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One of the fundamental assumptions of neoclassical welfare economics is that preferences are exogenous, that is, what people want is not affected by their activities as workers or consumers. People have a variety of basic needs such as food, shelter, sex, knowledge, affection, and self-esteem. However, these needs never exist in a pure form; they are always expressed through derived needs for particular commodities, relationships, or experiences. While the underlying needs, based in human nature, are exogenous to economic activity, the formation of particular derived needs is often endogenous. Economic theory is primarily concerned with derived needs, or preferences for particular commodities, and should therefore assume that preferences are endogenous. This paper asserts that preferences are often endogenous and explores the implications of this view for economic theory.

FORMALIZING ENDOGENOUS PREFERENCES

To examine the implications of endogenous preferences, consider a formal model that incorporates such preferences, but is otherwise identical to the standard neoclassical model. Specifically, assume that in any time period, an individual's utility, or satisfaction, depends on the individual's current characteristics - personality traits, skills, knowledge, and values - and on the commodities consumed and the types of labor performed during that period. The assumption of endogeneity states that current characteristics may depend on past consumption and/or work experience. Thus, current satisfaction indirectly depends on the ways in which the individual has been shaped by past economic activity. Any economic activity may simultaneously satisfy current preferences and develop future preferences.

Other assumptions of the model are largely the familiar neoclassical ones. Lifetime wellbeing is a function of satisfaction in each time period. Everyone has perfect knowledge, including knowledge of the endogeneity of preferences. The production side of the model is assumed to be purely neoclassical. The point is not that these assumptions are realistic; important questions have been raised about many of them. However, sticking to the standard neoclassical approach in all areas except for one highlights the effect of that one point of departure.

IMPLICATIONS FOR WELFARE ECONOMICS

Eight welfare theorems can be deduced from the endogenous preference model. The first pair show that conventional theory, based on exogenous preferences, leads to incorrect results.

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1. A theory that ignores the effects of present consumption and work activities on future preferences will systematically misestimate the welfare effects of economic choices. This theorem is analogous to an important result in human capital theory, e.g., on-the-job training and other human capital effects of current activities will change individuals' future budget constraints. Similarly, the preference-developing effects of current activities will change individuals' capacity to extract satisfaction from future options.

2. Rational individuals who recognize the endogenous nature of preferences will choose activities that reduce their preferences for expensive items, and develop their preferences for cheaper ones. This undermines the welfare significance of consumer sovereignty, that is, while supply is still governed by current demand (as in the neoclassical model), supply also shapes future demand. The rational adjustment of preferences - learning to prefer what is cheaper - makes the utility of a good depend on its price; this suggests a comparison with conspicuous consumption. However, the two effects point in opposite directions: when the price of a good rises, rational preference adjustment leads to lower demand, while conspicuous consumption may imply increased demand.

THE FUNDAMENTAL THEOREMS REVISITED

The first two theorems confirm the intuitive sense of the importance of endogenous preferences. The next three theorems, therefore, come as a surprise: under standard neoclassical assumptions plus endogenous preferences, the fundamental theorems of welfare economics are still valid. While some of the assumptions of the standard model are unrealistic, endogeneity of preferences does not make these assumptions any less plausible.

3. Under traditional assumptions plus endogenous preferences, a general equilibrium exists for any competitive market economy. The crucial assumptions for the existence proof concern the insatiability, continuity, and convexity of preferences. Recent social and economic analyses lead to questions about insatiability, and even more about convexity. Endogenous preferences, however, only play a minor part in those questions.

4. Under the same assumptions, any general equilibrium in a competitive market economy is a Pareto optimum. The critical premises here are the absence of externalities and "thick" indifference curves. Externalities are important in the real world, but this is true regardless of the endogeneity of preferences.

5. Under the same assumptions, any Pareto optimum is a general equilibrium of a competitive market economy with an appropriately chosen initial resource endowment. The crucial assumptions here are the same as those for Theorems 3 and 4.

Theorems 1 and 2 suggest that endogenous preferences have important implications for welfare economics, but Theorems 3, 4, and 5 seem to suggest that the effect of endogenous preferences is quite limited. The so-called "fundamental theorems of welfare economics" are still valid in the presence of endogenous preference formation. If that were the end of the story, endogeneity would require minor modifications to standard theory.

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WELFARE AND IMPERFECT MARKETS

The strength of the standard results of welfare economics, echoed here in Theorems 3, 4, and 5, derives from the high level of abstraction that is employed. All market imperfections and distortions are simply assumed away for purposes of analysis. Economic theory looks very different as soon as we start to move down from this pinnacle of abstraction. The last three theorems reveal the importance of endogenous preferences in an imperfect market economy. For purposes of analysis, we will use the smallest possible market imperfection, a single bias in relative prices (one good is priced above its marginal cost, while other goods are priced at their marginal costs.)

6. In an economy containing a bias in relative prices, the divergence from optimal resource allocation will be greater than indicated by traditional welfare theory, and will increase over time.

7. In an economy containing a bias in relative prices, individual human development patterns will be "warped" relative to those prevailing in an optimal economy; the extent of warped development will increase over time.

8. The full welfare effects of any bias in relative prices will not be visible to participants in the economy, nor to observers who believe that preferences are exogenous.

Although formal proof of these theorems is somewhat difficult, the underlying logic is straightforward. When relative prices are biased, rational individuals will modify their activities aimed at future preference development, as well as current preference fulfillment; neoclassical theory recognizes only the latter effect. The "warping" of human development that occurs in response to market imperfections is individually rational, but reinforces the socially suboptimal pattern of resource allocation - the theoretically optimum outcome is not only unavailable on the market, it is no longer even desired. Traditional analysts will fail to perceive the endogenous preference changes that result from market imperfections, and hence (as suggested in Theorem 8) will understate the resulting deviation from optimality.

In short, the greatest significance of endogenous preferences is not their effect in the ideal theoretical world of perfect competition with no externalities, but rather the increasingly nonoptimal outcomes that result in a world of market imperfections as people adjust their preferences and thereby aggravate the misallocation that results from any imperfection.

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