



ETHICS AND ECONOMICS

Lecture Notes for Week 5

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Neoclassical Synthesis, Post-Keynesian Economics and Justice

Besides the mainstream Neoclassical Synthesis, there exists another non-orthodox, broad research programme, sometimes referred to as the Post-Classical programme. Post-Keynesian economics is one of the schools within this programme. Other schools include e.g. Neo-Ricardians, Institutionalists, Socioeconomists, Evolutionarists, and Marxists. Some schools, such as the Austrian and Neo-Austrian schools, do not fit into the Post-Classical programme.

The philosophical foundations of the mainstream and Post-Classical programmes differ. Economists often discuss these differences in terms of methodology, though some differences are more epistemological (concerning the nature of knowledge) than methodological (concerning how knowledge is obtained). We maintain this terminology for simplicity.

The Neoclassical Synthesis has coherent methodological and theoretical foundations. Students learn these foundations in undergraduate courses on microeconomics, macroeconomics, and econometrics. Post-Keynesian economics shares its methodological foundations with other schools in the Post-Classical programme and has its own coherent theoretical base, developed primarily at Cambridge (England) by Joan Robinson (1903–1983), Michal Kalecki (1899–1970), Nicholas Kaldor (1908–1986), and others - not limited to Cambridge.

Mainstream's Methodological Base – Key Points:

- **Importance of Predictions and Instrumentalism:** Good knowledge leads to accurate predictions. Effective models are useful tools that yield accurate predictions, with unrealistic assumptions acceptable if they support predictive accuracy.
- **Methodological Individualism:** This principle posits that all economic phenomena can be explained by examining the actions and interactions of individual economic

agents. It asserts that collective behaviors, institutions, and structures result from individual decisions and interactions, emphasizing the importance of microeconomic foundations in understanding macroeconomic phenomena.

- **Substantive Rationality:** In mainstream economics, this implies optimizing behavior by individuals, with consumers maximizing utility and firms maximizing profit. Agents are assumed to have perfect information and unlimited computational capacity.

Post-Keynesian's Methodological Base – Key Points:

- **Importance of Understanding:** Good knowledge leads to thorough understanding and interpretation. A real-time narrative is essential, and assumptions must be realistic and testable. Assumptions are used as stylized facts (e.g., prices are set based on costs and a markup), while auxiliary assumptions (assumptions solely for model solvability) are minimized.
- **Methodological Holism:** This approach considers the broader social context as crucial to understanding economic phenomena. Individual choices are highly constrained by social structures (e.g., classes, norms, values, social pressures, macroeconomic events). Income distribution among classes critically influences macroeconomic activity. The typical industrial structure in modern economies is one of imperfect competition with strategic interactions.
- **Procedural Rationality:** Agents are assumed to have limited capacities for information gathering and computation. Decisions are often made under true uncertainty, where probability distributions are unknown. Instead of optimizing, agents rely on conventions and rules of thumb shared with others.

Mainstream's Theoretical Base – Key Points:

- Constrained optimization by consumers and firms.
- Utility maximization by consumers.
- Profit maximization by firms.
- Prices adjust to clear markets.

- Employment is determined by the labor market, with potential GDP dependent on employment via the production function.
- Classical dichotomy exists.
- Money supply is exogenous, with no long-term effect on the real economy.
- Inflation is a monetary phenomenon.
- The Solow growth model and its modifications are basic tools for analyzing long-term growth.

Post-Keynesian's Theoretical Base – Key Points:

- Consumer choice is based on procedural rationality.
- Firms in modern economies are price-setters, with growth as their main objective.
- Temporal equilibria with non-clearing markets exist.
- Credit and endogenous money are typical features in modern economies.
- The conflicting claims model is used for analyzing inflation.

In this chapter, we illustrate the differences between the Neoclassical Synthesis and Post-Keynesian economics in the theory of choice, the labor market, and inflation, with special emphasis on justice in the labor market and justice related to inflation. In the theory-of-choice section, we clarify the role of uncertainty in substantive versus procedural rationality. Appendix 1 presents points for discussing the ethics of war and peace, Appendix 2 promotes David Hume's *A Treatise of Human Nature*, and Appendix 3 provides further information on readings recommended in Chapters 3 and 4.

Theory of Choice

Uncertainty and Procedural Rationality:

Types of Uncertainty:

1. **Certainty:** Each choice leads to a specific, known outcome.
2. **Risk:** Each choice leads to a set of possible outcomes, each with a known value and probability.
3. **True (Fundamental) Uncertainty:** The probability, value, or even the existence of possible outcomes is unknown, as are some of the choices.

A rational agent in the real world encounters a mix of certainty, risk, and uncertainty.

Such an agent:

- Considers probabilities from past similar events or subjective introspection, along with the credibility of the information.
- Uses procedural (bounded) rationality, which involves rules of thumb based on conventions and social norms respected in their social group. Conventions and norms, shaped by imitating successful individual rules, influence individual decision-making.
- Relies on rules of thumb when information overload or high computational demands arise.

Procedural Rationality does not require optimization, only reasonable judgment.

Rules of Procedural Rationality (developed by the economists John Maynard Keynes and Herbert A. Simon):

- Stop searching once a satisfactory solution is found.
- Use the present and recent past creatively to shape beliefs about the future.
- Assume current beliefs about the future are correct but:
- Seek alternatives when existing options are too uncertain.
- Take actions that reduce uncertainty.
- Postpone decisions when uncertainty is excessive, if possible.

Mainstream Approach to Consumer Choice – Key Points:

- Based on Methodological Individualism and Substantive Rationality.
- Presented mathematically as constrained optimization:
 - Firms make choices based on expected profit maximization, subject to technological or institutional constraints.
 - Consumers make choices based on expected utility maximization, subject to budget constraints. Unlike the Post-Keynesian approach, consumers determine their substitutable wants, with savings resulting from intertemporal optimization to smooth consumption over time.
- Assumes perfect information. While risk can be included in calculations, situations involving fundamental uncertainty are not addressed.

Post-Keynesian Approach to Consumer Choice – Key Points:

- **Distinction between Needs and Wants** (worked on by economists Carl Menger, Alfred Marshall, and psychologist Abraham Maslow):
 - Needs form a hierarchy and are differentiated, with no substitution among them. Wants are undifferentiated, with substitution possible.
 - Consumers satisfy their needs through various wants.

Maslow's Hierarchy of Needs:

1. Physiological needs (air, water, food, sex, sleep)
 2. Safety needs (health, education, shelter, stability, protection)
 3. Social needs for belonging and love
 4. Needs for self-respect and esteem from others
 5. Moral needs (truth, justice, aesthetics, meaning of life)
- With rising income, consumers' needs and wants change, following the conventions of their social group. In other words, individual consumption patterns are influenced by the demand structure of consumers with similar income, jobs, or location.
 - Consumers can move up the pyramid and may return to lower levels by satisfying needs with other wants.

Realism of the Post-Keynesian Approach:

- Advertising relies on imitative behavior.
- It explains why households typically lack savings. Post-Keynesians believe permanent savings result just from forced saving, such as mortgages or pension plans. Households may voluntarily save temporarily when income rises if they need time to learn how to allocate the increased income

Labor Market and Justice

Mainstream Approach – Key Points:

- **Demand for Labor:** Demand for labor is decreasing and is determined by the marginal product of labor.
- **Labor Supply:** Individuals optimize their labor supply based on their preferences for labor and consumption. Labor is considered a disutility. The shape of the indifference curves is assumed to make the labor supply curve upward-sloping.
- **Labor Market Clearing:** The labor market clears through changes in the real wage, which is set at the level of the marginal product of labor. Similarly, payments for capital are based on the marginal product of capital, implying a sense of fairness.

Post-Keynesian Approach – Key Points:

- **Labor Demand:** Demand for labor is derived from supply and demand conditions in the goods market. Keynes called it the effective demand and believed that employment was determined by it. The effective labor demand curve is vertical.
- **Labor Supply:** The Post-Keynesian theory of labor supply is linked to its theory of consumption.
 - Consumers are driven by normative and cash flow considerations to maintain customary income levels.
 - A temporary increase in real wages may lead a consumer to work less, while a permanent increase might encourage them to change their reference group and aspire to a higher standard of living.
- **Labor as Utility:** Labor is not merely a disutility; people work both to earn income

for consumption and for self-realization.

- **Labor Supply Curve:** The individual labor supply curve in Figure 5.1 slopes downward, reflecting the income necessary to achieve the desired standard of living (SL). The curve's position depends on differing demands for living standards.

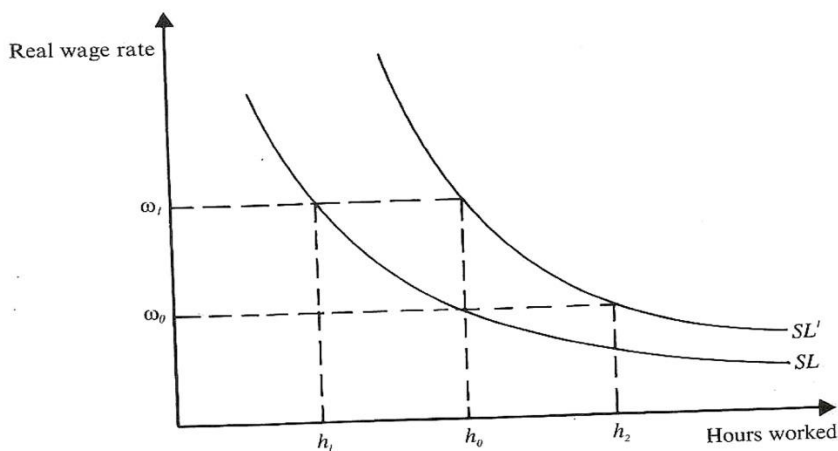


Figure 5.1: The individual labor supply curve.

After aggregation, the SL curve on the labor market can take any shape and slope, depending on the time horizon of the analysis. In the short run, labor supply is independent of the real wage, so the SL curve is vertical.

In Figure 5.2, we use the standard mainstream labor market diagram with effective demand for labor set on the goods and services market. The labor market does not clear through changes in the real wage. Instead, the real wage is the result of bargaining about the undetermined income between employers and employees, who are often organized in trade unions. Justice is here an important consideration.

Wage bargaining impacts not only the distribution of income but also affects unemployment—the distribution of jobs, and inflation—the distribution of wealth. All these

distributions have a high potential for discussions on justice.

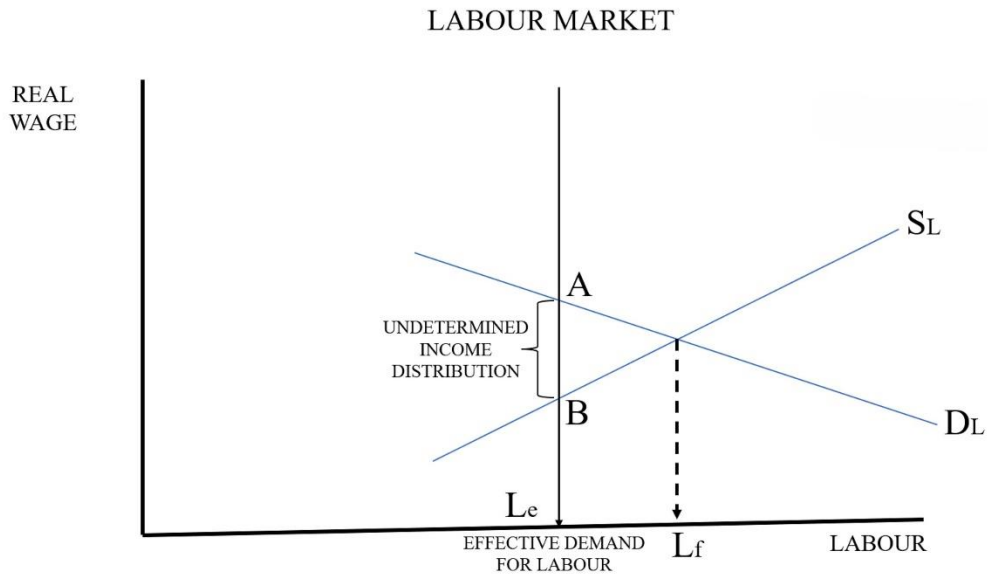


Figure 5,2: Undetermined income distribution in the labor market.

Inflation and Justice

Mainstream Approach – Key Points:

- Inflation is a monetary phenomenon.
- It redistributes wealth from creditors to debtors.

Post-Keynesian Approach – Key Points:

- Inflation is not a purely monetary phenomenon.
- It redistributes wealth from creditors to debtors.
- The competing claims model of inflation:
 - Each bargaining group attempts to secure a particular share of the economy's output. The outcome of bargaining depends on market power and the strength of each side's arguments.
 - If competing claims are inconsistent, each group may try to secure its claim using market power—workers may seek higher wages, rentiers their interest claims, the state its tax revenue, and foreign countries their import costs. Firms, assumed to be price-setters, will respond by raising prices, resulting in inflation.
- Seeking a fair wage is a primary motivation behind demands for wage increases.
 - *Just relative wages*: Workers seek to maintain their status in the labor hierarchy, where wage levels can be balanced by occupational prestige, though not entirely.
 - *Just real wages*: Real wage resistance occurs as workers strive to maintain purchasing power.
 - *Large or rising profits*: Increased profits can lead to demands for fair nominal wage increases.

The first point above relates to wage-wage inflation, while the second and third points relate to wage-price inflation.

Summary

The introduction outlines the differences between the mainstream Neoclassical Synthesis and the Post-Keynesian economics:

1. Methodological Bases:

- **Mainstream:** Emphasizes predictions and instrumentalism, methodological individualism, and substantive rationality, where individuals maximize utility (consumers) or profit (firms) with perfect information.
- **Post-Keynesian:** Focuses on understanding and realistic assumptions, methodological holism, and procedural rationality, where decisions are often made under fundamental uncertainty, relying on shared conventions rather than optimization.

2. Theoretical Bases:

- **Mainstream:** Relies on constrained optimization, market-clearing prices, an exogenous money supply, and uses the Solow growth model to analyze long-term growth.
- **Post-Keynesian:** Features price-setting firms focused on growth, non-clearing markets, endogenous money, and the conflicting claims model for inflation analysis.

The first part contrasts the mainstream and Post-Keynesian approaches to consumer choice. Mainstream approach assumes individuals maximizing utility (consumers) or profit (firms) with perfect information, using constrained optimization. It generally addresses only the situations of certainty and risk. Post-Keynesian approach addresses the situations of fundamental uncertainty, in which agents rely on rules of thumb and social conventions

instead of strict optimization. Consumers have a hierarchy of needs; their consumption patterns evolve with income and reflect social group norms.

The second part contrasts the mainstream and Post-Keynesian views on the labor market. In the mainstream approach, the labor market clears through adjustments in real wages, aligning wages with the marginal product of labor for perceived fairness. In the Post-Keynesian approach, labor demand is derived from supply and demand conditions in the goods market. The real wage is the result of bargaining about the undetermined income between employers and employees, who are often organized in trade unions. Justice is here an important consideration. Unlike the mainstream view, labor is also seen as a means of self-realization, with a downward-sloping individual labor supply curve reflecting the income needed for a desired standard of living.

The third part compares mainstream and Post-Keynesian views on inflation. The mainstream approach views inflation as a monetary phenomenon. The Post-Keynesian approach uses the competing claims model, where various groups (workers, rentiers, the state, foreign entities) vie for a share of economic output. This competition can lead to inflation as price-setting firms raise prices to balance competing claims. Ethical concerns arise from "just" wage pressures, where workers seek wages that reflect status (relative wage justice), maintain purchasing power (real wage resistance), and respond to rising profits with demands for fair nominal wage increases.

Appendix 1: Ethics of War and Peace

War is a controlled use of force by persons organized in a chain of command. Carl von Clausewitz, a prominent Prussian military theorist, thought that the use of force in war must be directed to an identifiable political result. In his seminal work "On War," he famously described war as "the continuation of politics by other means," emphasizing that military conflict is not an isolated activity but an instrument of political objectives. He argued that war is characterized by its inherent uncertainty, friction, and the "fog of war," where chance and unpredictability play significant roles. Clausewitz also introduced the concept of the "trinity" in war, comprising the government, the military, and the people, highlighting the dynamic interplay between these elements. His insights underscore the strategic, psychological, and chaotic nature of warfare, making his theories enduringly relevant to military strategy and political analysis.

A *realpolitik* perspective on justice in war prioritizes pragmatic and strategic considerations over moral or ethical ideals. From this viewpoint, the primary goal of engaging in or conducting a war is to advance national interests, secure power, and achieve practical objectives, rather than to adhere to abstract principles of justice or righteousness. *Realpolitik* acknowledges the harsh realities of international relations, where might often makes right, and decisions are driven by the balance of power and the pursuit of advantage. In this context, justice in war is measured by the effectiveness of achieving desired outcomes and maintaining state security and sovereignty, rather than by adherence to ethical norms or legal standards. This perspective tends to be skeptical of the idealistic pursuit of just war theories, focusing instead on the tangible benefits and consequences of military actions.

A pacifistic perspective on justice in war fundamentally opposes the use of violence and holds that true justice cannot be achieved through warfare. Pacifists argue that war inherently involves unjust actions, such as the killing of innocents, widespread destruction, and long-lasting trauma, which cannot be justified by any political or strategic gains. They advocate for nonviolent means of conflict resolution, emphasizing diplomacy, dialogue, and peaceful negotiation as the pathways to resolving disputes and achieving justice. From this viewpoint, justice in war is an oxymoron (a combination of words that creates a paradoxical effect), as the very nature of war contradicts the principles of respect for human

life, compassion, and moral integrity. Pacifists believe that a just and peaceful world can only be realized through the renunciation of violence and the commitment to resolving conflicts through nonviolent, ethical means.

Just war theory is a philosophical framework that seeks to provide ethical guidelines for the justification and conduct of war. It is divided into three main parts: *jus ad bellum*, *jus in bello* and *jus post bellum*. It attempts to conceive of how the use of arms might be restrained, made more humane, and ultimately directed towards the aim of establishing lasting peace and justice. Terrorism and counterterrorism warfare, humanitarian interventions and civil wars ought to be handled with respect to their specific features.

For early Christians, “do not meet violence with violence” was unambiguous. Becoming the “state religion” Christianity adopted the early Greek notion that some wars are just. In the Middle Ages, Thomas Aquinas wrote that a war is just, when:

- A legitimate authority declares the war,
- The war is waged for a just cause,
- The war is fought using just means.

International law specifies legal rules for war and mirrors the development of the just war theory.

Jus ad bellum outlines the conditions under which it is morally permissible to go to war, such as:

- Being declared by a legitimate authority,
- Being a last resort,
- Having a Just Cause: Throughout history, views on just causes have evolved. For example:
 - For Aristotle (384–322 BCE), a just cause was "to enslave those who naturally deserve to be slaves." However, he also believed, "We should wage wars for the sake of peace."
 - For Marcus Tullius Cicero (106–43 BCE), "The only proper cause for the use of force is 'wrong received,'" such as:
 - Verbal disrespect,

- Acts or policies of a foreign government that violate our rights.
- For J. S. Mill (1806–1873), it was "to bestow the benefits of Western civilization on less advanced people."
- Other views on just cause include:
 - Forcible conversion,
 - Love of war,
 - Love of conquest,
 - Anticipatory self-defense,
 - Collective self-defense:
 - Without a prior mutual defense agreement,
 - With a prior mutual defense agreement.
- According to the international law, the only just causes for entering a war are:
 - If the state is a victim of aggression,
 - For states that have a mutual defense agreement: if some member is attacked.
- Possessing the right intention: In just war theory, just cause and just intention are distinct but interrelated criteria that must both be satisfied for a war to be morally justified. Just cause refers to the legitimate reasons for engaging in war. It addresses the substantive reasons that warrant the use of force. Just intention, on the other hand, concerns the ethical motivations behind the decision to go to war. Even if a war has a just cause, it must also be waged with the right intentions, aiming to achieve peace and justice rather than pursuing self-interest, revenge, territorial expansion, or economic gain. Together, these criteria ensure that wars are fought for legitimate reasons and with ethical motivations, aligning the decision to go to war with both moral and practical considerations.
- The rule of proportionality in jus ad bellum: it dictates that the anticipated benefits of engaging in war must be proportionate to the expected harm and destruction it

will cause. This means that a state considering going to war must evaluate whether the use of force is likely to produce a greater good that outweighs the suffering and damage inflicted by the conflict. The principle ensures that military action is only taken when the positive outcomes, such as restoring peace, protecting innocent lives, or achieving justice, significantly surpass the negative consequences, including loss of life, economic disruption, and social upheaval. Proportionality serves as a moral check to prevent excessive or unnecessary use of force, ensuring that war remains a last resort used only when it is justified by a sufficiently significant cause.

Jus in bello sets the ethical rules for conduct during war. Over centuries, a vast array of rules and customs has been elaborated, e.g. the rights of (suspected) enemy combatants. These rights are based on following three leading principles:

- Principle of necessity: a wanton destruction is forbidden,
- The rule of proportionality in jus in bello: it dictates that the importance of a military action must be proportionate to the expected harm and destruction it will cause.
- The principle of non-combatant immunity (principle of discrimination): Even if casualties are unavoidable, there is a difference between intentional and unintentional killing.

Jus post bellum seeks to establish a stable and just order after conflict, preventing future violence and promoting lasting peace. It focuses on ensuring that peace and justice are restored once the conflict ends. Key principles of jus post bellum include proportionality and discrimination in post-war settlements, ensuring that the terms of peace are fair and just for all parties involved, and the war reparations are not overly punitive towards the defeated side. It also emphasizes the need for rebuilding and reconstructing war-torn societies, addressing war crimes, and ensuring accountability and reconciliation.

What are current wars like? Alvin and Heidi Toffler wrote in 1993 the book “War and Antiwar – Making Sense of Today’s Global Chaos”. They describe many phenomena that we can see in current wars, e.g.:

- The mass disinformation for getting the support of population,
 - Exaggeration of enemy’s cruelty,
 - Demonization or dehumanization of the enemy,
 - Enemy always lies,
 - Exaggeration of “what is in stake”,
 - Polarization: “Who is not with us is with the enemy”,
 - Religious or ideological support: “God is with us”).

Does the weapon industry contribute to peace? The weapon industry, by its very nature, is typically not seen as a contributor to peace, as its primary purpose is to produce arms and military equipment for use in conflict. However, proponents argue that a well-regulated and responsibly managed weapon industry can contribute to peace in certain contexts. For instance, it can support national defense and deterrence strategies, which may prevent potential aggressors from initiating conflict, thereby maintaining stability and peace. Additionally, international arms control agreements and regulations can help manage the proliferation of weapons, aiming to prevent them from falling into the hands of non-state actors or rogue regimes. Critics, however, contend that the weapon industry often exacerbates conflicts, fuels arms races, and profits from war, making its overall contribution to peace highly contentious and debatable.

Does the shift from conscription to a professional army contribute to peace? It can contribute to peace in several ways, though its impact can be complex and context-dependent. A professional army is typically composed of highly trained, volunteer soldiers who choose military service as a career, which can lead to a more disciplined and effective military force. This professionalization can reduce the likelihood of misuse of military power and ensure that the armed forces are better prepared and equipped for conflict resolution and peacekeeping operations. However, the move to a professional army can also lead to a detachment between the military and civilian populations, potentially reducing public

scrutiny and accountability. In some cases, professional armies might be more likely to be used in foreign interventions, which could either stabilize or destabilize regions depending on the circumstances.

Appendix 2: David Hume: “The Treatise of Human Nature”

David Hume (1711 – 1776) was an opponent of philosophical rationalists, Hume held that passions rather than reason govern human behavior. Hume was also a sentimentalist who held that ethics are based on emotion or sentiment rather than abstract moral principle. He maintained an early commitment to naturalistic explanations of moral phenomena and is usually accepted by historians of European philosophy to have first clearly expounded the idea that a statement of fact alone can never give rise to a normative conclusion of what *ought* to be done.



"The Treatise of Human Nature: Being an Attempt to Introduce the Experimental Method of Reasoning into Moral Subjects", first published in 1739-40, is a classic statement of philosophical empiricism, scepticism and naturalism. In the introduction Hume presents the idea of placing all science and philosophy on a novel foundation: namely, an empirical investigation into human nature. Impressed by Isaac Newton's achievements in the physical sciences, Hume sought to introduce the same experimental method of reasoning into the study of human psychology, with the aim of discovering the "extent and force of human understanding".

Appendix 3: More about readings promoted in the 3rd and 4th chapters

Jeremy Bentham: An Introduction to the Principles of Moral and Legislation. Chapters 1-4:

- „Nature has placed mankind under the governance of two sovereign masters, *pain* and *pleasure*.“
- „The *principle of utility* recognizes this subjection.“
- „The community is a fictitious *body*, composed of the individual persons. The interest of the community then is the sum of the interests of the several members who compose it. “
- „Is the principle of utility susceptible of any direct proof? it should seem not: for that which is used to prove everything else, cannot itself be proved: a chain of proofs must have their commencement somewhere. To give such proof is as impossible as it is needless. “
- „To prove any other principle, therefore, to be a wrong one, there needs no more than just to show it to be what it is, a principle of which the dictates are in some point or other different from those of the principle of utility: to state it is to confute it.“
- „It has been shown that the happiness of the individuals, of whom a community is composed, that is their pleasures and their security, is the end and the sole end which the legislator ought to have in view: the sole standard, in conformity to which each individual ought, as far as depends upon the legislator, to be *made* to fashion his behavior. But whether it be this or anything else that is to be *done*, there is nothing by which a man can ultimately be *made* to do it, but either pain or pleasure. “
- „Pleasures then, and the avoidance of pains, are the *ends* that the legislator has in view; it behoves him therefore to understand their *value*. Pleasures and pains are the *instruments* he has to work with: it behoves him therefore to understand their force, which is again, in other words, their value. “

Ludwig von Mises: Human Action Introduction and Chapter I "Acting Man" :

- Economics emerged as a science when a regularity in the sequence and interdependence of market phenomena was discovered.
- Economic problems cannot be isolated as they are just a segment of a general science of human action.
- Praxeology is the science of action as such, which studies the results deduced from the fact that people have goals and adopt means to achieve them.
- For an action to occur, the actor must be in a state of unease, imagine a more satisfactory state, and believe that purposeful behavior can reduce the uneasiness.
- The study of human action begins with the ultimate given of human action itself.