Economics in Social Policy: A Philosophical Analysis

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Abstract

Recent years have seen a substantial expansion of the role of neo-classical economics in providing analysis of, and advice on, social policy issues. Yet relative to the burgeoning role of neo-classical economic theory in social policy, there has been little philosophical inquiry into the social dimensions of this mode of economic thought. The paper below develops this inquiry from a diagnostic perspective. It outlines the aims and methods of neo-classical economics in social policy, and examines how these aims and methods are justified. The paper then identifies theoretical and practical problems with economics so conceived, and demonstrates how these problems affect contemporary social policy issues.

Introduction

Economics is fundamentally an advice giving discipline.[1] In all its various forms, it is orientated towards the social world, and is concerned with defending, re-shaping or rejecting existing social orders. The focus of this paper is the contemporary relationship between economics and the social order. More specifically, it is concerned with the existing economic orthodoxy - neo-classical economics - and the influence it wields on social policy. The fundamental question of this paper is the extent to which this influence is justified. Or, more precisely, it focuses on the extent to which the role economic theory has adopted in social policy is in our social interest; whether the voice of economists in social policy is too loud. It thus shares its motivation with that of Nancy Cartwright (1999), who eloquently wrote that

> not prizing the purity of our affirmations, I am not afraid that we might hold false beliefs... The problem is not so much that we will adopt the wrong images to represent the world, but that we will choose the wrong tools with which to change it. (p. 12)

The paper begins by outlining a prominent conception of neo-classical economics in terms of some basic, but relatively unexplored, questions. What is the task of neo-classical economics? What are its methods? And what knowledge do these methods reveal about the world? The paper then relates this theoretical conception to social policy. It examines the role neo-classical economists suppose themselves and their theories to have in social policy, and questions whether this role is adequately realised.

1. What defines neo-classical economics?

A definition generally associated with neo-classical economics is Robbins' (1972) famous statement that "[e]conomics is the science which studies human behaviour as a relationship between ends and scarce means that have alternative uses" (p. 16). The starting-point of Robbins' definition is that it is a basic condition of human life that we face a limited amount of resources and a practically unlimited number of uses towards which these resources can be put. Consequently, we are presented with an inescapable problem: how can we best allocate our resources in order to reach our goals?

Neo-classical economics purports to address this problem by analysing human behaviour in conditions of choice subject to constraint. Generally, this analysis consists of creating models of human behaviour, where a hypothetical person or group is attributed an outcome or desire, usually utility - or welfare - maximisation, and specified constraints, such as time or money. The goal of the economist is to say something systematic about behaviour in these hypothetical circumstances, from which conclusions can be drawn about how best to manage them in real life.

A simplistic model would work as follows. Assume a person has two choices of activity in a given day: work and leisure. That person's goal is to maximise his or her utility, subject to the constraint that there is only so much time in a day. Leisure and money increase utility, whereas work decreases utility. The interest of the neo-classical economist is to study how the hypothetical person would allocate his or her time between work and leisure, and how this allocation would be affected by different circumstances. For instance, would the hours a person works increase if wages were increased? The answer: maybe. On one hand, motivation to work increases with an increase in wages, as the person receives extra income for each hour worked. On the other hand, since overall income increases with an increase in wages, there is also a motivation to work less, as the same amount of income can be received from less work, thus leaving more time for leisure.

So far, the whole endeavour seems fairly plausible and uncontroversial. Surely, there are some systematic relationships in human behaviour, as in the last example, so why not analyse them in systematic form? However, there are two points to note about neo-classical economics that make it of critical significance to social policy.

First, because neo-classical economics is a *method* of analysing human behaviour, it is not limited to stereotypically economic questions, such as wealth, wages and income.
Rather, neo-classical economic analysis can be applied to, and generally has been applied to, human behaviour in *any* circumstance that can be construed as an instance of choice subject to some constraint. On reflection, all human behaviour can be construed in this way: choice and limitation are a part of human behaviour in love and war as much as in the context of market exchange. Hence, neo-classical economists have studied issues as diverse as the economics of family life, the economics of adultery, and the economics of suicide.

Second, neo-classical economic analysis is defined by selective attention to the different factors affecting human behaviour. In neo-classical economics, all relationships amongst individuals are modelled on market relationships, whereby individuals are conceived of as isolated, self-interested and relating instrumentally to whatever resources or people they encounter.

What is important is the conjunction of these two points; neo-classical economics is applicable to a vast range of circumstances, but takes on board only a limited number of factors.

Yet, the results of economic models are offered - and taken seriously - as revealing something useful about human behaviour in society, and so influence the nature and direction of social policy.

The question of the next section follows from this observation. Given that neo-classical economics offers advice on policy issues, what type of knowledge is being offered, and how is it supposed to be justified?

2. Economic methodology

This section examines two different accounts of the nature and justification of the claims economists make about human behaviour in society. These two accounts, based on the work of Lionel Robbins and Milton Friedman, are clearly not exhaustive. However, they are cited as significant reference points in the literature for determining the way economists explicitly or implicitly answer methodological questions. Since the ideas of economists do affect policy, it is these views I want to focus on.[2]

Lionel Robbins

Robbins' idea is that economic knowledge consists primarily of logical deductions from a series of basic postulates. On Robbins' (1972) account, these postulates are "simple and indisputable facts of experience" (p. 78), which only need to be stated in order to be obvious. From the model cited in Section I, such facts would include the claims that people face limited hours in a day, prefer more money than less, and prefer leisure to work. Although these facts may seem trivial, Robbins argues that economics can derive complex propositions from them by analysing their consequence formally and rigorously.

If one adopts this view of economics, what justifies economic claims is clear: logic and solid starting-points justify economic claims. In fact, if the chain of reasoning is correct, and the starting-points sound, then an economic claim is a necessary law, in a sense comparable to natural scientific laws. The caveat to this claim, and it is an important one, is that economic laws are only necessary in 'pure economics', which is another way of saying in economic models. Outside economic models, there is no way to be sure that the relationship modelled will observably hold in reality, as any relationship between economic variables can be overshadowed by a range of other factors.

For example, an economist may deduce that an increase in corporate tax rates will increase the inflation rate by a specific amount. However, a whole range of factors influences the inflation rate, so it is extremely unlikely that the relationship will be straightforwardly realised.[3] This illustrates a second difficulty: in economics, unlike many natural sciences, one can rarely create controlled experiments. What this leaves economics with are tendency laws: laws that identify certain tendencies in scenarios for specified outcomes to occur, but not a definite claim that these outcomes actually will occur.

A major difficulty with Robbins' approach is that the relationship between economic claims and the real world starts to look rather mysterious. On paper, economic knowledge is iron-clad, but it is not clear how the laws revealed in theoretical economic analysis relate back to actual social circumstances. This is particularly problematic where the assumptions used to generate particular economic relations are neither logical truths nor simple facts of experience.

For instance, assumptions of perfect competition and perfect information appear frequently in neo-classical economic models, but such conditions are never realised in the actual world. In such instances, Robbins' account leaves room for significant criticisms targeted at the use of patently false assumptions in economic models, while still purporting to deliver meaningful advice about real world circumstances.

Milton Friedman

Milton Friedman's alternative conception of economics is partly targeted at avoiding the whole line of criticism directed at the assumptions of economics. According to Friedman, economics is not about logical deductions, but rather about the prediction and control of empirical variables. Consequently, Friedman (1953) argues that economics is to be judged by "the precision, scope, and conformity with experience of the predictions it yields" (p. 4). On this position, economic assumptions, and economic models more generally, are means to an end. It does not matter whether the assumptions of economics, and the models they support, are accurate or realistic, but rather whether they identify some important economic trend or fact.

The paradigmatic illustration of this point is Friedman's defence of the neo-classical model of firm behaviour in setting prices and output. According to neo-classical economic theory, profit maximising firms set prices and output such that marginal revenue equals marginal cost. That is, firm mangers set prices and output at the quantity where the cost of producing the last unit of output equals the revenue received from the sale of that unit. However, this claim appears contradicted by the actual behaviour of firm managers, who, when surveyed (e.g. Eiteman and Guthrie, 1952), frequently reject the claim that they set price and output according to the neo-classical formula. Given the ubiquity in neo-classical economic analysis of the model of firm behaviour, whereby marginal revenue is equated to marginal cost, such survey results seem deeply problematic for the analytical framework of neo-classical economics.

In response, Friedman argues that what matters in this debate is not whether prices and output are consciously set by firm managers, such that marginal revenue equals marginal cost, but that the prices and output of firms can be usefully modelled *as if* they were. According to Friedman, the competitive pressures of markets ensure that the only firms that survive are those that maximise profit, and economic theory proves that profit is maximised when marginal revenue equals marginal cost. Consequently, regardless of the basis on which prices and output levels are consciously set, they will approximate the price and output levels attributed to firms by neo-classical economic analysis. The influential idea of Friedman's exposition is that economic analysis can deliver useful results, in terms of predictive success, independently of descriptively accurate characterisations of individual or firm behaviour.

There are a number of philosophical difficulties with this position. However, the most pressing issue is the absence of a strong predictive track record for economics, especially in comparison to many natural sciences.[4] In this respect, Friedman's account of economics draws the spotlight from one contentious issue, the assumptions of economics, to another, the absence in economics of a clear record of predictive success.

3. The common ground

Whatever their problems, however, the approaches of Friedman and Robbins are, as noted earlier, prominent means of thinking about economic methodology amongst economists. Clearly, there are significant differences between these approaches, so a natural question to ask seems to be: which one is right?

However, rather than engage in a compare and contrast exercise between Robbins and Friedman, I want to take an approach inspired by Kuhn,[5] and focus on ways that these apparently opposed views form a coherent whole. The idea is to show that if one adopts either conception of economics outlined above, as many economists do, then one will have a common view of the nature and role of economics on key points. I want to identify two of these points, and identify their importance for understanding the relationship between economics and social policy.

First, it is fundamental to both methodologies outlined above that economics is an objective, value-free science. From Robbins' perspective, economics is objective because it is based on logical deduction. These deductions reveal links between social factors that have the status of necessary laws. From Friedman's perspective, economics is objective because it is about, and accountable to, identifiable statistical trends. Clearly, the claim to objectivity has multiple meanings. However, for present purposes, the important aspect of objectivity is the claim that economic theory does not endorse particular social or individual goals over others; it only shows how different goals can be met.

A classic illustration of this claim is a prominent economic critique of minimum wage legislation. According to this critique, minimum wage legislation increases unemployment by increasing the cost of labour to employers. Further, unemployment is created amongst those the legislation presumably tries to protect - those with minimal marketable skills - who are now unable to offer their services at low enough wages for employers to hire them. Thus, it is argued, minimum wage legislation is counter-productive: by trying to protect members of a given social group, it in fact harms them.

Importantly, this argument is generally interpreted as being completely separate from the question of whether a minimum wage is or is not a 'valuable' goal for society to pursue. The idea is that the critique argues that, given existing social mechanisms, minimum wage legislation cannot adequately realise its aim, not that the aim itself is undesirable. It is thus objective or 'positive' economics rather than normative economics.

In a social policy context, the implication of the claim to objectivity is that the ideal economist is, on either Robbins or Friedman's account, the ideal bureaucrat: always an instrument of policy, never the cause. At first glance, there is a certain modesty to this position. Economics does not dictate what sort of goals we should be pursuing in society. Society decides what is valuable, and economics shows how whatever we value can be pursued. One cannot help but suspect at least an implicit contrast here between the modesty of the economist and the God-like aspirations of philosophers, or at least philosophers of a certain kind.

However, the claim to neutrality between social goals nonetheless situates the economist in a powerful position in the public sphere. While economists may decline to comment directly on what goals are *valuable* in themselves, they certainly will comment on what goals are *feasible*. That is, choose whatever social objective one likes, it is the economist that will claim to know the extent to which that objective is attainable. Consequently, economic analysis, at the very least, sets the parameters within which social goals can be pursued, even if it does not directly comment on their merit.

The second point of consensus between Robbins and Friedman is less overt. It concerns a distinction both methodologies draw between knowledge of human behaviour and what it is to *be* human: or, in philosophical terminology, between the epistemology and the ontology involved in economic claims. In particular, economic knowledge of human behaviour is seen as substantially distinct from such issues of how humans think and feel, how they relate to each other in society and, for that matter, what society actually is.

This distinction is seen clearly in Friedman's response to the critique of marginal cost pricing in economics cited earlier. What is central to Friedman's response here is the claim that it does not matter *how* people go about thinking or reasoning in pricing scenarios, only that the outcome predicted by economics eventuates.

The same distinction, although in different form, is seen in the way most economic models are established, which requires minimal reference to the person involved. There is a specified goal and specified resources, and the question is simply how the goal can best, or most efficiently, be realised. In this context, the person in economics figures essentially as a maximisation equation, which relates to an outcome, utility, to means towards that outcome, such as time, leisure or money. Such models are not meant to represent fully-fledged human agents, but rather are meant to reveal certain logical or statistical relations in narrowly defined scenarios.

So what is the relevance of this for social policy? What is relevant is that neo-classical economic methodology systematically endorses the view that economic knowledge of, and intervention in, society does not require detailed knowledge of the kind of questions typical of sociology, psychology and philosophy. In particular, these are questions such as what is human agency, and what range of factors motivate human behaviour in actual social scenarios. Indeed, questions of this sort often seen to be counter-productive. For instance, Meckling (1976) articulates one prominent view within neo-classical economics in stating that "[i]t is difficult to infer much of anything about social behaviour from the psychological model of man that is not trivial or false" (p. 555).

As a consequence, the approaches of economists to public policy modelled on Robbins or Friedman's methodologies tend towards broad theoretical considerations or statistical data, rather than the details of particular circumstance that are not explicable in such terms. This provides one explanation of the kind of attitude noted by Pusey in his study of the Australian public service during economic reform in the 1980s. During this period, Pusey (2003) noted a perception amongst top public servants, almost half of whom were trained in economics or commerce, to view society as a kind of "stubbornly resisting sludge through which one must drive the economy" (p. 183). This attitude can be explained not as some kind of in-built hostility to society, but rather as a conflict between the logic of economic analysis, which recommended reform, and people's felt experience, which frequently resists it.

Within neo-classical economics, people's experience carries very little epistemic weight, because the justification of economics is in logic or economic statistics, not psychology, sociology or philosophy.

4. Assessment of economic methodology

The conception of neo-classical economics examined so far is this: neo-classical economics purports to be an objective science that can provide useful policy advice. This advice is based on models or statistical studies that seek relationships among social variables, while making only minimal claims about the nature of the human agent or the experience which underlies these variables. The question of this section is: how adequate is this conception, particularly given how widely it is being applied? I will respond in terms of the two points outlined in Section III.

First, the claim of neo-classical economics to objectivity between different social goals is unsustainable, because the way economics models social situations influences what seems like plausible goals.[6] The basis of this claim is that, as mentioned earlier, neo-classical economics is in part defined by the fairly narrow way in which it models social circumstances. Specifically, social scenarios are modelled based on a conception of humans as isolated individuals, who approach each other and their world instrumentally, and who are concerned with maximising their utility.

Now, the neo-classical model of social scenarios may be a potent means of analysing certain problems, but the value of different goals, particularly in a social policy context, is not independent of the model. That is, after analysing a problem in neo-classical terms, it is not the case that whatever goals society wants to pursue are of equal value in relation to the model that has been developed. Rather, neo-classical economics has its own logic. In view of the way it models social scenarios, it highlights certain problems or objectives over others, and implies more or less rational ways of responding to them.

As an example, consider a basic neo-classical model of a university. Generally speaking, such a model construes education as an instrumentally valuable service, a university solely as a provider of that service, and students as purchasers of the educational product. My argument is that not only does this model a university, it also implies the broad goals that should be pursued in managing a university. Specifically, these are the kind of goals of many service providers, such as efficiency,[7] profitability and customer service.

By contrast, if one considers a university as part of an educational tradition with its own norms and values, and with intrinsic rather than instrumental value, then the goals involved in managing that institution are different. That is not to say that one will not consider efficiency, but that goals like efficiency have less weight, as there are other goals now in view. These goals may be centred on traditional academic ideals such as the unfettered pursuit of knowledge or the maintenance of a range of academic standards. The point here is not that one understanding of a university is necessarily better, or that one set of goals completely excludes the other. Rather, the point is that each interpretation of a model of a university has a built-in conception of value, because it is compatible with, or more suggestive of, some values or goals, and not others. Consequently, the claim of neo-classical economics to neutrality is a misleading one.

In policy terms, what this means is that a debate over how to manage certain policy issues is as much about how to understand the question as it is about the answer. For instance, from this perspective, contemporary debates over education are as much about how education is be conceptualised as how education is to be resourced.

It is important to be clear about when the claim to value neutrality is likely to be a problem. In some contexts, such as in an analysis of price movements in financial markets, there may be little inherent conflict between a neo-classical economic mode of thought and alternatives. In such circumstances, the orientation of neo-classical economic analysis towards particular goals may be of little practical interest. However, as noted in section I, neo-classical economics is applied in areas well beyond stereotypical economic questions concerned with financial management. In these areas, this form of economics frequently faces at least plausible alternative modes of thought with their own in-built modes of valuation. The main point, then, is that neo-classical economic thought in these contexts is a mode of valuation in conflict with others. It may be beneficial, and it may be useful, but it is certainly not neutral.

The conflict here between neo-classical economics and alternative modes of thought relates to the second issue, which is the extent to which economics can provide useful knowledge of human behaviour, while making minimal claims about actual human nature and agency. Or in other words, the extent to which economic knowledge of human behaviour can divorce itself from psychological, sociological and philosophical questions such as what it is be human, what *is* society, and what norms and goals govern existing social practices.

There are two points to be made here. The first is fairly straightforward: insofar as economists affect human society through policy, the primacy of logic or statistics in neo-classical economic analysis is inadequate relative to the self-professed aim of economics. If one intervenes in society with the goal of improving social choice, then wide-ranging knowledge of actual human nature and society is of paramount importance. The second point is subtler. It is based on the claim that human behaviour is affected by our understanding of what it is to be human, and by our understanding of the kinds of norms and motivations that underlie human relations.[8] For instance, the way I behave around family and friends is party driven by the idea that they are to some degree motivated by a concern for my interests as well as their own. The way I behave in a team is informed by the idea that we share an objective and a commitment to some goal. And, as Sen (1997, p. 332) famously noted, even the simplest interactions in society frequently depend on the perception that other people's behaviour is governed by more than just self-interest.

Now, economics, in studying human behaviour, offers one interpretation of how humans behave in a variety of scenarios, including all the scenarios just mentioned. In so doing, economics does not just model human behaviour, but in many instances challenges existing understandings of how humans behave. Consequently, it risks affecting how people actually behave by changing their perceptions of what motivates them and those around them. For instance, studies have indicated that economics students tend to act in a more self-interested manner than do non-economic students (Marwell and Ames, 1981; Frank *et al*, 1983). This supports the idea that economics offers a certain conception of what it is to be a human, the acceptance of which then affects human behaviour. In this context, as Hausman and McPherson (1994) note, economics does not just model behaviour, it also legitimises certain social forms of conduct over others.

This observation has widespread implications. Consider again the economic claim that setting a minimum wage rate will increase unemployment. Although this may seem simply descriptive, it in fact relies on a specific understanding of human behaviour, whereby employers will retrench low paid workers if wages increase to some basic living standard. The basis of this understanding is in turn a certain norm of firm owner behaviour; in particular, that the accountability of firm owners is almost solely to profits, such that if basic wages threaten profits even minimally, these profits will be defended. However, such a description simply excludes alternatives, such as that firm owners can choose to recognise a social obligation to the low paid workers they employ.

The point of this example is not to say what firm owners should or should not do. Nor is it to suggest that economics is solely responsible for cultivating existing attitudes. Rather, it is to note that, even in seemingly straightforward instances, the behaviour economics 'describes' depends on how the humans involved understand themselves, their motivations and their obligations. Neo-classical economics analyses situations primarily based on one motivational structure, and by so doing it endorses, in practical terms, a mode of conduct as well as models it.

The question I think this leaves is whether, given that economists shape society in this way, there is an onus on economists to develop a more rigorous understanding of the society it shapes. Although this question has moral overtones, I think it is a more practical one. It questions whether neo-classical economics, as it is, has the conceptual resources to live up to its self-appointed charter of improving social decision making. My argument is that such a charter cannot rest on the stripped back analysis of human behaviour currently found in neo-classical economics: it must incorporate a far deeper engagement with its human subject-matter.

Conclusion

To return to my opening quote from Cartwright. The difficulty with economics is that there is no clear distinction between the images with which it represents the world and the tools with which it changes it. The images with which economists represent the world are contested, and the success of different modes of representation necessarily changes the reality itself. Consequently, economics involves questions of value and social philosophy, irrespective of whether it wants or not, and such involvement is part of its own charter to improve social choice. The argument, then, is that, insofar as neo-classical economists are involved in these questions, they need to be pursued rigorously; otherwise this mode of economic thought will risk transforming individual and social behaviour and identity in ways it fails to comprehend. This is my main concern with neo-classical economics, not that it is necessarily wrong, but that a lack of reflexivity entails it altering society in ways it does not fully appreciate. It is this problem to which I hope critical social philosophy can provide a remedy.

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[1] As noted by Rosenberg and Hoover, among others. See Kevin D. Hoover (1995), p. 722.
[2] Given the focus on policy issues, the argument in this section does not attempt a historical recovery of the work of Robbins and Friedman: for instance, the fact that Friedman has a different definition of economics to Robbins is not discussed. The idea is to focus solely on the aspects of Robbins' and Friedman's work that are relevant to contemporary economics.
[3] This is assuming that the rate of inflation can be reliably measured, which is a major problem in itself.
[4] On this point, see MacIntyre (1981) chapter 8. In fairness to economics, this is a general problem across the social sciences. On this problem, see also Topper (2000) note 29.
[5] In particular, Kuhn (1996) in *The structure of scientific revolutions*. The connection of my argument with Kuhn's here is fairly minimal though: it simply concerns Kuhn's emphasis on certain common ideas as underlying scientific disciplines, surface disputes notwithstanding.
[6] The argument here draws significantly on Taylor's (1990) argument against value neutrality in political science.
[7] The term 'efficiency' is generally defined with reference to some other goal. However, within economic debates, it is frequently used as a goal in its own right, and it is in this sense that it is used here.
[8] Although there is no room to develop the point here, the idea here is that what it is to be human is fundamentally connected to certain norms. On this point, see Taylor (1989).