# Economic Model Analysis and Economic Thought:

## Effect of Social Relations on Model Analysis

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## Introduction

Throughout the ages studies of economics examine the interaction of individuals and societies within their communities. The goal is to determine the social values exhibited in the production, consumption and distribution of wealth in that community. Those social values are based on ethics, morals and cultural ideas. The purpose of this paper is to examine current economic theories to understand the level of inclusion of social relations in the analysis of those theories.

Ethics is the knowledge of right and wrong and a person's attitude towards the standards and values that 'should' be upheld. Their knowledge and attitudes form the base of ethical behavior. The origin of those values is based in a society's cultural ideas, morals and values.

Social legislation translates society's cultural ideas, values and habits into laws, rules, and regulations and provides ethical context to everyday life. Social legislation reflects individual and social values. Social laws and rules are designed to provide protection for people and nature and to enhance the well being of a community.

Institutional economists are interested in understanding the economy in terms of social order defined by rules and organizations in the community's economy. They explain that "…tastes, technology and economic behavior are shaped by institutions which they defined widely as a system of 'habits of thought'…" (Sandelin 2008, 74) Their interest is in understanding the impact of social order on economic theories and practices.

In economics today, there is a focus on understanding the economy through mathematics and modeling. A need exits to understand economic growth, income distribution, investments, savings and monetary policies in terms that allow for government intervention, policy implications and potential economic impact. Theoretical work is focused on these ideas; missing or at least minimized, is ethics, social values and institutions.

Social relations and values are foundational components of social laws and the study of economic theories. Neoclassical theory defines institutions as products of rational behavior, determined by a representative agent whose consumer preferences along with technology, determine economic activity. It does not sufficiently account for socialization and the effects that rationalization and legal failures have in an economy through policy and practice. Institutionalism is missing from or at least minimized in much of the economic theory developed today.

**The History of Social Relations in Economic Theory**

Social relations have been a part of economic analysis for centuries. The review and analysis of economic history provides clear insight into the evolution of understanding the social interactions within a community. That understanding is based on the economic system in use at the time. Those who provide insight use their knowledge of their economy and the society's values in which they live, as a foundation for their economic theories. A review of some of historical economist reveals their views of the interactions between social relations and economic theory.

Aristotle wrote that "A social instinct is implanted in all men by nature…for man, when perfected is the best of animals, but, when separated from law and justice, he is the worst of all…" (Aristotle 1999, 6) Aristotle lived from 384 to 322 BC. His writings tell the story of the importance of the social fabric to economics. He formed theories of the division of labor, household management, wealth acquisition, private versus public property and the exchange process. All of these economic concerns of his time were founded in social instinct with law and justice.

Hume, in essay II, describes social interactions in terms of luxuries and refinement. He tells the story of industry, knowledge and humanity as beneficial on the public. He expounds on the idea of refinement, stating that honor and virtue abounds in ages of knowledge and refinement. (Hume 1752, 268)

Adam Smith begins his discussion of the division of labor with its effect "…in the general business of society…" He uses the example of a pin factory to describe the advantages that the division of labor presents to a 'well governed society.' (Smith 1759, 3-11)

David Ricardo wrote *On the Principles of Political Economy, and Taxation* in 1817. The Industrial Revolution had begun and with it an inquiry into the sources of growth. He analyzed the world of his time, evaluating the effects of population growth and changes in technology. He focused on rents, value and foreign trade. John Stuart Mill believed that Ricardo had theoretically solved the essential problems of economic theory. Mill addressed a wider range of social issues including opportunity costs and the consumption of the community as it relationship with production. (Sandelin 2008, 33)

Karl Marx argued that the capitalist exploited the worker in what he considered an unsustainable mode of production. He presented the idea that the "… total labor-power of society…counts as one homogenous mass of human labor-power…" (Capital, vol I, 1867, 129) Much of his work was based on the fundamental idea of one classes exploitation of another; social interactions.

Like Marx, Thorstein Veblen economic theory was based on class struggle. He focused on the leisure class and viewed economic life as a Darwinian evolution. He saw evolution as the result of instinctual behavior of workmanship, idle curiosity, emulation and parental influence. Technology was the result of curiosity and status the benefit of pecuniary emulation, conspicuous consumption and conspicuous leisure.

John R. Commons created a general institutional economic theory by combining his view of mainstream economics with legal economic analysis. His analysis included the evolution of organization and control of the modern economic system. He created a model with a behavioristic theory of psychology, theories of social control and change, social laws; theories of system and institutional organization. (Medema and Samuels 2013, 681-686)

In 1867 William Stanly Jevons supported the idea of mathematics in economic theory. He emphasized that economics must be a mathematical science; differential calculus, if economics was to be a science. Jevons used mathematics and discovered the concept of marginal utility, using the ratio of exchange of any two commodities as the reciprocal of the degree of utility. He became known as a Marginalist. (Jevons 1871, 78-139)

Alfred Marshal picked up on Jevons utility and marginalist theories but minimized mathematics by placing it in footnotes and appendices in the *Principles*. He chose instead to study man as he is rather than as an abstract ‘economic’ man, a man of flesh and blood. (Marshall 1961, 21)

Marshall influenced John Maynard Keynes who was a colleague at the University of Cambridge. Keynes was considered a leading monetary theorist in his time. He revolutionized economic theory by examining the relationship between supply and demand, investment and savings, and that macroeconomic theory should include model instability where government fiscal and monetary policies had an impact on the level of economic output. (Keynes 1936, 209-223.)

After World War II, mathematical analysis began to dominate economic theory. Economist like Milton Friedman, Paul Samuelson, A. W. Phillips, Michael Kalecki, R.F. Harrod and E.D. Domar focused on theories of economic dynamics. The dynamic models focused on growth, interest, investment, business and trade cycles, and monetary rules. The inclusion of social relations was almost non-existent with many theories based on the 'rational man' and a representative agent. (Vaggi and Groenewegen 2003, 308-324.)

Early works on economic theory were based on the foundation of social relations and interactions. Over time, and spurred by the need to understand the growth rates of the Industrial Revolution, economists shifted from ideas of social interactions, communities and institutions to 'pure' science proved through mathematics. The idea that true scientific economic models could only be generated through mathematical modeling and that the primary focus should be on explaining the dynamics of economic systems, began to dominate.

**The Relationship Between Economic Theory and Social Values**

In early societies, economic theory was based on social values demonstrated through social relations and social laws. The morality and ethics of a community dictated the form and substance of the theories and laws. The relationship among morality, ethics, and law is somewhat problematic. Sociologist Phillip Cooper (1998, 76–79) points out that they can be at odds with each other. He explains his points as follows:

- What is immoral is not necessarily illegal; e.g., dishonesty is not illegal except in particular instances.

- Some laws regulate behaviors that are not inherently immoral; e.g., driving 5 mph above the speed limit.
- Some laws violate ethical principles; e.g., legislating special benefits for particular groups can violate the principle of fairness.
- Finding ways in veterans affairs hospitals to treat veterans for Agent Orange disorders as service-connected disabilities was not immoral although for an extended period it violated regulations.
- Relying on law to promote ethics does not necessarily promote ethical behavior. Not breaking the rules does not mean that one is necessarily ethical.

Ethics and laws taken alone cannot, therefore, be used to determine the relationship between theory and social relations. Sociologist Donald R. Cressey wrote his 1950 Ph.D. dissertation on embezzlement and white-collar crime. He later wrote *Other People's Money*, based on that dissertation. His theory, which became known as the Cressey Fraud Triangle, postulated that three components were necessary for fraud to occur in a social setting. The three components are: Rationalization or justification of dishonest actions, Social pressure which created the motivation or incentive to commit fraud and Opportunity.

Through this work, Cressey more clearly defined social relations in terms of ethics. His work uncovered the characteristics of social interactions within a community that determine its social relations. If any of the three characteristic components is missing, then the social ethics is sufficient to ensure compliance with social laws, rules and regulations. But if all three characteristics are present then ethics are insufficient in that social setting. That insufficiency becomes part of the social relations that results in fraud and other crimes. It is then possible to identify the characteristics of an ethical decision making process as:

1. Institutionalization consisting of laws, rules and regulations,
2. Socialization consisting of values and cultural influences, and
3. Rationalization or the relationship amongst individuals.

The idea that characteristics of ethical decisions can partially identify social relations in an economy is further explained by sociologist Lawrence E. Cohen and Marcus Felson. Their focus on the ethical characteristics of criminals during the commitment of crimes follows from the same three characteristics that Cressey discovered. They describe a social structure that produces the convergence of these characteristics which they call:

1. Absence of capable guardians (institutionalization)
2. Likely offenders or not capable but willing, (socialization) and
3. Suitable targets or seen as vulnerable (rationalization.)

They performed this study to examine the dramatic increase in crime rates, 263%, from 1960 to 1975. (Cohen and Marcus 1979, 1) Just as Cressey, they discovered that crime and fraud exists when one of the three characteristics is missing.

Social relations change when shifting from an ethical decision-making process to Cressey's Fraud Triangle or Cohen and Felson's Criminology triangle. Blake E Ashforth and Anand Vikas explain the shift of social relations by pointing out that systems and individuals are mutually reinforcing. (Ashforth and Vikas 2003, 1.) They sought to understand how society values change, over time to 'normalize' what was previously considered illegal social behavior. They use the same three characteristics of ethical behavior which they call:

1. Institutionalization, where an initial corrupt decision or act becomes embedded in structures and processes and thereby routinized,

2. Socialization, where naïve newcomers are induced to view corruption a permissible if not desirable, and
3. Rationalization, where self-serving ideologies develop to justify and valorize corruption.

The three theories of ethical behavior define the process of changing social values as the convergence of institutionalization, socialization and rationalization in society. At convergence, ethical behavior can be redefined and normalized which results in a change of ethical values and social relations. Those who make social laws and those who enforce them, adjust to the changes in social values and laws, effectively cementing the change in social relations.

The importance of social values to economic theory, as evidenced in social relations, is evident throughout history. Saint Thomas Aquinas understood two of the characteristics of social value changes as evidence when he wrote "…if he has recourse to deeds, and the deceit affects things, we have 'fraud'… just as theft is a special kind of fraud" (Saint Thomas Aquinas , 2262) He did not write about institutionalization or the laws, rules and regulation or the capable guardian.

William Petty recognized that social relations is a key component of economic theory and growth through financing. He wrote that fraud and the the glory of taking from others by "…fraud or rapine, then to gain ones self out of the bowels of the Earth and Sea." (William Petty 1662, Chapter 2 #8) In his writing, he referred to the methods that the Crown could use to finance their endeavors.

John Locke understood the connections between the three characteristics and included institutionalization when he wrote "…government being for the preservation of every man's right and property, by preserving him from the violence or injury of others, is for the good of the governed: for the magistrate's sword being for a "terror to evil doers," and by that terror to enforce men to observe the positive laws of the society, made conformable to the laws of nature, for the public good, i.e., the good of every particular member of that society, as far as by common rules it can be provided for; the sword is not given the magistrate for his own good alone." (John Locke 1823, 62) He demonstrated his understanding of the need of social laws and enforcement of those social laws. The enforcement of social laws ensure that society's values are upheld in the economy is for the public good.

It is easy to see that Lock also understood the need for a capable enforcer so that the rules and laws of the government would be enforced, leaving the social relations, ethics and values intact. The enforcer became the capable guardian of social values in the economic system.

Manderville's Fable of the Bees describes the effect of dishonesty and cheating in the absence of a capable guardian. Mandeville 1714, 220 &225) His understanding that social values can be changed through a normalization process where unethical and illegal behavior becomes the new norm is demonstrated in the Fable as follows:

- "One, that had got a Princely Store,
  By cheating Master, King, and Poor,
  Dared cry aloud; The Land must sink
  For all its Fraud; And whom d'ye think
  The Sermonizing Rascal chid? [220]
  A Glover that sold Lamb for Kid.
- The last Thing was not done amiss,
  Or cross'd the Publick Business;

But all the Rogues cry'd brazenly,

Good Gods, had we but Honesty! [225]

The relationship between economic theory and social values is through ethical behavior as defined within a society. The three characteristics of ethical behavior; institutionalization, socialization and rationalization, provide a road map to understanding how changes in ethical behavior result in changes in social relations through a process of normalization. It becomes evident that a study of economic theory, conducted to better understand how social relations determine the production, consumption and distribution of wealth in a community, is partially dependent on the social relations of that community.

**Analysis of Economic Theory Today**

Contemporary contributions to economic theory have a main focus of growth and fluctuation. Theoretical and empirical interest is in cycles and growth. Keynes' *The General Theory* spurred an interest in aggregate economics and dynamics. The distribution of wealth in a community became focused on sustainable per capita income. Production and consumption focused on investment and savings as a function of production.

The construction of a dynamical growth model does not allow for the explanation of some variables in pecuniary terms. Such variables include changes in population and in social and political institutions. These variables have obvious effects on output in long-run models. Because they cannot be explained in terms of economic principles within the growth models, they are excluded from the analysis.

I.H. Rima noted that there is a "…striking difference between recent contributions to the subject of growth and those of the classical school." The classical school viewed population and the size of the work force and as the determinant of capital requirements. Capital above a base requirement would be profit which would be used to increase production. Growth in this model would end when population growth would push capital costs up, creating diminished returns. Returns diminished to the point that profit was insufficient to support growth and stimulate further accumulation and the economy would reach a stationary state or what is known today as steady state growth. (Rima 1972, 428-429)

Joseph A. Schumpeter developed a hypothesis that economic development and fluctuation are related phenomena in dynamic economies. (Schumpeter 1934) He also believed that capitalism will eventually destroy itself because capitalists loses control of the entrepreneurial process. Production becomes more efficient but will lose support as few persons have the opportunity for individual action in the resulting bureaucratic society. Capitalism would therefore, become sociologically untenable. (Schumpeter 1942)

Although Schumpeter focused on growth, his focus was from a sociopolitical point of view. Modern theorist are "…concerned with the relationship between functionally related macroeconomic variables at different points of theoretic time." The result was a theory that business cycles and economic fluctuations characterized growth.

Contemporary theories of growth and fluctuations analyze the "…aggregate demand and capacity that is generated by new investment will be utilized." (Rima 1972, 431-432) Included in the theory is technology, a measurable growth variable. Excluded are the variables which cannot be expressed in pecuniary terms.

Much of current economic analysis focuses on fluctuations and growth with varying focuses. Evsey Domar focused on the rate of growth  of capital stock in expansion. Roy F. Harrod created a model that focused on a multiplier and accelerator coefficient which operate without a time lag. The resulting model allows for geometric growth of income. John R. Hicks' model assumed that the level of autonomous investment grows at a constant rate, creating a constant growth rate. Many other models were created in the last 50 years, all with a common goal of defining fluctuation and growth in terms of economic dynamics in theoretical time.

Missing is the ancient and classical economic theory focus on human capital and social relations. Human capital is replaced in modern theory with fluctuations and growth defined by variables of capital, investments, technology and theoretical time.

**Conclusion**

Social relations are fundamental to understanding economic theory. Social relations in the terms of ethical behavior based on cultural values and ideas, has a place in the analysis of an economy.

Investment in man as well as physical capital should be an economic principle of current theories. Growth models that include human capital allow for the inclusion of the technical knowledge gained through increased knowledge and skill. Inclusion also facilitates the incorporation of other social sciences like psychology, thus creating an increase in returns. Viewing improved knowledge and skills in human capital as technology, the returns on investment in capital can be measured in the growth model. Human capital becomes a pecuniary growth variable. T.W. Schultz recognized that many "… paradoxes and puzzles about our dynamic, growing economy can be resolved once human investment is taken into account."

He noted that human capital has been increasing relative to conventional capital and also relative to income which he uses to conclude that higher growth rates rely on increased investment in human capital. This he believes can be accomplished through education and health care. He believes that further research should be done to determine the allocation of resources in light of increasing human capital rates. (Shcultz 1961, 1-7)

Incorporating human capital requires an understanding of the social relations in a community. As we have seen, those relations are dependent on ethical behavior and social values. The characteristics of ethical decision making provide a key to understanding how social values and social laws change. Current economic models that omit the social relations cannot capture the change in values and thus miss a key growth factor, human capital.

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