

## **CULTURE, UNIVERSAL (OR NOT) PREFERENCES AND SOCIAL WELFARE<sup>1</sup>**

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### ***Abstract:***

*Real economic systems—at least during the past two hundred years or so—undergo rapid, qualitative and irreversible change. Economic change may be driven by exogenous factors such as changing resource endowments or climate change and also by different patterns and speeds of cultural adaptation, institutional change, and historical accidents.*

*To explain economic behavior, we need to move beyond the simplifying idea of Homo economicus. Without independent and rational agents economic theory loses its mathematical certainty. Studies in the field of game theory and behavioral economics promoted experiments that further the traditional economic conception of human behavior and emphasize the importance of cultural differences in determining economic behavior.*

*Modern welfare economics is increasingly interdisciplinary and influenced by psychology, sociology and anthropology and incorporates concepts such as interpersonal comparisons of utility and endogenous preferences.*

*This paper discusses how the existence of endogenous preferences and cultural institutions is the essential explanation to why the neoclassical model of competitive economies can not be adopted in every country.*

**Keywords:** endogenous preferences, culture, institutions, social welfare

### **1. Introduction**

The goal of New Welfare Economics (NEW) was to establish a positive economics based on the sanctity of individual choice. A major source of controversy in economic theory, at least since the days of Thorstein Veblen at the turn of the

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last century, is the notion of ‘economic man’ or *Homo economicus*. Neoclassical welfare economics characterizes human behavior as independent of social and cultural context, that is, preferences are considered to be *exogenous*. In the welfare model, the basic characteristics of rational economic man do not vary from country to country or from culture to culture. *Homo economicus* is narrowly rational, always consistent in his choices, insatiable in consumption, and egocentric to the point of having no social responsibilities other than maximizing his own happiness. This approach to describing human behavior is the subject of heated controversy when applied to many complex phenomena such as ecosystem health, long-term climate change, or the development of the macroeconomy.

The new welfare economics assumes that the basic units of analysis are individual consumers and individual firms. These units can be cast either as ‘representative agents’ or as the ‘average’ behavior of aggregate firms and households [van den Bergh and Gowdy 2003]. Human beings are reduced to “homogenous globules of desire” to use Veblen’s [1898] characterization of economic man. Human behavior is assumed to be so universal that cultural differences are inconsequential and may safely be ignored. All individuals strive to maximize utility by choosing logically and consistently among alternatives. Likewise, firms are assumed to be concerned solely with maximizing profits.

The developing alternative recognizes that the behavior of individuals and firms cannot be adequately represented without considering the *interdependencies* between them and this requires an approach allowing for multiple equilibria, interactions between agents, and recognizing that relying on a universal model to describe all human behavior and human cultures may be inappropriate. The experience of the last decades has demonstrated the limitations of welfare economic models and of the policies based on them. Policy failures in the areas of economic development, climate change, and biodiversity loss among others, have brought to the surface long-neglected questions about the basic assumptions and policy relevance of welfare economics. These controversies have also exposed the gap between theoretical advances in neoclassical economics and the applied work being done by mainstream economists. Extending the standard economic model of human behavior has been the research focus of recent Nobel Prize winners in Economic Science—Amartya Sen (1998 winner), Gary Akerlof and Joseph Stiglitz (2001 winners) and Daniel Kahneman and Vernon Smith (2002 winners). Recognition from the Nobel committee of their path-breaking contributions shows that the economic profession increasingly appreciates this kind of work.

## 2. Culture, preferences and empirical evidence

Georgescu-Roegen [1966] pointed out that the attempt to build economic science in a similar way to physics led to the assumption of exogenous preferences for consumers and to ignore the endogenous nature of preferences and the importance of institutions. Contemporary research in behavioral and institutional economics could help build the empirical database needed to reform/replace the standard welfare theory.

Criticisms of *Homo economicus* are not new. But they have taken on a new life with the current resurgence of theoretical and empirical work in behavioral economics, experimental economics, and game theory. Recent empirical evidence collected in a variety of cultural settings has demonstrated consistent deviations from the standard economic model of behavior [Alesina and Ferrara 2000; Gil-White 2001; Gintis 2000]. The general conclusion is that behavior is strongly influenced by cultural conditioning. Also, humans consistently behave more altruistically than the standard economic model predicts. While economists recognize that individuals may be motivated by intrinsic considerations, such as a sense of honesty, trust, fairness or commitment, they have either shied away from altruism “almost comically” [Samuelson 1993], or have adopted an approach to altruism based on the rational actor model. Recent empirical evidence suggests that it is more analytically useful to recognize the complex and multifaceted characteristics of human behavior. People act both selfishly and cooperatively [Caporael 1997], and they adhere to social norms and values that often generate immediate disutility for themselves [Fehr and Gächter 2002].

These empirical studies offer support for the “utility function” Georgescu-Roegen [1960] proposed:  $\Omega = \psi(Y; Y_s)$ . Utility is a function not only of individual utility  $Y$  but also  $Y_s$ , which stands for the “criteria by which the individual views the welfare of his community.” This result, however, cannot be incorporated into the framework of the New Welfare Economics. If the utility of one individual depends on that of another, then constrained utility maximization is undefined [Henderson and Quandt 1980, 297]. The optimal consumption of one person depends on the optimal consumption of the other and a unique equilibrium cannot be obtained. A realistic model of human economic behavior is inconsistent with standard welfare theory. Again, this argument has been made for over one hundred years [Veblen 1898], but the difference today is that economists can explain pro-social behavior in formal game-theory models that can be analyzed mathematically

and tested experimentally. The critique of economic man has reached a state of sophistication so as to be able to enter the mainstream.

The ultimate impact on welfare theory of these new results from behavioral economics and game theory is hard to gauge. Rational economic man is a key underpinning of the desirability of market outcomes and economists are quite vocal in touting the sanctity of individual preferences. In surveys by economists eliciting preferences, the common practice among surveyors is to throw out 'protest bids' that do not conform to the stylized description of behavior dictated by the axioms of consumer choice.

### 3. Preferences and Economic Policy

Aristotle and David Hume considered complementary behavioral theories. For Hume [1898[1754], 117] "Political writers have established it as a maxim, that, in contriving any system of government...every man ought to be supposed to be a knave and have no other end, in all his actions, than his private interest" while for Aristotle [1962, 1103] "Lawgivers make the citizen good by inculcating habits in them, and this is the aim of every lawgiver; if he does not succeed in doing that, his legislation is a failure. It is in this that a good constitution differs from a bad one." Economists have followed Hume...

As discussed above, the intent of the NWE was to make economics a true science, that is, to separate factual statements from value judgments. Interpersonal comparisons of utility were to be avoided. This was the major task of the economic man construct. Human preferences were the starting point of economics regardless of where they came from. Friedman [1962] justifies the traditional assumption of exogenous preferences.

Current work in neoclassical welfare economics questions the exogenous preferences approach, and more and more, considers preferences to be endogenous. In a way this current work is a return to the beginnings of neoclassical economics. More than one century ago, Marshall in his *Principles* mentions the importance of non-selfish motives and other preferences that are unknown to *Homo economicus*. Daily activities and the social and cultural institutions influence human preferences. Also, past training and activities influence preference formation. On the first page of *Principles* Marshall [1920[1890], 1] states:

...man's character has been moulded by his everyday work, and the material resources which he thereby procures, more than by any other influence unless it be that of his religious ideals...

Later on the same page he adds:

his character is being formed by the way in which he uses his faculties in his work, by the thoughts and the feelings which it suggests, and by his relations to his associates in work, his employers or his employees.

But Marshall's modern ideas were forgotten in favor of the more mathematically elegant Walrasian model.

Bowles [1998] asserts that assumptions about preferences may influence the effectiveness of economic policies while Hirschman [1985] suggests that the view of most economists regarding preferences leads to an underlying bias in favor of incentives to modify behavior.

The discussion of 'Pareto Efficiency,' 'Potential Pareto Improvement,' and 'Endogenous vs. Exogenous preferences' is important to contemporary environmental and development policies. The theoretical difficulties relating to the notion of a potential Pareto improvement are directly related to the almost exclusive reliance on the competitive market and the underlying rationality assumptions of development policies.

Calcott [2001, 2] discusses the 'efficiency criterion' and its stress on the view that government policies should be evaluated according to their effects on total surplus. Koning and Jongeneel [1997] discuss how in applied economics, the concept of a 'Potential Pareto Improvement' as an actual improvement is used in the literature to justify policies about welfare state reform, liberalization of foreign trade and investment, and European integration.

Chipman [1978, 580] observes that by accepting the concept of a Pareto-Barone-Samuelson welfare ordering, the compensation principle leads to "a very different conclusion than the founders of the New Welfare Economics had in mind: the need for an activist policy for the determination of the distribution of income and wealth, rather than exclusive reliance on market forces combined with a given pattern of private ownership of resources." Chipman [1978, 581] concludes that, after 35 years of technical discussions about welfare theory, we are forced to return to Robbins' 1932 position "We cannot make policy recommendations except on the basis of value judgments, and these values should be made explicit." In presenting the utilitarian justification for egalitarian measures Robbins stated [1938, 638]: "If [Henry] Maine's Brahmin had told me that members of such and such a caste or race were eligible for taxation ten times as heavy as others, since they were only one-tenth as capable of true happiness, the strength of my resistance would not have rested on belief in the social law of diminishing marginal utility.

The belief that that helped could only rest on the prospect of putting up a smoke-screen of technical jargon to terrify an ignorant antagonist...” Chipman [1978, 581] responds to this quote by observing: “When all is said and done, the New Welfare Economics has succeeded in replacing the utilitarian smoke-screen by a still thicker and more terrifying smoke-screen on its own.”

Bowles [1998, 22] suggests that “preference endogeneity gives rise to a kind of market failure” which requires a different welfare economics “encompassing the effects of economic policies and institutions on preferences and for this reason more adequate for the consideration of an appropriate mix of markets, communities, families, and states in economic governance.” The general conclusion of contemporary welfare theorists is that we should judge policies and institutions according to how effectively they function in a world characterized, not by perfect competition and rational behavior, but rather by uncorrectable market failure, imperfect competition and uneven political and economic power [Bowles and Gintis 2000].

#### **4. Conclusions**

Once we move beyond the rational actor approach to explaining economic behavior, the role of institutions becomes central. Without rational, independent agents economic theory loses the mathematical certainty of general equilibrium welfare economics. Institutions can no longer be analyzed solely in terms of their contributions to the efficiency of competitive markets. Not only can inefficient institutions persist, it is not even clear what the terms "efficient" and "inefficient" mean. If choices are not narrowly rational, independent, and consistent, then the outcomes of these decisions may not indicate an economic optimum.

Recent work has examined the role of institutions in shaping economic behavior. Work from game theory and behavioral economics has gone beyond the traditional economic conception of human behavior and revealed the importance of cultural differences in determining economic behavior. According to Henrich et al. [2001, 73] these studies "have uncovered large, consistent deviations from the predictions of the textbook representation of *Homo economicus*." People care about fairness and reciprocity and they are willing to punish, at substantial costs to themselves, those who deviate from acceptable social norms [Fehr and Gächter 2002, Henrich 2000].

Just as endogenous models of technological change [Arthur 1990] are transforming the way we look at firm behavior, so too are endogenous models of

human behavior beginning to change the way we look at individual decision-making. A number of approaches to explaining the institutional context of economic behavior are being developed. Nelson and Winter [1982] stress the importance of “routines” in shaping economic behavior. Following Veblen, they argue that habits and routines are quite stable over time and are frequently more important in explaining economic behavior than is rational choice. People often decide how to act by merely copying established patterns of action. Henrich also argues that human behavioral change cannot be explained by the accumulated actions of rational individuals choosing the most efficient solution to an economic problem. Henrich shows that, even after allowing for incomplete information and trial and error processes, individual-level models cannot explain the "S-shaped" pattern of innovation diffusion widely seen in the innovation literature. He argues that this pattern *can* be explained by biased cultural transmission. These new insights into the institutional context of economic behavior have important consequences for economic theory and policy.

The existence of endogenous preferences and cultural institutions is central to the debate in development economics about whether or not the neoclassical model of competitive economies is applicable everywhere. That is, is there one linear, progressive development path that will transform all "backward" countries into American economic clones? Stiglitz [2000] argues that in neoclassical development policy, local institutions and cultures are ignored as factors in stabilizing or destabilizing an economy. He argues that in the model of perfect competition, humans are regarded as being the same all over the world, rational, self-interested, insatiable, pleasure maximizing creatures. The local color of institutions is ignored and thus the entire social network in a particular country.

In the welfare economics framework, policies are directed at changing the non-developing or underdeveloped economies to become similar to what is considered the “successful” system, the Western type. This approach underlies the policy recommendations made nowadays by international organizations like the World Bank, the International Monetary Fund (IMF), and the World Trade Organization (WTO). It is true that the World Bank and other international agencies are financing small-scale projects by involving local communities in their design and implementation. But is also true that the economic side of those projects uses the concepts and the tools of the New Welfare Economics that gives them an incomplete image of the problem they try to solve.

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