dispositions.**

The Supply of Persons with Market-Supporting Ethical Dispositions (2)

- A typical mature individual's decision to exercise a virtue is illustrated in Figure 4.4.
- The virtue of interest is assumed to advance all three of the earthly categories of personal benefits: social (increased praise or deference), personal (increased self-esteem), and economic (increased income).
- The individual's overall marginal benefit from exercising this virtue is the vertical sum of the marginal benefits anticipated from praise, self-esteem, and income.
- The diagram makes the usual economic assumption about the marginal opportunity cost of time devoted to developing the virtue illustrated.

- **The forward-looking person depicted invests E* hours days to developing the virtue of interest**
- **Note that changes in any of these personal advantages from ethical dispositions will change the investment made.**

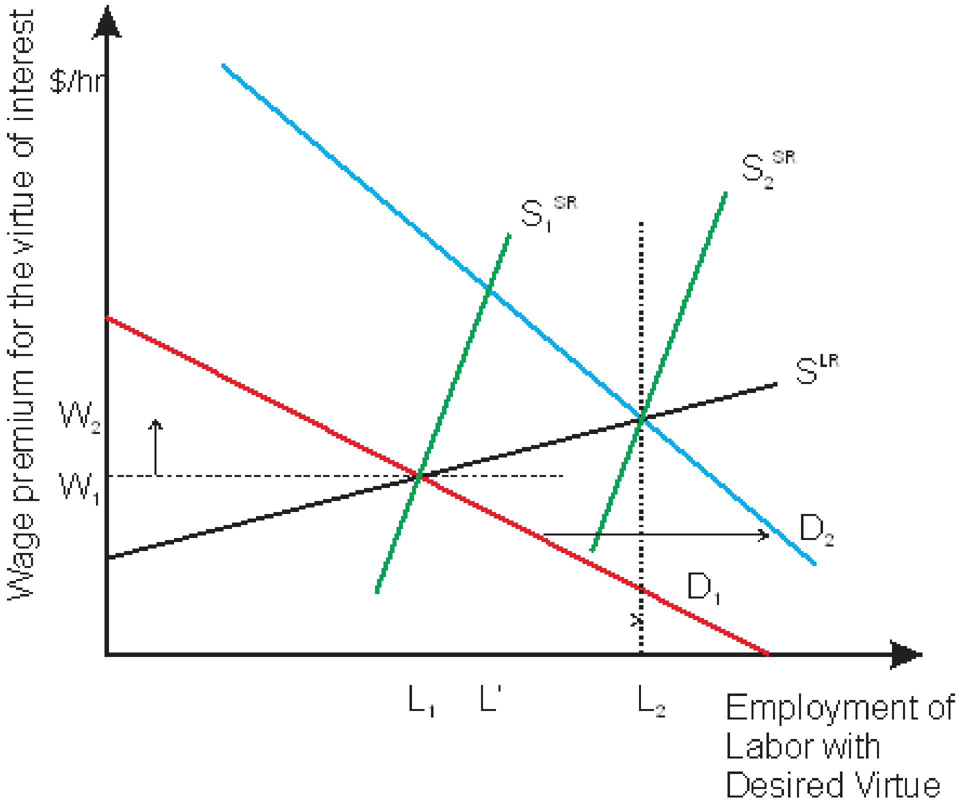
Figure 4.4 Investing in an Ethical Disposition for Social, Personal, and Economic Reasons



Economic Development and the Supply of Productive Virtues (1)

- The variance and average of a community's distribution of ethical dispositions are relevant for economic analysis because they affect both the supply and demand for goods and services. If persons with unusually productive (or unproductive) ethical dispositions can be identified, then employers will seek out the high outliers when choosing the persons to employ for position in which ethical dispositions are most productive. If individual propensities cannot be easily determined, then the average level provides a useful estimate of the likely propensities of potential employees.
- As noted above, market-supporting norms have effects, whether they are recognized and rewarded or not. When they are recognized, productivity-increasing virtues tend to be rewarded by markets. Figure 4.5 shows the effect of a general increase in demand for productive ethical disposistons. It holds the other sources of support for the virtue of interest constant and illustrates the long-run effect of an increase in demand for economically productive virtues

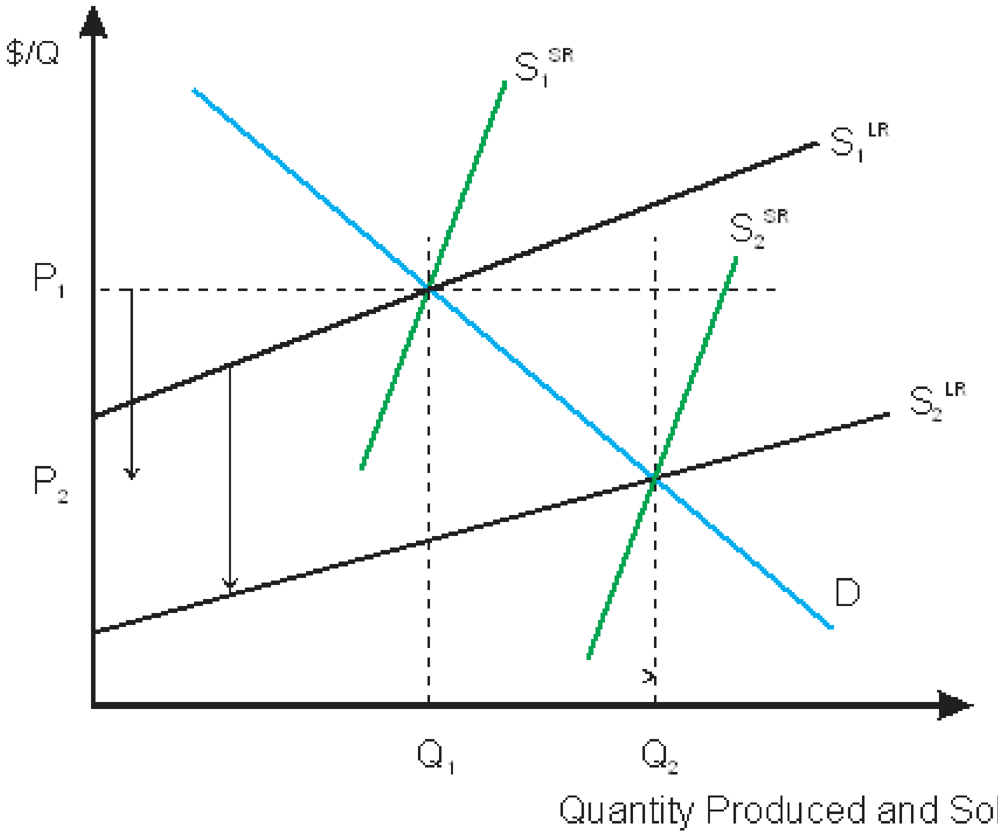
Figure 4.5 Effect of Increasing Demand for Ethical Employees in the Long Run Generated by Effects on Investments in the Sought Ethical Disposition



Ethical Innovations and the Cost of Goods and Services

- **Ethical innovations that increase the average productivity of labor and by reducing monitoring costs and creating new possibilities for organization tend to increase output in all markets.**
- Contrariwise, ethical innovations that increase monitoring costs and reduce organizational possibilities tend to reduce purchases of the goods sold, which may make some markets and some organizational forms disappear.
- Figure 4.6 illustrates the effect of a general increase in productive ethical dispositions relevant for a particular industry.
- Such ethical developments reduce production costs which induces an increase in both short-run and long-run supply, both of which tend to reduce prices and increase the quantity of goods sold in output markets.
- Note that prices fall in the long run, while output increases.

Figure 4.6 Effect on the Output of Final Goods and Services Induced by an Increased Supply of Ethical Employees in the Long Run



Some Conclusions: the **Codetermination** of Ethics and the Extent of Markets

- Aristotle, Smith and Kant argued that personal and social returns from virtue, rather than the economic ones, determined individual investments in virtuous dispositions and actions.
- Nonetheless, as suggested by Bastiat, Franklin, and the analysis in this and the previous chapter, market rewards for virtuous conduct create additional incentives for personal investments in such dispositions.
- **When ethical propensities create new market opportunities and markets reward such propensities, market and ethical systems are codetermined in the long run—at least at the margin.**
- The existence of such socio-economic equilibria provides an explanation for the long-term economic and cultural stability typical of many precommercial societies. Many systems of ethical beliefs and their associated markets were stable for centuries at a time. Gordon (2016), for example, reports that before 1800 long-term economic growth rates throughout the world were generally less than 1 percent per year.
- **Such stable or "evenly rotating societies" may be disrupted by political and military shocks (invasions), climate changes, and pandemics, but if the equilibrium is dynamically stable, the basic pattern of life re-emerges and returns to stability.**

Discussion Questions

- (1) Most of the ethical theories that we reviewed suggest that ethics are a means rather than an end, would economic rewards affect the strength of ethical dispositions under those theories? Which would be the most responsive?
- (2) Max Weber argues that the protestant work ethic helped to get "capitalism" or the commercial society underway. Which of the models developed in this chapter are consistent with his theory?
- (3) Which types of ethical dispositions tend to be rewarded in markets? Which types tend to be discouraged?
- (4) Which types of ethical dispositions tend to be rewarded by our educational system and which discouraged? Is this aspect of our educational system helpful on balance for supporting commerce?