

# Economic rationality and the optimization trap

The theme of this issue of the St. Gallen Business Review is “Harmony”. For this reason, we would like to discuss whether two aspects of our lifeworld are in harmony, namely economic optimization and morality. What is the relation between them? According to a widely shared view, which is one aspect of the doctrine of “mainstream economics”, **the functioning of an economic system does not require moral behaviour on the part of the individual economic agent.** In what follows, we will try to convince you that this is **false**. If all economic agents – managers, employees, bankers, consumers and so on – were purely self-interested, as mainstream economics assumes, our economic practice would fail. There are various reasons for this. Here we will focus on one of them, namely the pivotal role of interpersonal communication.



## Economic success depends on successful communication

**I**t is fairly obvious that our economic system depends on effective communicative structures and processes between individuals. There are multiple reasons for this. One reason is the division of labour that is involved in economic production. Various different individuals produce the parts that are then assembled into a product. In order to coordinate the activities between them effective communication processes are required. A further reason is trade. Our economic system is based on the idea that goods and services are exchanged between individuals for mutual benefit. This exchange process requires that the individual parties agree on the terms of the trade and this, in turn, requires an effective system of communication between them. It is thus obvious that effective communication is a prerequisite of a functioning economic system. Though true, this fact is rather easy to overlook because, as a well-known platitude has it, you never know what you have until you

lose it. Most of us seem to take communication for granted as its value only ever reveals itself when it becomes dysfunctional. Nevertheless, we have, as economic agents, an interest in suring up the basis of our communication with one another. But how is this possible? In order to understand this we need to dig a little deeper.

## Communication is inherently moral

**W**hat is necessary for successful interpersonal communication? We would like to illustrate our answer to this question by dissecting a typical communicative situation and laying bare its microstructure. Suppose two persons, call them Emily and Susie, discuss a more or less sophisticated issue, such as the question whether taxes should be lowered in order to stimulate the economy. Emily argues that lower taxes will stimulate growth because it will increase consumption. Susie objects that tax breaks are unlikely to result in increased consumption because they will mainly benefit the rich who spend a relatively smaller fraction of their income on consumer goods. The precise shape of the discussion shall not concern us here. What we are interested in is to spell out the conditions for successful communication between Emily and Susie. It is clear that Emily's and Susie's conversation will involve a large number of individual utterances through which they express their opinions. These utterances need to satisfy certain conditions if the communicative exchange between them is to be successful. What are these conditions?

It is clear that Emily expects Susie to be honest in her utterances (and vice versa). She expects her to say what she really believes. If Emily thought that Susie did not really mean what she said, if she thought, say, that Susie merely wants to mess with her, Emily would presumably refuse to engage in the discussion with Susie. Their communication would fail. Honesty is, hence, one of the conditions of successful communication. It is not the only one, however. Honesty and truthfulness have to be separated. Susie's opinions may be entirely untrue, even if she expresses them honestly. If Emily had reason to believe that most of what Susie says does not correspond with reality, Susie would not seem to be a reliable communication partner. Reliability, i.e. the (likely) correspondence of a person's beliefs with objective reality, is thus a further condition for successful communication. Finally, successful communication depends on trust between communication partners. This trust has two aspects: a subjective and an objective one. Emily should believe that Susie says what she subjectively holds to be true and that it is, in all likelihood, objectively true (and vice versa). Even if Susie is honest and reliable, the communication between her and Emily would still fail if Emily did not trust her.

This précis of an interpersonal communicative situation makes clear that successful communication depends on conditions that are inherently moral. In order to make communication work each communication partner needs to follow certain rules. They need to be honest, reliable and trusting. Following these rules is not, however, in the immediate self-interest of either of them. Rather, it is for the sake of a cooperative communicative practice – a practice that benefits all.

## Unrestrained economic optimization undermines our economic practice

**A**t this point, it may be objected that, our aforementioned reasoning notwithstanding, purely self-interested individuals (or *homines oeconomici*, as they are referred to in economics) would be able to communicate successfully. After all, successful communication is in everybody's self-interest. And is their self-interest not what they are after?

This reasoning involves a misstep in logic. Of course, self-interested individuals are motivated by their own self-interest. They will do what is best for them. This much is true by definition. But it does not mean that in a society of self-interested individuals each will do, individually, what is best for all. This is not a new insight. The political philosopher Thomas Hobbes famously expounded it in his book *Leviathan* already back in the 17th century. And some decades ago economic game theory has begun to analyse scenarios in which the pursuit of individual self-interest is socially destructive. A famous illustration is the so called prisoners' dilemma game, in which two prisoners, call them A and B, who have jointly committed a crime, are faced with the choice between ratting out their partner or keeping silent. The situation is such that it is always advantageous, from both prisoners' perspective, to rat the other out. If A rats out B and B keeps silent, A will go free and B will be put in jail for life. The same goes vice versa. If, on the other hand, both rat each other out they both get 10 years in prison as opposed to the one year that both get if they both keep silent. In this situation, it would be best from A's and B's perspective if they both kept silent. This solution is, in

the lingo of economists, Pareto optimal. However, it is individually advantageous, both from A's and B's perspective, to rat the other out – no matter what the other guy does. If, recall, A rats out B, A goes free if B keeps silent and gets 10 years of imprisonment if B rats him out, too. This is (individually) better than not ratting B out, which gets A one year of imprisonment in the first case and life in prison in the second. Hence, if A and B both act from their own personal self-interest, if they optimize their individual advantage, this will land them in an optimization trap.

As it turns out, then, the fact that successful communication is to everyone's advantage does not imply that self-interested individuals will communicate successfully. They will adhere to the constitutive rules of successful communication only when this is in their own personal self-interest. They will, e.g., be dishonest only when it pays and this will gradually erode communication between them. If, as we have argued above, economic practice relies on successful communication, then purely self-interested individuals will not be able to sustain it. They will be trapped in optimization – just like the two prisoners.



## A plea for interdisciplinary thinking

Our conclusion contradicts economic common sense. Nevertheless, we hope we have been able to make it plausible that unrestrained economic optimization would destroy our economic practice and land us all in an optimization trap. But even if we were not successful in doing that, we hope that we were at least able to raise your awareness for issues that transcend the boundaries of the economic domain. We hope that we were able to convince you that there are philosophical issues to do with our economic practice that are important and worthy of your attention. In our view, the economics profession and society as a whole would benefit enormously if its practitioners would devote more attention to the philosophical foundations of their discipline. One obvious place where this idea could be implemented is the education system. Many economics and business curricula eschew philosophical topics – even at elite universities. And even the ones which do go into them usually do not train students in the kind of interdisciplinary thinking that is necessary in order to mediate the various aspects of our lifeworld. At Ludwig-Maximilians-Universi-

tät München, where both of us are based, we try to resist this trend. Following the famous PPE model (which stands for philosophy, politics and economics), which was first implemented at the University of Oxford in the 1920's, we set up an executive degree programme called Philosophie, Politik, Wirtschaft (PPW) in 2005. The programme addresses itself to business executives as well as to leaders in political and non-governmental organizations. It aims to reflect economic theory and practice in light of philosophical considerations and with an eye towards policy implications. In the ten years since its inception the programme has been able to stimulate integrative discourse between the disciplines and has proven extremely successful in shaping and sharpening its graduates' ability to make responsible, reasoned decisions in complex environments. This example shows that it is both possible and tremendously worthwhile to transcend the narrow bounds of mainstream economics and to try to bring economic theory and practice into harmony with its own foundations. ♦

### **LMU Munich**

**Ludwig-Maximilians-Universität München was founded in 1472 and is one of the leading research universities in Europe. It encompasses 18 faculties, which cover the whole range of contemporary scholarship, including humanities and cultural studies, law, economics and social sciences, medicine and the natural sciences. Its philosophy faculty covers all areas of philosophy. It offers various degree programmes and specializations, including an extra-occupational degree programme in philosophy, politics and economics (Philosophie, Politik, Wirtschaft).**

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**Websites:**

[www.ppw.philosophie.uni-muenchen.de/ueber\\_uns/leitung](http://www.ppw.philosophie.uni-muenchen.de/ueber_uns/leitung)

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