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MORAL MARKETS

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## MORAL MARKETS

The complaint that markets make people greedy and selfish is old and familiar. We have been hearing it again on a daily basis in reactions to the current turmoil in financial markets.

However, it did not always hold sway. In the eighteenth century (the century of Adam Smith, to whom I will return), many philosophers maintained that commerce was a civilising force. To them, commerce, whereby people prospered by means of voluntary and mutually beneficial exchanges, was triumphing over militarism, whereby the strong prospered by plundering and exploiting the weak. In the early nineteenth century, the victory of Britain, the nation of commerce, over Napoleon's military empire seemed to confirm that the future lay in free markets and free trade.

In the course of the nineteenth century, this view was challenged by a variety of collectivist doctrines, of which the most notorious was Marxist socialism. Marx wrote vividly of capitalism destroying all relationships between individuals other than a cold 'cash nexus', which facilitated the exploitation of the poor and weak by the rich and powerful.

This moral critique of the market was far from confined to socialists: many conservatives espoused it too. And much of it has survived the demise of socialism in the late twentieth century. So-called progressive intellectuals in the West have accepted the market as a practical necessity, but retained their view of it as driven by greed and selfishness, and consequently in need of permanent moral oversight and correction. Since the market is not intrinsically moral, so the argument goes, morality must be bolted on to it. Hence the rise in recent years of the study of 'business ethics' and of the promotion of 'corporate social responsibility' as a bottom-line consideration alongside the search for profits.

At this point I should say that I have never had a problem with the moral justification of the market. In the first place, genuinely free and open markets enable individuals to promote their own, self-chosen goals (which

do not have to be selfish) as opposed to being exploited in order to promote other people's goals. So markets promote liberty, autonomy, personal responsibility and self-determination. They have been central to the emancipation of humanity from oppression, both in its old forms (like feudalism) and in its modern forms (like totalitarianism).

Second, since market exchanges are voluntary, they promote the welfare of all parties to them, and do so more reliably than any other known economic arrangement. Market prices bring the actions of self-interested individuals into harmony with the overall prosperity of society. The market system produces information that facilitates complex economic activities that are beyond the comprehension of any individual or planning agency to coordinate. Hence the persistent research finding that free markets – by which we mean markets subject to rules and ethical standards that facilitate trading – and prosperity go hand in hand.

Third, countries that enjoy economic freedom have thriving charitable sectors, and philanthropic foundations participate in the capitalist order to maximise their charitable donations. This is most strikingly the case in the United States, which hosts the world's most dynamic economy. It is also true of Hong Kong: an amazing number of Hong Kong charities are active throughout mainland China. So philanthropy is not crowded out by capitalism but is among the options it makes available to us.

These points strike me as elementary and uncontroversial. Yet the anti-capitalist mentality, based on ancient prejudices against trade and finance, persists among intellectuals and much of the general public. These days it is nourished by corporate scandals like the one that brought down Enron, and at present by failed financial firms and the highly publicised payouts received by executives in some of them. Charges of greed are being thrown in all directions, but are they best directed at profit-seeking firms or at the unqualified borrowers who sought loans from them?

These topics are worth discussing in their own right, but, since they are often cited to discredit the entire free market order, the moral case for

markets is in danger of going unheard by default. If markets are indeed driven by greed and selfishness, or make us greedy and selfish, then people may wonder whether our prosperity comes at too high a moral cost, and whether it is possible, in the words of the notorious anti-globalisation slogan, to “replace capitalism with something better”.

The book that I want to talk about today is therefore timely. Titled *Moral Markets: The Critical Role of Values in the Economy*,<sup>1</sup> it is a collection of 15 essays by 23 authors who are not mainstream economists but work in related disciplines like business studies or more remote ones like evolutionary biology. The editor, Paul Zak, is director of the Center for Neuroeconomics Studies in California. Neuroeconomics applies our fast-growing understanding of the brain to economic activity, and the book reports some of its recent findings. The authors conclude that what they call the popular ‘cartoon’ image of markets – that is, markets as sites of greed and selfishness – is wrong, and that, on the contrary, markets are, in their words, “values in action”. They believe that modern neuroscience and evolutionary biology are vindicating the claims that Adam Smith made about economics and morality in the eighteenth century.

Smith is, of course, well known for his claim in *The Wealth of Nations* (1776) that

It is not from benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest ...

Self-interest should not be equated with selfishness. We teach small children to look both ways before crossing the road: are we teaching them to be selfish or to act in their own interests as well as those of other road users? It would be a strange social order where someone else (the nanny state?) was presumed to know our interests better than we do. Moreover, Smith also said the following in a less well-known book, *The Theory of Moral Sentiments*, published in 1759:

How selfish so ever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it except the pleasure of seeing it. Of this kind is pity or compassion, the emotion which we

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<sup>1</sup> *Moral Markets: The Critical Role of Values in the Economy*, ed Paul J Zak, Princeton University Press, 2008.

feel for the misery of others . . . The greatest ruffian, the most hardened violator of the laws of society, is not altogether without it.

Paul Zak and his colleagues argue that this capacity for compassion has a biological foundation and is the source of human values and of markets as “values in action”.

I'll try to summarise the arguments and findings of the collection, without attributing all of them to their particular authors.

We may be tempted to be cynical and to believe that sympathy is a much weaker motive than self-interest. Yet benevolent actions are much more common than we realise because we tend not to notice them; and the main reason we tend not to notice them is that so often they amount to *not* doing things – that is, ‘passive altruism’. For example, we may not often drop a coin into a beggar’s hat, but it would never occur to us to steal a coin from a beggar’s hat, even when we could easily get away with it. In our everyday lives opportunities routinely arise for us to lie, cheat and steal with impunity. If we were all exclusively selfish, we surely would lie, cheat and steal whenever we could do so without fear of being found out and punished. Yet nearly all the time, nearly all of us refrain from doing so. We do have consciences, which affect our conduct.

However, the contributors to *Moral Markets* are not arguing that morality is a sort of adjunct to economic exchanges, as if it comes into play when necessary to correct self-interested behaviour. They argue that without morality there could be no social life and therefore no economic life. That is, economic life is possible only because we are moral beings. The key concept here is *trust*: unless people trust each other to some degree, they will not engage in market exchanges. And as with passive altruism, in stable societies trust is so all-pervasive that we hardly notice it or appreciate how important it is

Of course with instantaneous exchanges, like those in a sweet shop, little trust is needed – although even here the buyer normally trusts the seller not to hand over an adulterated product, and the seller trusts the buyer not to hand over counterfeit money. But in modern, sophisticated economies,

many exchanges take place between people who never meet each other, and over extended periods of time during which each party to an exchange is vulnerable to exploitation by the other. We typically place our savings in the hands of institutions of which we know little other than their names. Those institutions may invest our savings in companies on the other side of the world, and can exercise little control over how those investments are managed. Of course, sometimes things go wrong – a breakdown in trust is contributing to the spread of the present financial crisis because financial institutions don't know which counterparties are liquid or solvent. But most of the time they don't.

It's no argument against the central role of trust to say that we are deterred from wrongdoing by the threat of legal sanctions. The law is necessary to sustain trust, but it works only if it needs to be applied only occasionally; if it had to be used frequently, that would be a sign that trust was breaking down, and economic exchanges would start to dry up.

Nor is it correct to say that self-interest alone keeps the system going. Although economic actors have an interest in acquiring and maintaining reputations for trustworthiness, they are still routinely presented with opportunities for gain from breaching the terms of their agreements. Yet by and large people don't give in to the temptation to cheat, whether because they themselves think it would be wrong to do so, or because they are pressured by others who think cheating is wrong. Of course, we all know of con men who never seem to run out of victims, and some of those peddling subprime loans were crooks. Sad to say, not all the rotters come to sticky ends. But the reason they get away with it is precisely that most of us are *not* con men. Paul Zak estimates that the number of 'sociopaths' – people who cannot be trusted – amounts to about 2 percent of the population.

The originality of the *Moral Markets* collection lies in the authors' biological explanation of the origin of trust and the values that sustain it, like honesty and fairness. A good deal of the evidence for this explanation is derived

from the study of the higher primates like chimpanzees, our closest relations in the animal kingdom.

Observations and experiments involving primates establish that these animals form moral relationships with one another. They engage in reciprocal gift exchanges involving “grooming, sex, support in fights, food, babysitting, and so on” (p 67). What is more, they support these reciprocal relationships with sanctions on free riders, that is, on animals that ‘selfishly’ try to obtain the benefits of reciprocity without providing any such benefits in return. The most common sanction is ostracism, or withholding the benefits of cooperation from non-cooperators; occasionally physical sanctions are applied as well. Most remarkably, chimpanzees form hierarchies of relationships: the closer the relationship, the longer the time period the partners allow one another in which to reciprocate. Conversely, more distant relationships require relatively prompt reciprocity if they are to be sustained.

You hardly need me to point out how familiar these patterns of interaction are to us human beings. Chimpanzees and other primates appear to share with humans not just a “propensity to truck, barter, and exchange one thing for another”, whose importance Adam Smith stressed in *The Wealth of Nations*, but even a propensity to form long-term cooperative relationships. And indeed, observation and experiments involving humans show that people learn to obtain the benefits of cooperation by trusting one another. Some studies claim to show that the most efficient sanction to maintain trust is ‘tit for tat’: anyone who cheats is punished once only for a single offence and is then given a chance to return to the fold, so that the full benefits of cooperation can continue to flow.

In this collection Paul Zak claims that neuroscience has discovered the biological basis of trust in the form of a hormone called oxytocin. According to Zak:

. . .when a person makes an intentional monetary sacrifice signifying that he or she trusts a stranger, the brain of the person being trusted produces a surge in the neuroactive hormone oxytocin . . . Oxytocin is a physiologic signature of empathy, and appears to induce a temporary attachment to others . . .

Oxytocin appears to facilitate a representation of what another is feeling (p 267).

In other words, oxytocin makes possible the capacity for ‘compassion’ or ‘pity’ that Adam Smith identified. It is literally the ‘chemistry’ that cements people together. I think we’re going to hear a good deal more about oxytocin; already its potential is being investigated as a medical treatment for shyness, depression, and even autism.

In the remainder of his chapter on what he calls ‘moral economics’, Zak reports more findings relating to trust. He claims that, in his words:

. . . generalized trust is among the strongest predictors that economists have ever found of whether a country would have increasing or decreasing living standards. Low-trust countries have stagnating or declining per capita incomes, whereas high-trust countries enjoy steady income growth (p 273).

This finding tempts me to make the only half-facetious suggestion that in low-trust countries oxytocin should be put in the water.

Another significant finding reported by Zak is that exposure to market exchange, more than any other factor, causes people interacting with one another to make offers that their counterparties regard as fair. Observations and experiments show that both primates and humans are likely to reject offers of a share of the pie that is much smaller than the share claimed by the offerer – again, an opportunity to promote one’s self-interest is forgone for the sake of a principle. But free markets appear to promote shared views of fairness. As Zak writes:

. . . those in societies that traded appeared to have understood that trade freely entered into necessitates the acquisition of reasonable gains for both parties. Repeated trade is most likely to arise when parties work out a fair distribution of gains (p 275).

This finding is consistent with another related one, namely, that excessive regulation of social behaviour, in markets and elsewhere, crowds out the working of values. It threatens to produce laws that, Zak says:

. . . view punishment as the price one pays to engage in a behaviour rather than a violation of mutually shared values, and this may increase rather than reduce violations (p 275).

These last two findings are welcome, though I don’t find them surprising. Markets are places where we learn to communicate and to cooperate with

strangers on the basis of give and take – in short, markets help to make us moral adults. That is why in the eighteenth century commerce was viewed, uncontroversially, as a force for progress and civilisation.

Conversely, when market exchanges are suppressed by an excess of regulation, direct relationships between strangers are harder to foster. In the former Soviet Union one of the main obstacles to the emergence of a market economy and a civil society was the lack of trust in the society. That was a direct effect of seven decades of communism, which quite deliberately aimed to prevent citizens forming spontaneous relationships, and officially allowed them to form only those relationships that were approved and mediated by the state.

To summarise the argument of the book. Markets are intrinsically moral because they operate – and can only operate – on the basis of trust. They therefore cannot be sites of pure selfishness and greed, which militate against trust. Excessive regulation undermines trust by crowding out the spontaneous individual willingness to behave in a trustworthy and cooperative way. ‘Tick the box’ corporate governance requirements, for example, can easily become a substitute for individual business judgment. The emergence of a worldwide market order is a result of the extension of trust from our immediate kin to ever-wider circles of humanity, and ultimately to strangers with whom we have only the most impersonal contact. Trust works in the final analysis because the overwhelming majority of us share other parties’ pleasure in the maintenance of trust and pain in its breach, even when those parties are strangers living on the other wide of the world. And the more we engage in market exchanges, the more we learn to trust our partners in trade. This is not to say, however, that trust should be blind: ‘trust but verify’ is often the right commercial approach, a lesson Fonterra may have learned from its experience in China.

The biological approach to understanding the market is in its early stages, and the results reported in *Moral Markets* are likely to be expanded and revised over time. But enough has been done to dispel the notion that the

marketplace is driven essentially by selfishness and greed. If it were, its scope would never have developed beyond close neighbours engaged in immediate exchanges. Indeed market exchanges are best seen as an extension of the voluntary exchanges that occur within families and other institutions of civil society and benefit all parties. Compassion and altruism routinely feature in all these exchanges.

Thus, as I've indicated, the market is adequately justified by the liberty it embodies and by its ability to generate vastly more welfare than any other known economic arrangement. But we can also rest assured that that liberty and welfare are not somehow obtained by selling our souls to the devil. On the contrary, markets bring us all together in trusting relationships and, in the form of globalisation, may be on the way to realising the age-old dream of a genuinely integrated and interdependent humanity. Meanwhile, those anti-market ideologies and regimes that proclaimed and promoted the universal brotherhood of man have been relegated to the dustbin of history.