

Chapter 1

Introduction

Economic theory begins with certain general assumptions. People are purely rational. They maximize utility whenever possible. General rules are established without making interpersonal comparisons or moral judgments. It is assumed that people are basically selfish. It assumes that there is competition and in order to make decisions, everyone is able to gather economic information easily, quickly and without cost. Economists also have developed methods for dealing with situations where information required to make decisions is not exact. Risk and uncertainty abound in the real world and economists factor this into their models by using what is called expected utility, i.e., the utility multiplied by some probability of the event occurring. This enables economists to factor out risk by being able to equate the expected utility of different outcomes.

The assumptions of economic theory and economics in general is that all people are similarly rational and self-interested. Many other social scientists, such as sociologists and political scientists, have a different view. They contend that such generalizations ignore the uniqueness of people and culture. The best we can do is describe each individual and community or perhaps derive some structural relationships that apply locally but certainly not globally.

This book takes the point of view that there is merit in both of these approaches. The “truth” lies somewhere in between. There are many economic relationships that do seem to have universal (or nearly universal) features such as the law of demand, diminishing returns or the tendency of competitive markets to allocate resources efficiently. However, there are many other circumstances where the generalizations of economics break down and are more consistent with actual behavior.

This book looks beyond the standard assumptions of economics in the following ways:

- It examines the field of behavioral economics and discusses instances when bounded rationality may lead to decisions that are not consistent with standard economic assumptions.
- It considers altruistic and cooperative behavior as alternatives to competition.
- It considers game theory as a way to explore motives of cooperation versus competition.
- It discusses the determinants of happiness and the relationship between utility and well-being.
- It discusses the concept of social capital including motivations for charity, being a responsible citizen, and the relationship between social capital and economic efficiency.
- It looks at the ethical concepts such as trust and fairness and how they relate to economic actions and the motivation to cooperate rather than compete.
- It analyzes risk and the processes by which investors and consumers make decisions.
- It looks at the concept of justice and income distribution from an ethical point of view.
- It explores the interaction of individuals within groups and the interaction of groups with the rest of society with regard to cooperation and trust.
- It looks at behavior such as crime, corruption and bribery from ethical, social and economic points of view.
- It considers the formation of “social capital” and its impact on the economic system.
- It looks at the ethical and behavioral patterns with respect to cooperation, trust and ethical behavior.
- It discusses possible ways that ethical and virtuous behavior, along with the formation of social capital, can be encouraged in economies.

Our approach is more eclectic than doctrinaire. In many cases, economic analysis makes useful contributions to understanding these

different issues. In other cases philosophy, psychology, sociology and political science have also made important contributions to our understanding. By widening the scope of inquiry beyond a narrow interpretation of economic theory, we are able to better understand the motivations of “economic actors”.

In the remainder of this chapter, we outline some of the basic features of the following chapters, including a short discussion of some of the issues covered. We begin with a short introduction to scientific method as it relates to economics.

Mainstream or orthodox economic theory likes to think of itself as being “scientific”. As part of the scientific method, neoclassical economics is careful to draw a distinction between positive and normative statements. By taking opinions out of the picture through the use of positive logic, it hopes to make economic analysis rational and subject to the process of scientific verification. It strives to examine “what is” rather than “what should be”.

Economics is willing to incorporate theories from other disciplines that it believes to be valid, such as attitudes toward risk or aspects of sociobiology which allow individuals to treat relatives differently from others with whom they share fewer genes. However, the general thrust of economic analysis remains focused on positive analysis. Judgments and normative analysis are relegated to the branches of economics where public goods and the role of the government are discussed.

Economists make a number of assumptions about how economic agents assemble and analyze information and how they make choices. These assumptions lead to certain theoretical constructs and certain conclusions about economic behavior flow from this analysis that is deductive in nature. Over time, these theoretical models have been modified and extended based on observations of actual behavior of economic agents. Throughout their analysis, economists are particularly emphatic in stressing the rational behavior of economic agents and the importance of competition and economic efficiency against a background of positive analysis.

Consideration of Pareto optimality is a feature of much economic analysis. Policy makers are often presented with a variety of possible choices to make, each of which has the characteristics of being efficient

and optimal in some sense. The relationship between the public and these decision makers is the subject of considerable economic analysis within the neoclassical framework. Within this framework, economists assume that the public is also aware of the options presented to policy makers and is sufficiently informed to make their voice heard through the ballot box.

Economic theory is also based on the general assumption that all individuals are “rational”, insofar as their economic decision making goes. They do not reverse their decisions quickly from one period to another without good reason. They follow the transitive laws of mathematics: if A is preferred to B and B is preferred to C , then A is preferred to C . Economists believe that every person when faced with similar circumstances will make the same basic decision, assuming that their tastes are similar. People are similarly rational and follow self-interest.

Actual decisions may differ because each individual has different tastes. These tastes may change and influence behavior accordingly. However, the basic calculus for making decisions remains the same for all individuals everywhere and anytime. Tastes are ordinarily assumed to be fixed and given, and the motivation for changes in taste is not explored systematically in most areas of standard economic analysis. It is assumed that economic agents have access to all the information they need to make decisions and that this information is, for all intents and purposes, costless. In the rest of this introductory chapter we explore ways that the parameters of the economic model have been questioned and replaced by more general behavioral assumptions which incorporate other aspects of behavior besides pure rationality. This includes exploring the role of emotions and incorporating other ways in which agents arrive at decisions as part of their general behavioral pattern.

1.1 A Model of Individual Decision Making — Bounded Rationality and the Inclusion of Emotions

In recent years, standard economic assumptions have been challenged on several different fronts. Proponents of what has become known as

“bounded rationality”, beginning with Herbert Simon (1972, 1982) and continuing through to Daniel Kahneman (2003), have stressed the importance of emotion as a strong input into decision making along with the notion that agents know, can know or choose to know only a limited number of possible options available to them when they make decisions. Decisions are often made using intuition and a variety of short-cut methods that sometimes violate the assumptions behind the rationality calculus that is the foundation of economic decision making. Focusing on the behavior of individuals, this approach suggests a variety of alternatives to the mechanistic, mathematical, detached view of economic agents as rational actors evaluating all sensory inputs objectively and then proceeding methodically to make an objective decision.

Both Simon and Kahneman won the Nobel Prize for economics, more than two decades apart. Simon was an economist while Kahneman was trained as a psychologist. Kahneman argues that by ignoring a wide variety of anomalies in the way people behave, economists are missing out on many aspects of behavior that do not fit into their neat little package of neoclassical inferences. He stresses the fact that people’s emotions play a role in decision making: “Findings about the role of optimism in risk taking, the effects of emotion on decision weights, the role of fear in predictions of harm and the role of liking and disliking in factual predictions — all indicate that the traditional separation between belief and preference in analyses of decision making is psychologically unrealistic” (Kahneman, 2003, p. 1470).

1.2 An Extended Model of Decision Making — via Interactions with Others

In a broader sense, a new breed of interdisciplinary economist is also looking at the role of emotions and value in decision making processes where economic agents interact with other agents in society. The role of emotions and decisions to cooperate with others or to compete with them are important components of these interactions. These behavioral economists are often interested in more interdisciplinary approaches and believe that anthropology, psychology, political

science, sociology, ethics and moral philosophy have an important contribution to make to economic analysis. They are not tied to a fine distinction between positive and normative judgments. They acknowledge the interdependence between economics, psychology, ethics and politics. They also acknowledge the need to make normative judgments in a more general way than strict neoclassical economists do.

These economists also relate well to social scientists in other disciplines such as anthropology, sociology and psychology where individual motivations can differ and where culture plays an important role in decision making. Douglas, Thomson and Verweij (2003) construct a diagram (see Figure 1.1) which relates an axis of competitiveness and cooperation (which they call low group and high group) against an axis of low versus high social mobility (which they refer to as high grid and low grid). The authors go on to indicate that in a low mobility/high grid environment, there are many rules that prescribe people’s roles in society. Conversely in a low grid/high mobility environment, there are fewer rules to conform to group behavior and

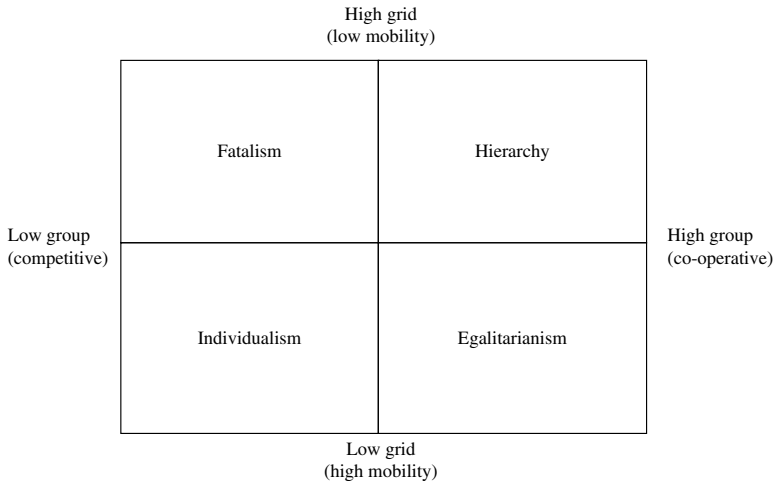


Figure 1.1 Axis of Competitiveness and Cooperation

Source: Douglas, Thomson and Verweij (2003, Figure 1).

Note: Some modifications to the title of the original figure have been made by the authors.

which constrain action. For example, the Mormons have specific and rigid rules that constrain the members of the religion. Similarly, in monasteries, the military and other rigid organizations, there are many rules that constrain behavior.

As a result of these rules, members will have different demands for goods and services than the “average” person. Mormons do not drink or use alcohol; they tithe and follow other codes. These rules constrain their consumption patterns. Monks take vows of poverty and chastity which constrain their participation in the market for goods and services.

Combined with tendencies toward competition or cooperation, we can group behavior according to four categories described in the four quadrants of Figure 1.1. These groupings and the names associated with them can be used to categorize different attitudes that members have toward different public issues as well as describing how they develop preferences for goods and services. The typical agent as described by conventional economic theory will fall in the lower left quadrant designated as “Individualism”. Economic man is selfish and competitive; he values free choice and is also quite mobile physically, economically, socially and psychologically. Those with similar attitudes toward social mobility but with greater emphasis on social justice would fall in the lower right hand quadrant labeled “Egalitarianism”. In the upper right hand quadrant labeled “Hierarchy” we have members of the religious and militaristic organizations. Those in the upper left hand quadrant are constrained by social laws and customs and at the same time are very competitive. This is a rather strange group and the authors have labeled them “Fatalists”. Perhaps the existentialists of the French school such as Camus and Satre would fit into this category.

The introduction of these different categories at this juncture in this book is meant to give the reader some idea of possible alternatives to the standard model of economics. To break out of the narrow box that economists have drawn for themselves with their restrictive neo-classical economic theory, economists need to consider what happens when they move out of the lower left hand quadrant. Kahneman *et al.* (1986a, b) noted, for example, that there is no role for generosity and

social conscience or even goodwill or indignation in economic theory. They also note that it is embarrassing to the economics profession that people vote, give to charity, take altruist actions, and do not always free ride or apply rules of equity when allocating resources between themselves and others, rather than following a “take it all” strategy.

All of these behaviors are left unexplained by conventional neo-classical analysis. There are many other examples including the role of trust, fairness, revenge and other emotions in decision making. Kahneman and his colleagues are among a group of social scientists (see Kahneman, 2003, for references) who are questioning whether other approaches are needed to explain these sorts of behavior (see also Camerer *et al.*, 2004).

These social scientists realize that to obtain better insights into behavior we need to expand our scope of reference to include topics which are normally considered to be beyond economics, such as fairness, happiness, trust and justice. In this new approach to decision making and economic analysis, we can still apply some of the tools of economics. However, we have to develop a different platform to analyze and evaluate what generally motivates human behavior. Much of this analysis has to do with how individuals interact with others in an economic setting and how these actions depend upon emotional factors and ethical value systems. Looking at how people make decisions from such an expanded perspective also enables us to explain aspects of behavior which are hard to understand using conventional tools of economic analysis.

1.3 Taste

In one way these aspects of behavior go beyond conventional analysis by looking at the concept of “taste” in a more detailed way. Broadly, taste reflects a predisposition toward buying and consuming particular goods or services. It can also be associated with emotional attitudes toward different people or social situations. Taste is widely used by economists to describe the utility or satisfaction derived by behavior or consumption patterns. While taste may influence decision making,

such as having a taste for discrimination or cooperation in the ways described by Becker (1981), there have been limited consideration of how tastes are formulated and adjusted. A perspective that considers taste in a more systematic way allows us to look at normative questions that economics ordinarily shy away from.

1.4 Ethics and Happiness

There are emotional as well as ethical, moral and cooperative/altruistic factors that play a strong role in motivating human behavior. For example, we can explore fairness and what people view as fair and unfair decisions and practices. Trust and justice can be viewed from both a behavioral and ethical standpoint while using tools of economic analysis. The concept of happiness or subjective well-being is important and we discuss what factors increase well-being. We can also explore the issue of the provision of public goods from an ethical perspective and consider the provision of some goods which we call “merit goods” from a normative point of view. These “merit goods” are essentially private goods that are important enough to society that the wishes of consumers are over-ruled and more of these goods are provided than would occur under consumer sovereignty. The decision to supply merit goods is a matter of judgment and another area where ethical considerations are involved.

1.5 The Road Ahead

We begin the substantive discussion of these issues in Chapter 2, with a short introduction to the standard neoclassical description of the theory of the consumer and how this relates to the theory of markets and of the efficiency of an economic system in allocating resources in production through competition. This discussion is at an elementary level and is not mathematical in nature. However, it does give the reader an important background glimpse of the values, methods and approach of economic analysis.

In doing so, we recognize the importance of the concept of utility and satisfaction in the formulation of economic models of behavior,

the role of competition, the importance of making rational choices and the elevation of economic efficiency to a position of prominence in decision making. This chapter also provides the reader with an ability to move on to discuss other aspects of economic behavior from the platform of “conventional” utility maximization. We begin with the standard analysis of the economic solution to utility maximization to show the importance that some economists put on subjective views of utility aside from pure utilitarianism. The importance of normative as well as positive judgments is discussed. Utility maximization and Pareto optimality are also briefly reviewed.

Chapter 3 looks more closely at the way in which decisions are affected by perception and interpretation. The chapter examines individual decision making within the context of bounded rationality and the psychology of behavioral economics. Often, conventional analysis of decision making using expected utility theory has to be augmented by new concepts such as prospect theory and the framing of choices developed by Kahneman and others. The chapter also investigates the pivotal role of emotions. It looks at attitudes toward risk and how attachment to possessions influences behavior. Using various psychological approaches, we discover that knowledge or information that is more accessible is valued and acted upon more systematically than information that is less accessible. We also learn that changes or departures from equilibrium or a given situation are often more important than the levels of attainment or the absolute size of variables. This is important in the analysis of many economic phenomena including the pursuit of happiness. Further, the chapter explores the use of heuristics to evaluate the likelihood of various uncertain outcomes. Prospect theory looks at the way agents make decisions in terms of the context, or what Kahneman calls “framing”. This methodology leads to a number of surprising conclusions that are often at odds with conventional economic analysis. Sometimes, conventional expected utility analysis can be replaced by evaluation of alternatives that takes cognizance of other factors such as the size of the probabilities of alternative outcomes and the way that problems are framed with reference to probabilities of success and failure. They also include a possible reversal of a decision when only the wording of

a problem is changed. Prospect theory throws new light on the risk return trade-off and it shows behavior is sensitive to the probabilities of different patterns of outcomes. The subject of risk and the process by which consumers and investors make decisions in a sequential manner is also considered within the general framework of prospect theory.

In Chapter 4, our attention shifts from the individual to decision making in a societal context. We first discuss game theory as a tool for exploring the relationship between self-interest and cooperation as they relate to how economic agents interact with others. Cooperation and self-interest is discussed within this game theoretic context. Various strategies are discussed for resolving conflicts including win/win and lose/lose games. We begin with an intuitive introduction to game theory and the concept of Nash equilibrium. Ways to break out of lose/lose situations are also discussed and strategies for bargaining are explored.

The concepts of trust, fairness and social pressure are also examined within the game theoretic context. The situations in which people tend to cooperate and how these situations differ from more competitive environments are then reviewed. The range of inquiry is extended to a broader understanding of motivations for actions, including the role of emotions and a sense of ethics and morality. Pressure from society, including friends and associates, is considered within the context of ultimatum and dictator games as well as the standard prisoner dilemma and public goods games. The concept of a “warm glow” arising from altruistic actions is also discussed within the context of game theory. How are motivations altered by the recognition of this “warm glow” that arises from a selfless or charitable or cooperative action? These kinds of altruistic or cooperative actions or tendencies are then related to other topics that are covered in subsequent chapters including public choice, charity and family exchanges and bequests.

Chapter 5 extends the analysis begun in Chapter 4 to the subject of altruism. The concepts of “pure” and “conditional” altruism are considered along with a number of exceptions and extensions to the “standard” economic maximization model that may be explained by

altruistic or cooperative motives. An expanded framework that includes cooperative as well as competitive motives can explain these “exceptions”. Characteristics of the products we buy and our attitudes toward them as well as the social context and developments in the workplace have a direct bearing on prices and economic choices. These include decision making within the family that involves aspects of cooperation rather than competition. This chapter draws on the work of Becker (1981) and Stark (1989) among others to explore a number of cases where altruistic and cooperative motives lead to results that differ from the standard neoclassical economic models.

In Chapter 6, we explore the general field of happiness or subjective well-being. We consider the question, “Does *utility* bring happiness?” We explore research which suggests that happiness is often not directly equated with the economist’s concept of utility maximization. The chapter explores happiness and how it relates to the utilitarian concepts of economics that stress the accumulation of goods and services subject to constraints on income. Much of the research in this area suggests that the economic calculus of the utilitarian school needs to be modified to take into account a number of other factors, including leisure and social relationships, as determinants of happiness and social well-being. Within this context we then explore different aspects of happiness including the relationship between income and happiness, the role of trust, the importance of social interaction as a determinant of happiness, how fairness enters into establishing a social environment where happiness can flourish, and the role of government policy in formulating policies that can increase the level of happiness in society. In this section, we draw on the work of Lane (2000), Frank (1999) and Layard (2004) among others. There is also reference made to the historical literature including Scitovsky (1976) and early work by Veblen (1899). One objective of this chapter is to show that the concept of happiness is complex and depends upon many aspects other than “utility” in the economic sense. It is demonstrated that often, the concept of “relative utility” is more important than “absolute utility”. It is also the purpose of this chapter to show that happiness requires a broader definition of welfare economics than we usually see in economics courses. Emotions often intervene to

cause changes in behavior and possible reversal in decisions typified by the term “buyer’s remorse”. Other behavioral anomalies are also observed such as valuing the present more than the future and the importance of comparisons with others. The importance of leisure and spending time with family and friends is highlighted and found to be very important in many societies. On the other hand, unemployment and poor health have strong negative impacts on happiness. This ties in with the topics discussed previously regarding the importance of ethical virtues and the value of cooperation and building of social capital. The inability of most people to judge when others are happy and to determine what makes them happy is also discussed. Social ramifications of breakdown in family and kinship groups, and the lack of or deterioration in social capital that leads to crime, corruption and other antisocial behavior are investigated. The research in this area suggests reasons for valuing high status in one group and unwillingness to move to a lower status in another group, even though monetary rewards are higher. Discrimination among social groups and the theory of lemons by George Akerlof (1970) is also reviewed as it relates to the emotional content of economic decision making.

We introduce ways to increase happiness by increasing the opportunity for forming cohesive social groups and creating social capital. Making sound choices to maximize the chance of happiness are covered. This chapter also discusses differences between traditional and modern societies and the way societies and people change as development takes place, and as they have more money. Suggestions for changing the incentive system include the role of government to intervene when people generally make poor choices like providing for their own retirement.

In Chapter 7, we extend our analysis further to consider how societies create social systems where formation of social capital can take place. We study aspects of cooperation and altruism as contrasted with competition and narrow self-interest, and how these different perspectives influence participation and integration into the social capital network. “Social capital” can more generally be defined as the ethical and socially responsible actions of individuals as well as the ability of

people to work together for common purposes in groups and organizations. See Putnam (1995, 2000) and Temple and Johnson (1998) for discussion of definitions of social capital.

We argue that the formation of “social capital” — broadly defined to include trust, fairness and collective action flowing from cooperation and social cohesion — are important components of the social and economic fabric of societies. In this view, the social virtues and ethical attitudes that promote the development and nurturing of social capital contribute positively to both income growth and the feeling of well-being and happiness in the general population.

Ethical issues for the individual as well as societies are discussed within the broader context of economic efficiency and operation of cooperative behavior and the formation of social capital. Market failure, public goods, free riders, principal agent, tragedy of the commons, overexploitation of resources, moral hazard, corruption, ethics and economic decision making are all touched upon. How these issues relate to the propensity for cooperation and competition is also explored. The potential benefits that accrue from cooperative action and the development of social capital are explained and discussed. Fairness, trust and social isolation are also discussed within the context of the formation of social capital and participation in social capital networks. Furthermore, the material presented ties into other topics discussed in particular field courses in economics such as altruism and the general case of market failure including the environmental literature, as well as selective readings from welfare economics.

Welfare economics and collective action are considered in more detail in the next two chapters. In Chapter 8, we take into account the collective action which occurs when individuals decide as a group to take actions that increase the collective benefit of the group. This could take the form of private clubs and institutions. Clubs provide a private alternative to the provision of public goods and the challenges clubs face in such provision of goods is further explored using game theory. In addition, the reasons why clubs are formed, persist and dissolve are explored. The ramifications of club actions on the general public are also discussed along with numerous examples of how clubs

work to further the interests of their members to the detriment of overall welfare. The work of Olson (1965) plays a critical role in this chapter.

In Chapter 9, we consider the general question of public goods. We discuss the nature of public goods including what kind of goods are provided by the public, why they are provided and how the provision of such goods is influenced by motives such as altruism and selfishness. Analysis of public choice decisions, particularly charitable giving and role of private versus public charity, are explored. The importance of motives for charitable giving and how these motives interact with the supply of public goods by the government are reviewed. The work of Warr (1982), Andreoni (1988) and Akerlof (1970) among others are discussed. Emphasis is placed on how particular motivations for private giving would influence charity when public goods are introduced or when the supply of public goods is increased. Substitutions between public and private giving is also discussed and analyzed, as well as motivation for private charity. As an undesirable aspect of public choice, we also look at the topic of corruption, graft and bribery in this chapter. We explore motives for corruption and how these motives are influenced by the economic and ethical environment. Incentives for corruption and how they relate to cooperative and altruistic motives and economic incentives are also explored. Several country examples are presented. In concluding this chapter, we discuss how altruism fits in the picture and also how the allocation and provision of merit goods requires ethical analysis and careful consideration of public policy.

In Chapter 10, we consider income distribution, the theory of justice and how decisions are made to allocate public resources to redistribute income. The philosophy of social justice is discussed, including the work of John Rawls (1993), James Buchanan (1976a), Robert Nozick (1977) and Amartya Sen (1995). Different approaches to the concept of social justice and the way in which the market interacts with the government are also discussed. Values such as efficiency, equity and social context are explored to see how they inform the discussion of income distribution and justice. The philosophy of Buchanan

(1976b) and Nozick (1977) places particular emphasis on the process by which decision making is carried out by the government, while Rawls (1993) and Sen (1995) emphasize the outcomes of the process. The importance of fairness in determining justice is discussed along with the motivation for adjusting the distribution of income. The importance of achieving an ethical stance and how to incorporate the views of a wide variety of public opinion are explored along with the difficulties in arriving at a solution that values the opinions of both the minority and the majority. Different ways of achieving social justice including capitalistic and socialist solutions as well as different forms of government are also analyzed. The importance of fairness, justice and happiness are incorporated into the discussion.

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