What is Wrong with Economics is What is Wrong with its Methodological Foundations

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I. Introduction

There have always been sceptics outside economics about the ability of economics to provide a complete analysis of human behavior. But now even among economists who believe that economics is not intended to provide a complete analysis of all aspects of human behavior, one senses a growing uneasiness. Although, implicit in most of the criticisms on economics is the attack on its methodology and more specifically its epistemological underpinnings, the discussions almost always elude these issues. This paper is an attempt to fill this gap. The paper begins with a critique of the neoclassical methodology. This is not to say that neoclassical methodology is the only methodology used in economics. But this remains by far the most dominant one. Moreover, the arguments put forward in this paper are applicable to methodology of economics in general. The rest of the paper is structured as follows. Section II is devoted to a brief look at inductivism and individualism—the two related but autonomous elements of neoclassical methodology. The epistemological basis of the neoclassical methodology is examined in section III. Section IV looks at psychologistic individualism and its underlying reductionist agenda. Section V presents some concluding remarks.

II. A Brief Sketch of the Methodological Issues in Economics

Inductivism plays a dominant role in modern economics. As Koopmans puts it, “As in any empirical science, progress in economics comes about through continual interaction of observation, proceeding from the casual to the systematic, and reasoning, proceeding from incidental to the more general and formal (1957, pp. 130-131)”. But induction will take for ever to find a proof of anyone’s claim to empirical knowledge. The conservative methodologists would reply that one needs only those facts which conform to positive statements to establish a truth and not all the facts. ‘A duck quacks, and therefore all ducks quack’, may be subjected to a narrower universe by specifying that ‘duck is bird’. The liberal methodologists, while recognising the impossibility of inductive proof, simply deny the necessity of it. According to them, theories are considered only ‘better’ or ‘worse’ rather than ‘true’ or ‘false’. Conventionalism, on the other hand, looks for the ‘best’ theory as per some standards of acceptable truth, rather than searching for an objective inductive proof of absolute truth. Koopmans remarks, “The purpose is that of recommending to one or more of the persons or organizations represented in the analysis, a choice or course of actions which can be expected to serve his or their objectives better than or at least as well as, alternative actions open to them (1957, p. 134)”. To Instrumentalism, usefulness is the only criterion necessary for judging the validity of a theory.

Individualism is another dominant methodological element in modern economics. It considers individuals as the ultimate decision makers. It regards the given psychological state of a decision maker as an irreducible minimum. But how can all individuals be alike (having same irreducible minimum) and yet be able to maintain their individuality? This represents the classic conflict between free choice and rationality1. The neoclassical economists allow all individuals to have different utility functions, thus maintaining individuality, but require that all utility functions demonstrate a common characteristic of negatively sloping marginal utility curve, thus, satisfying rationality. In other words, marginal utility curves are permitted to have different slopes as long as they are all negatively sloped.

Inductivism and individualism come into direct play in the neoclassical equilibrium analysis. Machlup defines, equilibrium as a “constellation of selected interrelated variables, so adjusted to one another that no inherent tendency to change prevails in the model which they constitute (1958, p. 9)”. But what happens when for any reason this balance with inherent
tendency not to change is disturbed? This question remains unanswered. A complete definition should satisfy three requirements. First, an equilibrium is a balance with no inherent tendency to change. Second, there must be a driving force which ensures a return to equilibrium once it is disturbed (maximization hypothesis is such a driving force). And third, it must specify a behavior pattern. It is possible that the first two conditions are met and yet an accidental disturbance can still move the system away from equilibrium rather than towards it. Using the two alternative behavior patterns, namely, Walrasian and Marshallian, one gets six possible configurations of which only two are consistent with both behavior patterns, and only one is of special interest to economists because of the assumption of downward sloping demand and upward sloping supply curves.

In neoclassical models an individual agent is always in equilibrium. So long as a consumer, for example, knows the prices, budget, and his or her taste, he or she always reaches a point in the consumption set where he or she maximizes his or her utility and will have no incentive to move away from it. The consumer does all this without even knowing his or her utility function. All he or she has to do is to compare the marginal utilities of the last penny spent on various goods per unit of time. But an individual is or is not in equilibrium with reference to his or her planned and actual activities. The neoclassical economists get around to this problem by assuming a perfectly flexible wage structure, a topic which is outside the scope of this paper. For equilibrium of the group(s) of individuals on the other hand, the actions of all individuals must be compatible. If all individuals are in equilibrium, the system is in equilibrium. A system can also be in equilibrium without all its components being in equilibrium so long as the excesses are cancelled out. But does it also mean that the system will converge to an equilibrium once it is disturbed? The assumption of perfect foresight ensures such a convergence.

III. Epistemology and Role of Information

That the convergence postulate is consistent with the epistemological beliefs of the neoclassical economists can be seen by classifying individuals into three categories. (1) An 'apriorist' whose expectations are formed independently of the new set of information and therefore there is no learning process. (2) A 'positivist' who welcomes new information but only if it helps in empirical verification of his or her beliefs. (3) A 'scepticist' in which case a new information will always lead to a dramatic change in his or her expectations and hence a convergence will never come about. The 'apriorist-cum-positivist' view adopted by the neoclassical economists is not only consistent with both the existence and the convergence of equilibrium, but it also gives knowledge its exogenous and fixed character which, in turn lends itself to the assumption of perfect foresight.

The assumption of perfect competition means that all information are not only available but they can also be relied upon. The price system is efficient in leading the system to another equilibrium once it is disturbed and the process is automatic. However, the instantaneous character of the process is less obvious. If one accepts the impossibility of inductive proof, then the system may never reach another equilibrium. Moreover and contrary to neoclassical beliefs, such a disequilibrium can persist even in perfect competition.

In this connection, it is important to point out that Hayek (1937) makes a distinction between subjective data which originate in individual decision maker's mind and objective data which is readily available to everyone. Neither the subjective nor the objective data alone is enough for attainment of equilibrium because such data may not be mutually compatible. There must also be a correspondence between the two sets of data. In perfect competition, such a correspondence is assumed to exist. To Hayek however, the assumption of perfect competition is not a precondition for the attainment of equilibrium, but rather a defining characteristic of its existence. The only requirement for consistency of disequilibrium dynamics is the assumption that people form their expectations rationally in that expectations become more and more correct as they acquire new information. Here, knowledge is neither fixed nor exogenous, and therefore, equilibrium may never be attained. But Hayek is interested in the process rather than the actual convergence. That there is an undercurrent of inductivism in Hayek's stream of thought is quite obvious.

Richardson (1959) makes a similar distinction between primary and secondary information. Information about own taste, income and prices constitutes primary
information. But for convergence it is also necessary that all individuals have perfect knowledge about each other's plans and their reactions to any change in these plans. This, he calls secondary information. Malmgren (1961) calls these two types of information controlled and uncontrolled. Since knowledge becomes endogenous there may never be an actual convergence. But he also demonstrates that contrary to neoclassical beliefs, perfect competition is not compatible with the attainment of equilibrium. He describes three ways of acquiring secondary information. (1) Through explicit collusion with regard to prices and quantities in which case all plans are bound to be correct and the system will converge. (2) Through implicit collusion. Here, everyone expects the prices to continue because everyone else expects no change in their present activities. (3) Through restraints. An entrepreneur who sees a new opportunity for making profit may not be able to meet the entire demand due to some real constraint. This may lead to a tacit agreement to live and let live—a sort of market sharing arrangement. Although the first and third are consistent with the convergence process, they are contrary to perfect competition. The second is the neoclassical world, but it makes sense only when he system is already in equilibrium.

The neoclassical epistemological process is deficient in dealing with disequilibrium dynamics primarily because learning is not automatic and certainly not instantaneous. The efforts to defend neoclassical methodology using expectational approaches themselves have come under attack. But this is not the only problem with the neoclassical methodology. It has also resulted in a rather less than satisfactory treatment of market failures in general and externalities in particular. Individualism in the market place which is supposed to guarantee efficiency has not been able to tackle externalities. Although, their presence is widely acknowledged, their treatment has ranged from 'they are not important' to 'let us deal with them separately'. One reason for this lukewarm treatment is that the tools of analysis which have evolved within the neoclassical framework do not lend themselves to such a task or if they are applied, one gets results contrary to the received theory. One finds an excellent example of the latter in Ladd (1990). He, following Dugger (1985), has shown that when environmental degradation is modeled as a by-product of consumption or when the interdependence arises from conspicuous consumption and positional goods, then, contrary to traditional theory, (1) price reductions can make people worse off, and (2) increases in consumer incomes can make consumers worse off. As he puts it, "The reason that the welfare implications of this model are so different from the conventional ones is quite simple: it is the difference in the treatment of variable 'e' (which he defines as a scalar measure of quality of the consumer's environment). The versions of the conventional model that do allow environmental quality to affect utility assume that environmental quality 'just happens'. It is exogenous—quite independent of human behavior. Everybody can increase their consumption indefinitely without having any effect on environmental quality. Environmental quality is a cause of economic behavior but is not an effect of economic behavior. In this paper, environmental quality is cause and effect. It influences consumer behavior. And, it is influenced by consumer behavior; to the extent it is economically determined (1990, p. 56)". Similarly, when the idea of externalities is extended to include some kind of interdependence in consumption patterns of individuals, the received economic doctrine fails by and large to obtain the standard results that usually follow from the competitive equilibrium analysis.

IV. Rationality and the Reductionist Agenda

The criticism against received methodology is not limited to its epistemological simplifications where knowledge plays a rather trivial role. Psychologic individualism underlying the deterministic character of the discipline has also come under attack. The neoclassical economists cherished intellectual freedom which is matched by their zeal for deterministic models. The Hobbesian view of human nature seems to have offered a perfect answer. The only thing needed is a reductionist agenda in order to offer a common denominator to all human motivations. This, they achieve by the postulate of rationality.

Rationality is defined in two alternative ways: (1) as pursuit of self-interest, and (2) as an internal consistency of choice (See, Sen, 1987 and 1989). The rationality postulate in both of its forms has been subjected to criticism (not to mention the issue of whether human behavior is
egoistic, which forms the basis for rationality assumption, or altruistic or both). Rationality in the former sense dates back to Adam Smith or even before. The passage in *The Wealth of Nations* where Smith talked about the behavior of the butcher, the brewer and the baker is too well-known to repeat here. But he was aware of the dangers of pursuit of self-interest and pointed out how merchants and tradesmen would tend to conspire against the public to raise prices. Moreover, Adam Smith named his book *The Wealth of Nations* and not *The Welfare of Nations*, implying that it was a treatise on economic growth – emphasis on material progress. Also, prior to writing *The Wealth of Nations*, he wrote *The Theory of Moral Sentiments*. Thus, he seemed to have assumed the existence of a minimum moral environment as a prerequisite for pursuit of self-interest to result in larger social interest. While defending Smith, Sen maintains that “Adam Smith did not assign a generally superior role to the pursuit of self-interest in any of his writings”. He goes on to say that “the defense of self-interested behavior comes in specific contexts, particularly related to various contemporary bureaucratic barriers and other restrictions to economic transactions which made trade difficult and hampered production (Sen, 1987)”. Sen, like many other economists, thinks that the pursuit of self-interest precludes many other objective functions.4

Boland (1981) has argued that any criticism of maximization hypothesis either on logical or empirical ground is futile. To quote, “I will argue here that even if one could prove that a consumer is not maximizing utility or a producer is not maximizing profit, this would not constitute a refutation of the neoclassical hypothesis. The reason why is that the actual form of the neoclassical premise is: ‘For all decision makers there is something they maximize’ (1981, p. 1034)”. There are a number of points that can be made on this rather very bold claim. First, the statement is faulty in extensional sense because it fails to distinguish between preference and an act of choosing. See Sen (1973). Not all actions can be labelled as part of maximizing process. Second, even if one accepts the premise that every agent must be maximizing ‘something’, it is essential that he or she must be maximizing the same ‘something’ consistently for any standard results to follow. One can simply imagine what will happen, if a producer maximizes profit one minute and sales, power and prestige, and market share the other. Third, the subject of most of the criticisms is seldom the maximization hypothesis in its universal form, but rather its restricted version, namely, the pursuit of self-interest. It is here that the maximization hypothesis seems to capture only a part of the landscape, important as that part may be. And it is precisely here that the automaticity of pursuit of self-interest resulting in larger good of all in the ‘invisible hand’ framework is put to jeopardy.

Rationality, as an internal consistency of choice requires a preference ranking. And transitivity (if state A is preferred to state B and state B is preferred to state C then state A must be preferred to state C) constitutes an important element of this. The emergence of vast literature on preference reversals in recent years constitutes a serious blow to rationality postulate in this internal consistency sense (See, i.e., Holt, 1986; Kahneman and Tversky, 1979, 84; Segal, 1988; Slovic and Lichtenstein, 1983; Tversky and Thaler, 1990; and Thaler, 1981). The effectiveness of product advertisement to exploit the phenomenon of ‘impulse buying’ is also a clear violation of the postulate of rationality. Other areas where the prevalent methodology seems to run into problems include voting behavior; work motivation; solidarity in wage bargaining; a tendency toward wage equalization across sectors with varying productivity performance; companionship, and publishing; and all cases of prisoners’ dilemma.

In recent years, the criticism against the postulate of rationality has taken a new twist. The thrust of the criticism is upon the power of subtle but sublime message contained in the maximization hypothesis. The jump from ‘how people behave’ to ‘how they ought to behave’ is smaller than is made to believe by the proponents of positivist economics. Values influence behavior. And this hypothesis seems to provide a context for such value formation. It is even claimed that an overarching emphasis on this postulate in textbooks is creating a new breed of followers. Whether or not the claim is true is an empirical question, but the world has seen the power of religion.

V. Concluding Remarks

This paper argues that current epistemological views are incompatible with disequilibrium dynamics. Further, that individualism in the market place may lead to
efficiency, but its record in handling externalities is less satisfactory. This paper criticises the rational utility maximization hypothesis (RUMH) in its extensional form. But most importantly, it points out that it is the postulate of self-interest which is the subject of most of the criticisms. The moment we move from RUMH where any action can be construed to be consistent with the postulate, to pursuit of self-interest, the inductivism appears to offer even less defence of the neoclassical methodology.

What is needed is an alternative characterization of the learning process, and as Sen has suggested, a richer structure of preferences to include sympathy, commitment, and duty. It may be a tall order but a worthwhile one. In this sense, the current debate bodes well for the discipline.

Notes

1. I am indebted to Professor A. K. Sen for his extremely useful comments on the earlier draft of this paper. My special thanks to Professor Lawrence Boland who initiated me in methodology. He also provided extensive and useful suggestions for improvement. I am also grateful to Professor John E. Rowercroft for his helpful suggestions on earlier versions of this paper. All remaining errors are the sole responsibility of the author.

2. The neoclassical economists found a resolution of this conflict in the Kantian philosophy where freedom is a necessary condition for rational choice. But as Uriarte has argued, for maximization the individual agent must use a rule and to that extent he or she is not free. To quote, "In a word, this rule would render all actions of the agent to be 'reactions', properly speaking. In consumption theory, this rule is the claim that marginal rates of satisfaction per dollar become equalized for the range of those goods purchased. When the relative prices of these goods change, the agent must reallocate his expenditures in order to maximize his utility. The agent is free only to alter his preferences, an inherently non-social and non-economic act (1990, p. 609)."

3. Economists argued that assumption of rational expectations and/or adaptive expectations (weaker assumptions) will allow equilibrium to be restored. The former implies that information gathering is efficient and therefore, the individual is not fooled by the market events. The latter implies that agents will make systematic errors which can be eliminated in a systematic fashion.

4. For a detailed discussion of disequilibrium dynamics see Clower (1965); Barro and Grossman (1971); Grossman (1971); Varian (1975); and Nakagome (1982).

5. One can find discussions on this theme in Veblen, (1934); Duesenberry, (1949); Arrow, (1951); Bergson, (1954); Scitovsky, (1954); Hirsch, (1976); and Frank, (1985).

6. As Sen states, "Why should it be uniquely rational to pursue one's own self-interest to the exclusion of everything else? It may not, of course, be at all absurd to claim that maximization of self-interest is not irrational, at least not necessarily so, but to argue that anything other than maximizing self-interest must be irrational seems altogether extraordinary (1987, p. 15)." In another place he says, "If people have other goals and motivations, why should they be compelled by economic theory to pursue self-interest? People may truly want to promote causes which are not identical with their own welfare, and which they don't perceive as their own self-interest. There is no reason why rational human beings should not pursue those other causes. For example, if we wish to promote what we see as the interest of some group, such as family, a community, a class, a political party, a social group, even at some personal sacrifice, what's irrational about intelligently pursuing that goal? (1989, p. 142)"." See also Frank (1989).

7. McCormick states, "One simple example of this is the phenomenon of 'impulse buying' which is so dear to the hearts of marketing people. The very premise of impulse buying is that people buy without really thinking about what they are doing (See, for example, Berkman and Gilson, 1981, pp. 408-416). True impulse buying is the complete triumph of emotional desires over reason. Nevertheless, many economists continue to teach their students about the RUMH (rational utility maximization hypothesis) while marketing professors teach the very same students about how to increase the volume of impulse buying (1989, pp. 317-318)." On consumer's sovereignty in the market place, Scitovsky says, "He (producer) cannot sell, of course, what the consumer does not want, but advertising has given him the means to free himself from too slavish dependence on consumer's tastes and to try, instead, to mould consumer's tastes to fit his product (1989, p.53)."

8. See Simon (1987) and Arrow (1987) for an excellent illustration of some of these cases.

9. Wiseman observes, "Guided by positivist canons of appropriate scientific methodology, it (mainstream economic theory) pretends to take the ends or goals to be pursued as determined outside of the science, to be taken as exogenously given. However, this has never been more than a pretence: since the very beginning of economic theorizing itself, economic theories have continually participated in formulating and legitimizing that which is worthy of pursuit. Insofar as humans are dialectically related to their own knowledge, it could not be otherwise. Positivist economics does not recognize the substantial extent to which it participates in socially determining the very ends which it pretends for methodological reasons to take as externally given. It fails to recognize the necessary dialectical relationship between economic theory and the social orders of which it is a part (1989, pp. 21-22)."

10. Frank maintains, "There is strong evidence, for example, that economics and business students are much more likely than others to behave opportunistically in social dilemmas (1989, p. 13)." Lutz and Lux (1988) also refer to a similar study.
References


