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"Economics and the Good, I: Individuals" by David Kiron

> Economics as a science of human behavior has been grounded in a remarkably parsimonious postulate: that of the self-interested, isolated individual who chooses freely and rationally among alternative courses of action after computing their prospective costs and benefits.
>
> - Albert O. Hirschman[1]

This neoclassical model of *homo economicus* is defended more for its predictive power than for its psychological realism. However, there is mounting concern that the model's simple assumptions, while perhaps adequate for many aspects of economic behavior, fail to explain or promote those features of the human condition necessary for a good life. This section develops both empirical and theoretical objections to the prevailing "revealed preference" analysis of welfare, challenging especially its assumption that preferences are the correct terms in which to understand human welfare.

As discussed in Part III, the ordinalist revolution in the 1930s seemed to obviate the need for an accurate measure of cardinal utility and a more sophisticated theory of human motivation. Subsequently, economic behavior could be explained with a few assumptions: as long as individuals are rational and their choices reflect their preferences, individuals maximize their utility. Utility was retained as a useful rubric for understanding human welfare, not because problems with earlier formulations had been solved, but because they could be avoided.

Revealed preference theory assumes that the satisfaction of a person's actual preferences must improve her welfare. However, preference satisfaction may in fact fail to improve well-being if preferences are irrational, poorly cultivated, malevolent (based on the misery of others), or based on incomplete or false information. In response to such objections, efforts have been made to improve this theory to account for the many instances in which preference satisfaction detracts from or contributes nothing to human welfare. The main thrust of these modifications is to idealize preferences and model individual preferences as those that a person would have if fully informed about her choices. However, this move brings other significant problems that offer strong reasons to reject any preference-based theory of well-being.

PSYCHOLOGICAL REALISM AND ECONOMIC ASSUMPTIONS

The ordinalists were motivated by one especially thorny problem: the measurement of utility. In the early 20th century, the subjective quality of individual experience--pains, pleasures, emotions, and feelings--seemed completely beyond the terrain of empirical study. To logical positivists and psychological behaviorists, entities beyond the empirical pale were mythic substances, objects of rhetoric and unworthy of scientific consideration. However, developments in the discipline of psychology, such as the recent growth of studies of subjective well-being in the past two decades, have opened a window into the nature of individual satisfaction and led to the construction of tools for making interpersonal comparisons. Statistical methods are now used to verify personal reports of satisfaction and measure levels of happiness. As a result, the hedonic quality of experience is more widely accepted as understandable and measurable.

Two leading researchers in this fast growing field, David Myers and Ed Diener, provide an overview of its major findings in our first summary. Their review of empirical work in the psychology of subjective well-being reveals that human welfare is structured by the presence or lack of strong supportive relationships, challenging work, and personality traits that include self-esteem, extraversion, optimism, and feelings of personal control. Consumption plays a more limited role in promoting happiness than is assumed in economic theory: a wealth of studies demonstrate that the correlation between income and happiness is weak above minimum income levels. In wealthy countries, self-esteem is a better predictor of happiness than income.

Myers and Diener also sketch a theory of subjective well-being that incorporates culture, the human propensity to adapt to changing conditions, and the pursuit of chosen goals: elements ignored by the neoclassical theory of consumer behavior. Cultural outlooks on the world tend to shape individual perceptions of satisfaction. Norwegians and Portuguese with similar incomes differ considerably in their self-reports of happiness: the Norwegians are four times more likely to consider themselves happy than the Portuguese subjects. Traumatized accident victims and ecstatic lottery winners both adapt to their respective emotional extremes in relatively short periods of time, and then return to baseline happiness levels. Progressive incremental increases in happiness play a larger role in global judgments of well-being than momentous events. They also hypothesize that active involvement in valued activities and making progress toward one’s goals contribute more to subjective well-being than does passive experience of desirable circumstances.

The possibility that empirical data from psychology could be used to advance economic theory poses a significant challenge to the neoclassical approach to consumer welfare, given that its founders and later proponents disavowed the need for greater psychological complexity and realism. However, within the discipline of economics a small but expanding group of economists are beginning to place more stock in the uses and value of psychology and its study of motivation.

In the late 1970s and early 1980s, the attention of economists was captured by the work of Tversky and Kahneman, experimental psychologists who examined individual decisions made under conditions of uncertainty. Their findings led some economists to the conclusion that the standard model of the rational economic actor is not always an appropriate explanatory tool; real people make decision errors that result in lower rather than higher utility. Studies in the psychology of decision theory provide dramatic evidence that *decision utility* (i.e., preference satisfaction), may diverge from *hedonic utility*, the subjective experience of good and bad. The upshot is thatpreference satisfaction implies much less about well-being than assumed by revealed preference theory. A full reliance on the model assumes too much (and as we discuss later, it also assumes too little).

In more recent work, summarized here, Kahneman surveys findings from one area within experimental psychology and argues that hedonic utility is not only measurable, but that measures of it reveal that rational choice does not always promote welfare. He disputes the assumption that individuals are inveterate utility maximizers and provides evidence that individuals neither try to maximize utility functions nor act as if this was their motive. Research demonstrates that, instead of summing utilities that are experienced over time and arriving at a final, cumulative judgment, people often judge their satisfaction according to a “peak and end” rule--combining the most intense experience of an episode with what is experienced at its end. People are also unable to make accurate estimates of the utility they will receive from future consumption. Individuals are vulnerable to *framing effects*(subjects may perceive objectively equivalent options as gains or losses given alternative descriptions) and are susceptible to *endowment effects*(cognitive phenomena in which losses loom larger than gains), a point acknowledged by classical utilitarians such as Bentham, but only recently rediscovered in modern theory.

The adaptation effect noted by Myers and Diener and some of the psychological phenomena noted by Kahneman had been discussed by economists earlier in this century, but none of these early attempts had much of an impact on the mainstream. Today, much of the new empirical research is couched either in the familiar language of rational choice or is based on new sophisticated statistical analysis -- both of which are respected by economic theorists. Of course, this does not fully explain why there is a growing acceptance of psychology now, rather than twenty years ago.[2] Other contributing factors may include a growing sympathy for the claims of social critics who proclaim a modern crisis of values -- a sympathy based on their observation that the simplistic assumptions regarding human motivation diminish economists ability to predict the contribution of economic activity to human welfare.

In the next summarized article, Robert Frank argues that economic theory should sacrifice some of its parsimony for greater psychological realism. Frank points out that economists ignore the fact that people adapt to changing circumstances, as with the accident victims and lottery winners, and the fact that an individual’s consumption is influenced by his or her reference group.

It is evident from Frank’s exposition that he believes that the standard neoclassical model need not be sacrificed in order to introduce a number of contextual assumptions. However, it is far from clear that many psychological complexities can be accommodated within this model. For instance, the possibility that some tastes and preferences are endogenous is a frequently raised challenge to the conventional assumption that all tastes are exogenous and relatively stable. The possibility of endogenous preferences, however, undermines standard proofs of efficiency and optimality of competitive outcomes. Will adding this bit of psychological reality complicate economic discourse beyond the capacities of the neoclassical model?

Albert O. Hirschman argues that economic theory omits two features of the human condition that influence various socially desirable activities: the capacity for self-reflection, and the capacity to engage in noncalculating behavior such as voting and collective action. Economic theory has no place either for the idea that individuals may want other preferences than the ones they possess or for the idea that individuals may be moved through rational discourse to change their preferences. The former, sometimes referred to as metapreferences or second order interests, and the latter notion of preference change are central to ethical theory and offer a plausible explanation for behaviors in which individuals seem to act against their own best interests.[3]

Similarly, economists' focus on calculation as a key to rational motivation misses the fact that striving toward and achieving one's goals can be a significant source of personal satisfaction. This point echoes the psychologists claim that having and pursuing one's goals is an important source of satisfaction and central to building one's identity. This cannot be replace by monetary incentives. As a result, productivity increases that derive from a sense of belonging or from loyalty may actually be undermined by incentive based approaches.

PREFERENCE SATISFACTION AND HUMAN WELL-BEING

Kahneman's conclusion that measures of subjective utility should be considered as a supplement to the rationality assumption represents a scientist's conservative interpretation of the difficulties faced by the revealed preference model of economic behavior. A less sanguine interpretation of the divergence between preference satisfaction and well-being is that any economic theory based on revealed preferences ought to be abandoned. This perspective is developed by philosopher Mark Sagoff in an article summarized later in this section.

Sagoff vigorously attacks the idea, implicit in welfare economics, that a social optimum can be obtained by maximizing the preference satisfaction of individuals. This approach assumes tight links between choice and preferences (the former reveals the latter) and between preference satisfaction and well-being (the former increases the latter). Sagoff argues that neither assumption is correct. With respect to the first assumption, our visible acts of choice are supposed to reveal subjective mental entities called preferences, but actual chosen behaviors have moral and legal consequences, unlike self-contained preferences that moral maturity often requires us to override.

The problem with the second assumption is that it conflates different meanings of preference satisfaction--what Kahneman refers to as hedonic and decision utility. Preferences are supposed to be the psychological motivation for all behavior, yet the economist must deduce what these preferences are from descriptions of behavior. These inferred preferences are logical constructs, not a causal source of motivation. The belief that maximizing the satisfaction of such preferences increases subjective well-being requires either an empirical or a logical defense. The evidence from psychology is very strong that it is false. If it is nevertheless maintained as a truth of logic, then the economist faces a tautological definition of well-being that destroys the theory's predictive power, since its explanations cannot be falsified.

For Sagoff, preference satisfaction cannot be identified with well-being and thus cannot be the fundamental source of value for economics; therefore it should not be used as a conceptual tool to guide policy. Instead, Sagoff contends that welfare economics can retain its normative significance only if it breaks the tight connection between preference satisfaction and well-being, defining the latter in terms that distinguish humans as responsible citizens from humans as consumers.

Although Sagoff does not explore the possibility, it is possible to abandon revealed preference theory and still argue that some other preference based theory is the appropriate way to understand well-being. Many such attempts have been made, and they all reject the traditional utilitarian assumption that preference satisfaction or desire fulfillment must be experienced in order for it to contribute to well-being. Preference satisfaction is understood in the logician's sense of having a clause in a contract satisfied. It does not matter whether a person realizes that his or her preference is satisfied, or whether it is experienced--all that matters is whether the desired or preferred states of affairs obtains. To avoid problems associated with defective preferences, such theories also assume that preferences that are relevant to well-being are informed or ideal in some way. Such "corrected" preferences are formed under ideal conditions that permit individuals to be fully informed about the objects of his or her desires. Thus, individuals know and act upon what is in their best interests because they have absorbed all relevant and available information about alternative options.

One significant benefit of this approach is that it avoids the need to distinguish self-regarding and other-regarding preferences. If you desire that a political prisoner be freed from a foreign jail, you are better off if this comes about. But this approach runs into two major problems. The first problem can be illustrated by a classic philosophical example. Consider the situation in which one meets a stranger on a train ride. After a pleasant conversation, you wish him well, say good-bye and never talk to or think about him again. If his life does go well, satisfying your preference, it is commonly supposed that you are no better off; his success has nothing to do with you, contrary to what is implied by the informed preference theory. The problem becomes one of specifying or restricting informed preferences to those whose satisfaction actually contributes to one's wellbeing.

Political philosopher Thomas Scanlon, in the next summary, discusses one solution to the first problem. One of the goals assumed by well-being theorists is an answer to the Socratic question: What makes a life good for the person who lives it? This question can be asked and answered from many perspectives, e.g., from an individual perspective, the point of view of friends or parents, from an economic policy perspective, or from a moral perspective. Presumably, one of the virtues of an informed preference account is that it provides an answer for the first person perspective: what is good is whatever is the object of a person's informed preferences. However, there are two possible interpretations of this claim. Either goods are valuable because they are preferred or they are preferred because they are valuable. In each interpretation, preference plays an important role since it is the fact that goods are preferred that is common to or unifies all the values that are relevant to well-being.

One influential but rather eclectic informed desire theory has been proposed by James Griffin.[4] It is eclectic because it tries to accommodate both interpretations--some goods are valued because they are desired, while others are desired because they are valuable. It is influential because it appears to solve many problems associated with restricting the range of desires relevant to well-being. However, as Scanlon argues, in Griffin's account of human good, preferences do not provide a unified account of the good. As a result, Griffin's view resembles less a desire theory of good and more what philosopher Derek Parfit refers to as an *objective list* theory of human good.[5] Objective list theories provide a list of things that are good and bad for people whether or not they want the good things or want to avoid the bad things. Scanlon himself subscribes to one version of this type of theory and believes that citizens should arrange a contract among themselves concerning the kinds of activities, goods, and ways of living that are worth promoting--creating a shared list of substantive goods.

The other significant problem with informed preference theories remains even if such views were to resolve all the problems associated with specifying the correct range of desires. According to Connie Rosati, such views mistakenly assume that it is possible to evaluate different possible lives by adopting a birds-eye view of all such lives.[6] She argues that informed desire theories provide no way to compare different possible lives that contain opposing personality traits and/or conflicting commitments and belief systems. A person cannot simultaneously be fully informed about such different lives. How could someone know, even theoretically, what it would be like to? She concludes that it is impossible to value certain intrinsic rewards of a life from any vantage except from within that life.

WELL-BEING VERSUS QUALITY OF LIFE

Where does this leave us? Revealed preference theory was introduced as a theory of behavior that had strong ties to human well-being, but the problems discussed by Sagoff and others question the connection between preference satisfaction and well-being. Psychologists make clear that the satisfaction of actual preferences often leads away from well-being. Conceptualizing preferences as informed or rational brings other seemingly insurmountable problems. Is there no coherent structure to be found for what makes a human life good? Are we left with Scanlon's proposal to arrive at some social understanding of what kinds of things are good and develop some social contract to ensure that society promotes such goods?

One alternative approach is to argue that the subjectivist interpretation of well-being is correct; that well-being can be fully explained by referring to mental states, but that the significance of well-being may be more limited than commonly acknowledged. This approach avoids having to specify what kinds of desires when fulfilled actually contribute to a person's well-being. Consider the plight of the deceived businessman who dies believing that his life has been a success, that his family loves him, the community respects him, and he has created a successful business. In fact, his family has been nice to him only to safeguard their own interests, the community believes him to be a spy, and his business partner has embezzled all his company's funds. Such examples often motivate attempts to expand the limits of well-being beyond a person's experiences.

In a novel approach, Shelly Kagan draws a different lesson from such examples and argues that those facts that make a person well off (a person's well-being) may differ from those facts that make his or her life go well. Kagan argues that the deceived businessman has a great deal of well-being on his deathbed but a much lower quality of life. Instead of trying to stretch the concept of well-being to account for such examples, Kagan develops the thesis that the concept of well-being should be retained as the correct way to understand changes in a person's mental states. He then introduces the concept of quality of life, as a better way to understand facts about an individual's life that do not impact his or her mental states. His review of familiar examples in the philosophical literature on well-being convincingly argues that a person's quality of life, though related to, may differ from the level of her well-being. Situations that affect one may not influence the other at all. This distinction has serious consequences for economic planning and political policy. To the extent that quality of life differs from well-being, which should be the focus for political and economic analysis and policy?

This section concludes with an essay on the work of Amartya Sen, one of the most influential contemporary writers in interdisciplinary debates on quality of life issues. Sen provides critiques of revealed preference theory and a constructive proposal for an alternative, multidimensional conception of human advantage. He elaborates the relationship between well-being and quality of life and dramatizes the importance of promoting individual freedoms and achievement in economic planning. Sen distinguishes various dimensions of human advantage, a concept that is defined in terms of capabilities to achieve valuable functionings. In his view, quality of life is constituted by what a person is able to achieve in addition to the quality of available choices.

Sen's distinction between well-being achievement (e.g., experienced satisfaction) and agency success (goal achievement, whether or not it results in satisfaction) permits him to argue that a person's goals may extend beyond what directly affects an individual's well-being. One may achieve agency success at the expense of well-being levels (construed narrowly in terms of desire fulfillment or satisfactions) or even of one's standard of living. Although Sen and Kagan do not use precisely the same terms to distinguish well-being from quality of life, they both argue that subjectivist interpretations of well-being are an inadequate guide to social policy.

CONCLUSION

Both empirical and theoretical objections to the rational egoist model of human behavior call for a more realistic account of individual motivation and a rejection of preference satisfaction as the appropriate concept for understanding either well-being or the broader concept of quality of life. Psychologists as well as philosophers recommend that economists expand their criteria for rational choice beyond the consistency standard, to include measures of subjective well-being and the quality of available choices. Other social scientists also suggest that the revealed preference theory of human behavior offers few tools to explain valuable social outcomes due to the importance of moral preferences and intrinsic motivation. Individual commitments to projects and goals may be relevant to a person's well-being, even if a person does not benefit from his or her success--a possibility that is denied by preference-based accounts of the good. Finally, economic discussions of well-being seem to ignore issues related to self-realization and character development. The conclusion is unavoidable: economists need to develop a comprehensive answer to the question of what makes a person's life go well--the concept of preference satisfaction will not suffice.

Notes

1. Albert O. Hirschman, "Against Parsimony: Three Easy Ways of Complicating Some Categories of Economic Discourse," in *Rival Views of Market Society and Other Recent Essays* (New York: Viking Press, 1987), 142-160; cited from 142.

2. Some might question that there is such a growing acceptance. George Loewenstein describes this recent trend:

> In recent years, despite lingering skepticism, the influence of psychology on economics has steadily expanded. Challenged by the discovery of individual and market level phenomena that contradict fundamental economic assumptions, and impressed by theoretical and methodological advances, economists have begun to import insights from psychology into their work on diverse topics.

Loewenstein, "The Fall and Rise of Psychological Explanations in the Economics of Intertemporal Choice," in *Choice over Time,* eds. George Loewenstein and Jon Elste, (New York: Russell Sage Foundation, 1992), 3-34; cited from 3. Robert Frank reinforces this sentiment in his introduction to the recent republication of Tibor Scitovsky's, *The Joyless Economy* (Oxford: Oxford University Press, 1991). Frank says that when Scitovsky's book was first published in 1976,

> most economists were not ready for it....The profession was on a roll, triumphantly extending the neoclassical model into one new area after another....It has become increasingly clear that theories and evidence from psychology have something useful to contribute this reassessment....This time, I think, the profession is primed for Professor Scitovsky's message.

The quotation is from pages iii and iv of Scitovsky's book.

3. For a related discussion, see the comments on the economics of addition in the Overview Essay for Part VI of the previous volume, *The Consumer Society*, eds. Neva R. Goodwin, Frank Ackerman, and David Kiron (Washington, D.C.: Island Press, 1996). 198-199.

4. James Griffin, *Well-Being* (Oxford: Oxford University Press, 1986).

5. Derek Parfit, Appendix I in his *Reasons and Persons* (Oxford: Oxford University Press, 1984), 493-502.

6. Connie Rosati, "Persons, Perspectives and Full Information Accounts of the Good" *Ethics*, 105 (1995), 296-325.