

Lionel Robbins conference LSE December 2007

# **Economics and Ethics: Juxtaposition, Illicit Relationship, or Fruitful Partnership?**

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# **1. Welfare economics 1932-2007**

- **Welfare economics sidelined**
- **Policy targets and social indicators**

# **2. What (academic) economists do today: a furtive relationship?**

- **Three approaches**
- **Two Presidential Addresses**

# **3. Possibilities for a fruitful partnership: examples**

- **Employment as an objective**
- **Giving for overseas development**

# **Concluding words**

# 1. Welfare economics 1932-2007

My text is from Chapter VI of *The Nature and Significance of Economic Science*. The chapter opens with a totally justified criticism of the view that “developments in modern Economic Theory furnish *by themselves* a set of norms capable of providing a basis for political practice” (page 120), but goes on to argue for the complete separation of ethics and economics.

“Unfortunately it does not seem logically possible to associate the two studies in any form but mere juxtaposition. Economics deals with ascertainable facts; ethics with valuations and obligations. The two fields of enquiry are not on the same plane of discourse” (Robbins, 1932, page 132).

**But must economists “only stand and wait”?**

# The response to Robbins' "celebrated attack" (Sen)

Economists did not in fact stand aside.

The first in the series of Surveys of Economic Theory to be published in the *Economic Journal* by E J Mishan (1959) on "Welfare economics, 1939-59" referenced more than 60 articles on the theory of welfare criteria, with titles such as:

"Welfare propositions in economics" (Kaldor)

"The foundations of welfare economics" (Hicks and Little)

"Some aspects of welfare economics" (Pigou)

"Evaluation of real national income" (Samuelson)

1960s was high water mark.

According to K J Arrow and T Scitovsky, Introduction to *Readings in Welfare Economics*, 1969, “recently, welfare economics has greatly increased in importance. ... Economists want to know exactly what they are after, what is the meaning, the limitations, and the importance of economic efficiency and economic progress.”

“Welfare economics is back in fashion”, Editorial Foreword to D M Winch, *Analytical Welfare Economics*, 1971.

## **But in fact all went quiet. Welfare economics was side-lined**

- Relatively few journal articles on welfare criteria.
- Welfare economics incorporated into micro-economics and marginalised.

### **GULF WITH POLICY WORLD**

Governments adopting specific policy criteria:

- Millennium Development Goals
- EU Structural Indicators
- National targets such as halving child poverty or the Bank of England inflation target.

# 1. Welfare economics 1932-2007

## 2. What (academic) economists do today: a furtive relationship?

- Three approaches
- Two Presidential Addresses

“[Fraser] complained that Robbins’ definition of economics did not cover what economists *did*. This was essentially beside the point” (O’Brien, *Lionel Robbins*, page 30).

“In this article, we examine *the* welfare consequences ...”, with typically little explicit discussion of the welfare criterion applied.

## Three approaches:

- Assume away differences in all relevant economic interests – identical representative households. Welfare measured by  $u(c)$ .

Intertemporal differences subsumed in dynastic utility function:

$$\sum_{t=1}^{\infty} u(c_t)/(1+\delta)^t$$

Or

- Assume away differences in social judgments. “Provisional utilitarian”.

Or

- Identify situations of dominance

## Three approaches:

- Assume away differences in all relevant economic interests – identical representative households. Welfare measured by  $u(c)$ .

Rules out many interesting problems

## Intertemporal differences subsumed in dynastic utility function:

$$\sum_{t=1}^{\infty} u(c_t)/(1+\delta)^t$$

Whose utility function? What is the democratic counterpart?

Or

- Assume away differences in social judgments. “Provisional utilitarian”.

Critiques of utilitarianism

Or

- Identify situations of dominance

Still welfarist

## PRESIDENTIAL ADDRESS 2003

“Suppose we want to compare the effects of two policies, A and B say, on a single consumer. Under policy A the consumer’s welfare is  $U(c_A)$ , where  $c_A$  is the consumption level he enjoys under that policy, and under policy B is  $U(c_B)$ . Suppose that he prefers [policy B]. Let  $\lambda > 0$  solve

$$U((1+\lambda) c_A) = U(c_B)$$

We call this number  $\lambda$  ... the *welfare gain* of a change in policy from A to B. To evaluate the effects of policy change on many different consumers, we can calculate welfare gains (perhaps losses, for some) for all of them, one at a time, and add the needed compensations to obtain the welfare gain for the group” (Robert Lucas, AER 2003, pages 1 and 2).

# Intertemporal version used by Lucas

$$\int_0^{\infty} u[c(t)] e^{-\delta t} dt \quad (\text{A})$$

where  $c$  is consumption per head and  $\delta$  is the pure rate of time discount applied to utility.

Lucas takes  $u(c) = 1/(1-\sigma) [c^{1-\sigma}-1]$ .

Not unproblematic.

Question 1: Where the population is growing at exponential rate  $n$ , do we use (A) or (B)?

$$\int_0^{\infty} u[c(t)] e^{(n-\delta)t} dt \quad (\text{B})$$

Question 2: What guarantees convergence?

## PRESIDENTIAL ADDRESS 2005

Martin Feldstein suggested that concern with “the general extent of inequality”, as when using the Gini coefficient, involved a rejection of the Pareto principle, and involves “spiteful egalitarianism” (Feldstein, 2005, page 12).

He imagined a situation in which “everyone reading this article received \$50 by some magical process that did not decrease the income or wealth of anyone else. Since we are an above-income group, national inequality would rise. Nevertheless, I think there are few who would reject bestowing this extra wealth on us all” (2005, page 12).

HOWEVER If we evaluate according to the social welfare corresponding to the Gini coefficient ( $G$ ), which is the mean income ( $\mu$ ) times  $(1-G)$ , then a rise in social welfare will in fact be recorded as a result of Feldstein's magical process.

The rank order weights implicit in the Gini coefficient imply that the social marginal valuation of income is  $2(1-F(y))$  where  $F(y)$  is the cumulative distribution function. The valuation is never negative. Indeed, Sen (1976), which demonstrates the  $\mu(1-G)$  formula, begins from an assumption of strict monotonicity, requiring in the case of a finite number of individuals that welfare be strictly increasing if there is an increase in the income of anyone.

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# EU Structural Indicators

1	GDP per capita	Growth
2	Labour productivity	Growth
3	Employment rate 15-64	Employment
4	Employment rate of older workers	Employment
5	Youth educational attainment	Social Inclusion
6	R+D spending % GDP	
7	Comparative price levels	
8	Investment spending % GDP	
9	At risk of poverty rate after social transfers	Social Inclusion
10	Long-term unemployment rate	Social Inclusion
11	Regional cohesion	Social Inclusion
12	Greenhouse gas emissions	Sustainability
13	Energy consumption	Sustainability
14	Inland freight volume	Sustainability

## Why exactly is raising employment (not reducing unemployment) an objective of EU policy?

One view is that Europe's labour market is heavily distorted and discourages work. In this case, increasing employment is a means to an end. The end is welfare improvement. The government aims to level the playing field.

However, this is only part of the story. Governments seem more interested in the total elasticity of labour supply than in the compensated elasticity relevant to welfare measures. When studies of early retirement refer to "unused productive capacity", they are attaching a positive value to work, quite independent of how it is viewed by the worker. We have therefore to recognise that social decision criteria may be influenced by considerations other than individual welfare levels. Market employment is a "merit good".

How can this be operationalised? We can, as with merit goods, allow the variables of direct concern to enter the social welfare function alongside individual utilities. This immediately raises further questions. How do we weight the different elements of the social welfare function? Suppose for example that we are concerned with the relative position of the least advantaged and the employment rate,  $e$ , where these enter linearly in the social welfare function:

$$Y_{\min}/Y_{\text{average}} + \beta e$$

The first term can be thought of as a “replacement rate” for the unemployed. The parameter  $\beta$  measures the rate at which we are willing to trade employment and the welfare of the least advantaged.

**Or we can leave the welfarist framework entirely. E.g. capabilities and social inclusion. ...**

**Does the capability approach have a positive as well as a normative dimension?**

## Example II: Individual giving for overseas development.

Behaviour governed by:

$$U_i = u_i(y_i - d_i) + f(y_r + d_i)$$

individual

circumstances of recipient

living standard

as perceived by donor i

$y_r$  is the income of representative recipient

$d_i$  is the gift by person i

**Is SWF a function of  $U_i = u_i + f()$  or of  $u_i$  ?**

If the second element captured *negative* feelings towards others, then we would have little hesitation in ignoring such feelings of jealousy. Sir Dennis Robertson, referring to the possibility that the existence of envy might make it impossible to say social welfare had increased even if everyone had more of everything, said that we should “call in the Archbishop of Canterbury to smack people over the head if they are stupid enough to allow the increased happiness ... to be eroded by the gnawings of the green-eyed monster” (1954, page 678).

But there are also those who argue that we should ignore  $f()$  where the feelings are *positive*. In his recent discussion of warm glow preferences for giving for public goods, Diamond notes that “the fact that warm glows improve the description of individual behaviour does not necessarily imply that social welfare should be defined including warm glows” (2006, page 915). In part, his counter-arguments are specific to the warm glow formulation, treating it as a concern with process rather than outcome, whereas here I have adopted an outcome interpretation of giving for development. But in terms of outcomes, too, Diamond concludes that  $f()$  should not be included. In part, his argument is that inclusion of warm glow motives is double counting. In the case of a national SWF, however, there is no double counting since the recipients are assumed to be in a different country.

**f() may be welfare, but also may capture**

- **reduction in poverty**
- **reduction in specific poverty (food, shelter, water, health)**
- **increase in capabilities**

**If f() is non-welfarist, can the SWF be purely welfarist?**

## Concluding words

**“Robbins is undoubtedly correct. ... ethical conclusions cannot be derived in the same way that scientific hypotheses are inferred or verified. But it is not valid to conclude from this that there is no room [for] “welfare economics”. It is a legitimate exercise of economic analysis to examine the consequences of various value judgments” (Paul Samuelson, *Foundations of Economic Analysis*, 1947, page 220).**

**"Theoretical welfare economics proceeds from a number of definite assumptions ... which are seldom stated explicitly. If their nature were more widely appreciated by professional economists, it is improbable that the conventional conclusions of welfare theory would continue to be stated with as little caution as is at present the custom" (Jan Graaff, 1957, page 1).**

## Partnership needed

**“There are few moral philosophers with the command of the technical apparatus of economics required” (Hausman and McPherson, 1996, page 207).**

**“I quite agree with Mr Fraser that an economist who is only an economist ... is a pretty poor fish” (L Robbins, *Preface to the Second Edition*, page ix).**