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Subjective Psychological Preferences within Economics

The impossibility of studying economics as an empirical science has resulted in a great variety of economic theories over time. The subjectivity of economic theory can be attributed to its dependence on psychological principles. Although psychology and economics are not the same discipline, they are clearly linked, and while different economists have disagreed on the extent of the link between the subjects of psychology and economics over time, the subjective psychological preferences of individuals have an especially clear impact on interest rates and on Wicksteed's development of total demand-stock analysis. The implications of the connection between psychological preferences and economics cannot be ignored.

Economics cannot be studied in the same objective way that empirical sciences can be studied. Many economists throughout history such as Hayek, Fetter, Menger, and Mises have noticed the subjective nature of economics and some of the implications for how economics should be studied. Empirical sciences, such as physics or chemistry can be studied through objective methods of observation and experimentation. The scientific method is used to support or reject hypotheses. One important part of the experimentation process is having and defining constant conditions and variables that make it possible to test for a single variable with as little discrepancy as possible.[1] Another key part of the empirical sciences is duplication of experimentation. The theories which are true can be tested and supported by further study and

[1] Ludwig Von Mises, *Human Action: A Treatise on Economics*, Scholar's ed. (Auburn, Ala: Ludwig Von Mises Institute, 1998), 6.

those that fail are rejected. The theories that stand the test of time and study are built upon, and progress is made in these sciences. Throughout history, discoveries in the empirical sciences have amassed to form huge bodies of knowledge which can be learned from and utilized by those in the field today. For example, physicists today are able to use the findings of Galileo, Newton, and Einstein to aid in their study of the natural world.

This is not true in the same way for economics. Economics is studied through observation and speculation rather than direct experimentation because of the impossibility of maintaining constant variables in economics. Economists throughout history have attempted to explain the processes they observe with a variety of theories and models. While economic theories do build on one another over time, it is difficult to objectively accept or reject economic theories or models. These theories and models are influenced by those of earlier economists as well as by the contemporary economic and political situation. As a result, different, conflicting theories and models have been proposed, accepted, and rejected over time.[2] This can be seen in the fact that mercantilism was the primary economic system during the colonial period, and in the development and popularity of Keynes' theories at the time of the Great Depression. Besides being influenced by current politics and world events, the subjective nature of economics leads to economists borrowing, stealing, tweaking, and shifting existing theories, as well as creating their own new theories. Sometimes theories previously thought to be correct are lost or forgotten in favor of popular new theories which may or may not be legitimate.[3] This weakness results from the fact that objective data is not identifiable in economics. Facts cannot be directly observed in economics as they are in the natural sciences.[4] Hayek believed that attempting to

[2] Von Mises, 7.
[3] Von Mises, 6.
[4] F. A. Hayek, "The Use of Knowledge in Society," *The American Economic Review* 35, no. 4 (September 1945): 520.

study economics in the same was the natural sciences are studied would be a mistake because of the inherent differences between objective and subjective sciences.

Economics is more closely related to social sciences than to natural sciences. The social science to which economics has the closest relationship is psychology. Both psychology and economics are inherently subjective in nature. However, economics and psychology have vastly different objectives. Psychology as a science hopes to study motivation and causes of behavior. Psychology asks why people do and think what they do. Economics on the other hand is the science of human action. It takes psychological principles as given and hopes to determine how the actions of humans influence one another in a system. Economics asks how subjective preferences interact to form a complex system that works to satisfy needs and wants of people efficiently.

Human behavior cannot be predicted and is inherently subjective, making planning an economic system impossible. Because preferences are temporary and unpredictable, adjustments would need to be made constantly to maintain an efficient system.[5] In economics, prices function to organize collections of decisions much like an individual uses subjective valuation. According to F. A Hayek: "In a system where the knowledge of the relevant facts is dispersed among many people, prices can act to coordinate the separate actions of different people in the same way as subjective values help the individual to coordinate the parts of his plan."[6] Prices based on subjective preferences of individuals allow the market to function efficiently to satisfy needs and wants without a central plan.

[5] Hayek, 523.
[6] Hayek, "The Use of Knowledge in Society," 526.

Without consideration for prices, the effects of subjective preferences still matter. This is because the motivation for economic and noneconomic behavior is the same.[7] This further strengthens the connection between the disciplines of economics and psychology. The lack of distinction between the psychological preferences for economic and noneconomic goods show how subjective economics truly is. Subjective preferences govern human choice regardless of the presence of monetary values. According to Mises: "All human values are offered for option. All ends and all means, both material and ideal issues… are ranged in a single row and subjected to a decision which picks out one thing and sets aside another. Nothing that men aim at or want to avoid remains outside of this arrangement into a unique scale of gradation and preference."[8] Everything that is done or acquired comes at the cost of doing or acquiring something else, on a scale which is unique to each person. This is referred to as opportunity cost. The proportions in which an individual chooses to spend their time and money are determined by their subjective preferences which may be based on a variety of criteria such as income and personal values.[9] The subjective decisions of individuals create a basis for the economic system to function as a whole.

Even time is a limited economic good governed by subjective preferences. Time preference is one of the primary subjective psychological preferences which has a profound impact on economics and holds a primary position in economic theory, as related to the existence of interest rates. Different time preferences of individuals account for the creation of interest rates because people generally prefer present goods over future goods. How much certain people

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[7] P. H. Wicksteed, "The Scope and Method of Political Economy in the Light of the 'Marginal' Theory of Value and Distribution," *The Economic Journal* 24, no. 93 (March 1914): 5.
[8] Von Mises, *Human Action*, 3.
[9] Wicksteed, "The Scope and Method of Political Economy in the Light of the 'Marginal' Theory of Value and Distribution," 3.

prefer present goods differs subjectively based on a variety of criteria such as what the good is and who the person is. This preference, like most human preferences, is generally unpredictable. How then, does the economic system efficiently deal with time preference to allocate goods? A prediction of the difference between present and future goods is shown by the interest rate.[10] The interest rate can be described within the following equation: A (future value) equals p (present value) times one plus r (the discounting or augmenting factor, also known as interest rate). This equation, which can also be written p= A/(1+r) allows for the calculation of how much a present good is preferred over a future good, based on the interest rate. The interest rate is constantly changing based on the market, responding to subjective changes in time preference of the people. The existence of interest rates shows the general trend in preference towards present goods over future goods.

The collection of time preference of individuals for a variety of different goods results in one general rate for the market.[11] However, as previously stated, the market interest rate changes continually. These changes can be explained by changes in subjective individual preferences. Subjective time preferences of individuals affect the market interest rate significantly. One thing we can learn from the market interest rate is whether people are optimistic or pessimistic about the future economy. Whether optimism or pessimism is the precedent on the market is directly related to the subjective psychological state of its participants. Lower interest rates for long-term investments show that lenders are pessimistic and would prefer to keep their money more liquid in case of economic downturn, while high interest rates for long-term investments show that lenders are optimistic about their choice to invest and are not worried about the liquidity of their

[10] Jacob H. Hollander and Frank A. Fetter, "The Principles of Economics, with Applications to Practical Problems.," *Political Science Quarterly* 22, no. 1 (March 1907): 87, https://doi.org/10.2307/2140929.
[11] Hollander and Fetter, 86.

assets in the current economic climate. This is important because how people feel – an inherently subjective principle – determines a concrete economic number which can help drive markets to boom or bust.

Economists create models to explain and demonstrate the fluctuations within the economic system. There is one particular model of analysis which hopes to explain the economic system of prices by accounting for the subjective psychological preferences of all participating individuals. Philip Wicksteed developed his total demand-stock analysis to show that subjective preferences drive not only buyers but sellers as well. Wicksteed rejected the traditional supply and demand analysis developed by Alfred Marshall in favor of his new analysis. Wicksteed hoped to explain the process of supply and demand within one curve: the total demand-stock analysis. Wicksteed hoped to do away with the supply curve from Marshall's analysis, explaining his reasoning in this way: "But what about the "supply curve" that usually figures as a determinant of price, co-ordinate with the demand curve? I say it boldly and baldly: There is no such thing. When we are speaking of a marketable commodity, what is usually called the supply curve is in reality the demand curve of those who possess the commodity."[12] Instead of including a supply curve, in Wicksteed's analysis, total demand accounts for the subjective preferences of both buyers and sellers. Subjective preferences of consumers determine the highest price they will be willing to pay for a product, and subjective preferences of sellers will determine the lowest price at which they are willing to sell their product. This is referred to as a reservation price: buyers have a maximum reservation price while sellers have a minimum reservation price. This data for demand of both buyers and sellers is shown in one negative sloping curve (total demand) and is compared against a vertical and therefore constant total stock curve which is

[12] Wicksteed, "The Scope and Method of Political Economy in the Light of the 'Marginal' Theory of Value and Distribution," 13.

considered to be fixed in the short term. Where these two curves intersect determines the price at which the product will be traded. The reservation prices of both buyers and sellers are inherently subjective, and while Marshall's popular supply and demand analysis acknowledges the subjective preferences of buyers, it neglects to show that the same subjective forces affect sellers within the market. In this way, Wicksteed's analysis better demonstrates the effects of subjective preferences of individuals on the price system.

The total demand-stock analysis is useful for determining the price of a product in the short-term based on subjective preferences and the amount of a product that is currently available within the system. However, Wicksteed's analysis is likely to fail in a long-term analysis in which the total stock of a product could change. Marshall's supply and demand analysis is better able to show the effects of long-term changes in the market because of the analysis' ability to show changes in supply and their effects on equilibrium prices. Wicksteed's analysis is a reminder of the system's dependence on psychological preferences and makes a short-term evaluation of the market price more accurate. However, for basic long-term analysis, the traditional supply and demand curve analysis is still useful. While the total demand-stock analysis cannot explain the entire economic system, it is able to force an acknowledgement that all participants in the system are driven by subjective psychological preferences, and for this reason is valuable as an additional form on economic analysis. Wicksteed's total demand-stock analysis and Marshall's supply/demand analysis can and should both be used for their strengths to explain the economic system. One should not be disregarded for the other.

The successes and failures of Wicksteed's total demand-stock analysis create a question about the possibility of having objective theories about a subjective science. While Wicksteed's theory is a convincing one, it cannot explain the system on its own or in its entirety. It might not

be possible to create an objectively correct economic theory or model because of the subjectivity of economics. The dependence of economics on the unpredictable psychological preferences of individuals makes objectivity exceedingly difficult. As is clear by the variance of economic theories over time, progress in economic science is difficult to make and measure.

Economics cannot be studied as an empirical science, and as a result includes a variety of theories that evolve over time, none of which have succeeded at explaining the economic system objectively. Subjective psychological preferences of individuals drive economics, and despite economists' disinterest in explaining human behavior or motivation, economics is a science of human action. An analysis of time preference can be used to explain the existence of interest rates and the economy's dependence on subjective preferences and decisions of individuals. Wicksteed knew that economics was a science based on subjective psychological preferences and created his total demand-stock analysis as a model to help explain the interactions of these preferences within the market. However, objectivity in a subjective science has not been an achievable goal for economists. Economics will continue to be a discipline open for interpretation, but its connection to psychological principles should continue to be considered as an integral part of the field in future study.

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