

Explanation: The “Ekon” are standard textbook writers. The other people (including Dr. Spearman) are imaginary folks used to spice up the prose. I leave out the issues of expected utility maximization because this is aimed at a lay audience.

James Devine/29 December 2006

## DRAFT: How to Talk (Back) to an Economist: *A Citizen’s Guide*.

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## How to Talk (Back) to an Economist: *A Citizen's Guide*.

“The self is not something ready-made, but something in continuous formation through choice of action.” – John Dewey

### DRAFT chapter 6: Decisions, Decisions

Gwartney, chapter 1 (pp. 4-9, p. 17)

Krugman, p.2

McConnell, p. 3

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This chapter considers the Ekon's vision of the human creature. That perspective is empirically *inaccurate* and grossly incomplete. Further, the development of an alternative vision is quite possible within the framework of standard social science and even economics. Most crucially, the Ekon's vision of human nature is *not necessary* to the economists' understanding of markets and other human institutions. It is an ideological weed among the flowers.

For example, some Ekon link the common assumption that people have “unlimited wants” to some kind of inherent human proclivity. Others swear allegiance to Adam Smith's assertion that “the propensity to truck, barter, and exchange one thing for another” exists as a basic “propensity in human nature.” While these propositions might arguably be true, economists – and especially the Ekon – do not argue for them in a serious way. They do not study psychology or biology to see if there is any theoretical or empirical basis for these assertions.

Again, it turns out that these kinds of assumptions are not required: a common-sense understanding of social forces helps us understand why it often seems that people have insatiable wants and why people engage in exchange.

We can choose between *homo economicus* and *homo sapiens*. The former (the economic person) is the highly ideological image of human beings that the Ekon cling to, while the latter signifies the complex people of the real world.

#### ***The Standard View...***

In the Robbins view quoted in **chapter 2**, economics studies the process of each individual decision-maker seeking to attain specific goals – by crook or by hook. Because the resources available (the means that can be used) have alternative uses, each economic actor chooses how to use them. Because those means are in scarce supply, we have *no choice* but to decide how to use them. If Ahmet's company ships a product to Chicago by train, it is missing out on the possible benefits of shipping it by truck. (There is an opportunity cost.) So Ahmet, as CEO, is forced to choose. Even if he does not think about it, anything he does (including doing nothing at all) represents a choice in practice, with clear implications for his business.

Similarly, parents are forced to “choose their battles” in trying to get their children to behave. Given the large number of legal statutes, the cops have no choice but decide not to enforce all of the laws on the books to an equal degree.<sup>1</sup>

**Definition:** **Maximizing** behavior refers to trying to get or have as much as possible of something good. In economics, it means trying to attain one’s goals as completely as is doable: Zelda writes an application for a job in a way that maximizes her chances of getting it.

**Minimizing** behavior refers to trying to reduce something that is unwanted as much as is feasible: Ahmet tries to minimize his nail-chewing during job interviews.

If these concepts remind you of calculus, that is because they are straight from there. Calculus is so key to economics that it represents the core of intermediate microeconomics. If you know it well, you can get an A, even if calculus is not required. And you thought you’d never use that math ever again! Luckily for math-haters, it is not needed at the introductory level or in this book.

McConnell’s definition (p. 3) adds that economics is about **maximizing** behavior. Ahmet chooses the result that allows him to achieve his goals as completely as possible. He does anything for which *the benefits exceed the (opportunity) costs*. (This involves seeking a version of micro-level efficiency discussed in **chapter 5**.) For example, he might decide to break the law if

the expected benefits of lawbreaking > the expected costs of lawbreaking

Done consistently, this behavior allows the achievement of the maximum possible profit for his business. Ahmet acts to get the best possible result on the bottom line. This behavior is called **rational** – in the economic sense of the word.

**Definition:** In the simplest terms, **economic rationality** rejects the Nike slogan “just do it” as irrational. Instead of buying over-priced sneakers on impulse (perhaps because an advertising slogan tells her to do so), the rational consumer (Jazmine) would buy them only if her benefits received from them exceed the costs to her (the alternative use of her money and other resources).

The economic definition of rationality differs from other definitions. Jazmine might be economically rational but legally insane, culturally deviant, or mentally ill. The main alternatives examine her *goals*. For example, most people would agree that her use of crack cocaine is *irrational*, even if she sees it as giving her more benefits than it costs.

One alternative vision of rationality would be thinking and acting in a way that allows Jazmine to attain the greatest amount of physical and psychological health possible within her society over her life span. This would realize her potential as a human being. This is *the ideal fulfillment of needs* of **chapter 7**. This alternative kind of rationality seeks that fulfillment.

Economics assumes that people act as if they have *utility functions*, though other terms are often used. To Krugman, for an individual this mathematical function indicates the “total utility generated by his or her consumption bundle,” the collection of all goods and services consumed (p. 231). When they talk about us maximizing our utility functions, economists are simply using an abstract or mathematical way to say that individuals are consistently trying to attain their goals (whatever they are).

Sophisticated economists treat utility as a hypothetical measure of behavioral. It does not directly correspond to mental states suggested by “happiness,” “satisfaction,” and the like. There need not be something inside one’s brain or one’s mental state that can be

measured, even with an electroencephalogram. Rather, it represents the assumption of consistent goal-seeking.

But the view that people have something called “utility” to maximize says something more. It assumes that each of an individual’s goals can be easily compared to all of the others. Trade-offs can be made. This in turn allows the reduction of the achievement of any individual’s goals to a single performance indicator, a single number. This number is then maximized. Alternatively, this behavior can be summarized by saying that each individual has a clear and consistent *preference ranking*, preferring pasta to potatoes and potatoes to poi, etc.

But now we move away from this more sophisticated view to discuss the views of the Ekon, who are trying to communicate their views to students. This means that we have no choice but to talk about individual choice in terms of happiness, satisfaction, and other psychological concepts.

### **... Reconsidered.**

In his chapter 1, Gwartney starts with the first half of the Robbins definition of economics: “Economics is about how people choose” (p. 3). To understand economic issues, it is absolutely true that Zelda has to focus on *choice*, how choices are made – and the goals of the decision-makers.

If she is buying a used car, she must consider the *motives* of Snidely, the sales rep, trying to understand the tricks he uses. After all, he works for a profit-seeking company. And he likely wants to receive as large a commission as possible. So she should be careful.

After the sale is consummated, if she files a lawsuit against the dealer, it would be a big mistake for Zelda to ignore the fact that the company is *actively seeking to get as much profit* as it can. She should not skip reading the small print in any agreement she and the company come to. The company’s lawyers will seek out all loopholes possible, while trying to reinterpret the contract to help the company. She also should not trust her own lawyer too much, since he too may be greedy – at her expense.

This profit motive – i.e., greed – is more than the ruling principle of capitalism, the economic system we live in. It is also a key reason for the time-honored slogan *caveat emptor* (buyer beware!).<sup>2</sup>

Because of the simplicity of the profit motive, economists’ research on the behavior of profit-seeking firms has been relatively successful (in my humble opinion), despite the work by Leibenstein and later students of the internal workings of businesses. That is, the study of consumer behavior by economists is still in its infancy.

### **What Does a Person Want?**

The economist’s standard approach to consumer choice is vacuous. The model suggests little or nothing that reveals facts about the world that we do not already know. It tends to predict that people will do what they do. Let’s examine these assertions in greater detail.

As McConnell writes, the Ekon assume that

human behavior reflects “rational self-interest.” Individuals look for and pursue opportunities to increase their utility – that is pleasure, happiness, or satisfaction. They allocate their time, energy, and money to maximize their well-being. (p. 4, emphasis suppressed.)

The problem here is that the Ekon and mainstream economic models cannot say what gives individuals utility, pleasure, happiness, satisfaction, or well-being. They do not even *try* to understand human tastes or preferences and their origins. They do not put what gives people pleasure or promotes their well-being under their microscopes.

Some key distinctions. Below, it is noted that more sophisticated economists separate the direct pleasure or satisfaction or utility that Zelda receives from some good or service from *happiness*, i.e., the subjective assessment of her own well-being. Utility describes her goals: economics assumes that she acts as if she were maximizing it. Happiness refers to her after-the-fact judgment about the degree of her success, given various constraints on her actions.

There is also a difference between her short-term or up-front utility (pleasure) and what allows her to receive desired long-term benefits (as a means to an end, instrumental).<sup>3</sup> Further, in **chapter 7**, I distinguish pleasure, happiness, and usefulness from actual objective well-being or *health*. The latter refers to the successful fulfillment of *needs*.<sup>4</sup>

In other words, the Ekon skip over one of the three key elements in any mystery, *motive*. The focus is entirely on means and opportunity. So Detective Spearman deliberately closes his eyes to some information he could use in solving the mystery.

This makes it hard to address situations where there are several suspects who all have the same opportunity and equally-effective means (which somehow never show up in the Spearman books). This is like the board game Clue, in which none of the suspects has a distinct motive from the others. (Strangely, the detective himself can be the murderer.) That game is fun – but hardly an accurate representation of actual human life.

More importantly, that means that as far as Spearman is concerned, people do not need to have consciences, passions, or social relationships with others. They are calculating machines that seek to obey a specific directive to a maximum extent.

Despite their hope to understand the “ordinary business of life,” this vision means that the Ekon cannot predict *that people would choose fresh milk over sour milk* – or potatoes over poi, *ceteris paribus*. The Ekon’s “science of choice” is all about form with little concern for content. It is all hat and no cattle, dealing only with questions of *how* people make choices rather than *why* they desire things.

Economists often admit that a ranking of wants found in reality is true, as people “reveal” their preferences in practice.<sup>5</sup> But standard economics has absolutely no theoretical explanation for that ranking.

### ***Internal Conflicts.***

The Ekon often presume that individual adults know what is good for themselves. For example, in the passage quoted above, McConnell equates utility, pleasure, and satisfaction, on the one hand, with happiness or well-being on the other. In this view, the only judge of what is good for Ahmet is Ahmet himself. Back when I took introductory economics (1971!!), one of the textbook’s major points was that any other attitude than this

is *paternalistic*.<sup>6</sup> Though this perspective has some normative validity (see the “normative note,” below), it is not good positive economics.

This assumption of “Ahmet knows his own business” cannot be made without some actual study and understanding of individual psychology, physiology, and society (i.e., of human nature). A serious study of this sort would lead economists to understand that there is often a conflict between “pleasure” and “well-being.” To truly understand this conflict, economists must apply some sort of *medical model* of human beings, based on actual research.

Most readers can identify with the inner conflict of the sort that Jazmine encounters: she wants what is good for her pleasure right now (eating a deep-fried Twinkie)<sup>7</sup> but that subverts her long-term health and happiness (staying slim, living outside a hospital, etc.) In fact, since they’ve gotten beyond the struggle for survival, this kind of conflict seems central to the drama of most middle-class people’s lives. Most people I know are always trying – and failing – to lose weight, give up cigarettes, or something like that.

But the standard vision of what makes people tick – *homo economicus* – ignores all inner conflicts. To the Ekon, each individual has only one ranking of which goods are preferred to which (pasta > potatoes > poi, etc., where “>” means “is preferred to.”)

Economists do sometimes deal with conflict. For example, a major part of the modern economist’s toolkit is the “prisoner’s dilemma” model. In this “game,” the cops (Lenny and Green) catch two perps. They separate them and try to get them to rat on each other. Lenny tells Snidely that if he tells on Bill, he will get a reduced sentence. In a separate room, Green tells Bill that if he betrays Snidely, he will get similar preferential treatment. If the two alleged offenders are total individualists, they will fink on each other. This is the worst result for both. But if they remain mum, they can *both* do relatively well. There’s a conflict between the suspects that can be solved if they figure out how to cooperate and avoid defection. There’s also a conflict between what’s good for the two of them and their individual interests.

But economists haven’t been watching enough cop shows – not that there’s a lack of them on TV – or heeding their content. There are other methods of getting culprits to sing. The most favor is the good cop/bad cop routine: Lenny could be the bad cop (ragging, threatening to beat up Snidely) while Green is all sweet reason (the good cop). This “messes with” Snidely’s mind, making him more likely to admit his guilt.

The use of this tactic suggests that we go beyond standard economics. In psychodynamics (psychoanalysis) and some other schools of psychology, however, there can be clashes among an individual’s various motives. That is, an individual may have more than one preference ranking and must figure out how to reconcile them.

Let us borrow (but not keep) Sigmund Freud’s terms. Spicing up the kind of conflict that Jazmine faced, let’s add conscience and change the identity of our subject. The example deals with the choice to commit a crime, faced by Ahmet above.

1. Short-term Pleasure: Snidely’s Id says it is best to steal from Zelda right now;
2. Instrumental Reasoning: His Ego says that a more strategic approach (discussed below) is necessary. After all, if he waits and plans, he is more likely to get away with it;

3. Conscience: His Superego says not to steal at all.<sup>8</sup>

This fight between these three different ways to visualize the decision might cause Snidely to freeze up, or to suffer from neurosis or even psychosis.<sup>9</sup>

An analogy with research on the internal workings of business firms by Leibenstein's research can be used here, in a different context.<sup>10</sup> As discussed in **chapter 5**, he rejected the Ekon view of the business firm as being like a geometric point, i.e., something that cannot be divided into smaller pieces. Instead, a standard firm is nothing but a bunch of people with some trying to get them to cooperate in production. Because each participant has different goals, a firm sometimes maximizes its profits. But often it does not.<sup>11</sup>

Similarly, individuals sometimes seek to attain single clear goals, but sometimes are in conflict with themselves. Leibenstein called this phenomenon *selective rationality*.

The economists' assumption that no individual has conflicting internal goals is much the same as assuming that everyone enjoys total and utter mental health. I doubt that this is a reasonable assumption. (Consider my friends...) One indicator of its falsity would be the amount of resources spent on psychological services and medications in any given year.

Most people want to manage their internal conflicts. One partial solution for Snidely and others is to develop *rules of thumb* for making decisions. For moral issues, it helps to have clear "thou shalt not" or "thou shalt" commandments. These may make the internal conflicts easier to manage, by adding some backbone to the Superego.<sup>12</sup>

Similarly, Snidely's Ego may be reinforced and protected by having a clear sense of his identity – of who he *is* within the context of society.<sup>13</sup> These two might ally, reinforcing each other, enabling Snidely to suppress his Idiotic urges. The roles of identity and rules of thumb helps explain the persistence of customs, as discussed in **chapter 8**.

***Calling Dr. Sociologist!***

Rules can also be used for more prosaic issues such as what products to buy. They can then be picked up by learning from one's *reference group*, i.e., our friends, our neighbors, our kin, and the people we admire, including the artificial ones on TV.<sup>14</sup> We may get them from existing social conventions or rely on the (allegedly) better-informed decisions of others. Many of these rules of thumb may be – or become – unconscious, in which case they are *habits*.

Marketing experts argue that "word of mouth" is one of the factors most likely to create a successful product. People usually believe their friends, relatives, and acquaintances (their real-world reference group) more than an ad or some TV sit-com. If Zelda tells her friend Jazmine that the Gunkzalot<sup>®</sup> hair-processing machine is a great product for the money, Jazmine is likely to believe it (if she has similar tastes and interests). But she questions the motives of some paid spokesmodel and thus doubt her veracity.

Social networks also spread information about the prices and availability of products. Because of these networks, promoters use "viral marketing" and the like: they try to artificially create a word-of-mouth buzz, brand awareness, and even a full-scale fad.

What this story suggests is that the decision to buy involves social psychology or even the dreaded sociology. The network among consumers may easily be as important in determining market demand (for example) than is any individual consumer. That is, the in-

dividual consumer's purchases may be determined more by the network than by their own individual genetics or experience. Their tastes or preferences may be more of a result than a cause.

But the Ekon ignore the way in which our preferences (what we like) and morals (what we see as right) are determined. It is our histories, our biographies, within the institutional structure of society which determine what we want and which social values we embrace. That is, sociological or social-psychological forces help make our tastes and ethics what they are (as do our genes).

It is but common sense to think that what we value as individuals and our ethical values – especially the details – are largely determined by the training we receive from living in a complicated network of relationships with other people. Many raised in Islamic or Jewish cultures reject pork. For Hindus, beef is taboo. Most in the U.S. sneer at dog, horse, camel, and kangaroo meat. This kind of taste in food is usually linked to one's ethical vision. The content of that outlook largely arises from one's upbringing.<sup>15</sup>

### *Inconsistency over Time.*

In addition, internal conflicts can lead to inconsistency in an individual's behavior over time. To economists, this lack of harmonious uniformity is *irrational*.

But tastes normally change over time, again suggesting that economic rationality is vacuous. Once we have accepted the fact that people like to eat potatoes more than poi (all else constant), a big poi fad might hit. Economists know that they cannot predict such crazes, as with Beanie Babies in 1999.

Worse, irregularity and unpredictability may develop due to the consumer's own actions. Snidely may decide, perfectly rationally, to drink a beer. His intoxication might then cause his preferences to change. Alcohol often suppresses the Superego and Ego, while unleashing the Id. The direct pleasure received from beer might then play a much bigger role in his decision-making than when he started. This might in turn push him into a bender of self-destructive drinking.

There is nothing in economic models to assure us that individual tastes do not change in this way. Rather, this constancy is simply *assumed* for a specific period of time. Then Spearman treats taste changes as **exogenously** determined: it's something in heaven and earth that's not dreamt of in his philosophy. It's a *deus ex machina*, something that comes from the outside to save the day (here, the Ekon's explanation). The cause of the change in tastes is left for others to study as part of a division of labor among social scientists.

Definition: **exogenous** refers to something that's not explained by a model. For example, what goods people want (their tastes) are exogenous to the supply and demand model. **Endogenous** refers to something that's explained by a model. The price of a product is endogenous to the supply and demand model. What's endogenous to one model may exogenous to another.

But the Ekon do not try to benefit from this division of labor. They do not follow the lead of marketing experts (another group that economists sneer at) who study sociology, psychology and the like.<sup>16</sup> But these fields might help us understand *what people want* and even how that changes over time.

### *Constraints and Autonomy.*

So the standard economic theory of human behavior is empty. But economists reasonably respond by asking “so what?” That is, the economist’s scientific pretensions are saved by the *existence of constraints*, since they limit the ability of humans to choose. As noted in **chapter 4**, the economist’s understanding of individual choice relies entirely on being able to specify barriers to individuals being able to attain their goals.

Remember Farmer Frank, stuck in the iron cage of the perfectly-competitive market. His behavior is extremely predictable. He may be torn by neuroses, but if he is going to stay in the farming business, he will behave in very predictable ways (which I will not describe here). His tastes may be inconsistent and his attitudes sociologically-determined, but he will act largely like a profit-seeking robot.

In contrast, the rent-receiving Pharmer Phyllis is free of that cage. She may battle on the political plane to protect her rents (or even to increase them), but she has the luxury of not protecting her rents until it is absolutely necessary. Owning the best land in the country gives her the luxury of expressing her individuality, her uniqueness. She might give some her winnings to charity, whether or not this makes her privileged status more acceptable to others. Such insulation from the discipline of market forces opens the door for idiosyncratic, even odd, behavior. The existence of rents cancels out some – though nothing near all – of the role of constraints in economics, making human behavior unpredictable again.

Back when Henry Ford ran the Ford Motor Company, the company had a certain amount of monopoly position and thus received monopoly rents. This allowed him to express his peculiarities as when he declared that “People can have the Model T in any color – so long as it is black.”<sup>17</sup> In the longer run, it turned out that his rents were transitory (as new companies such as General Motors rose to challenge Ford). But he took advantage of his freedom as long as he could.

On a smaller scale, many markets are not like iron cages, even without the presence of rents. Consider the markets that economists call *monopolistically competitive*. This often refers to markets dominated by a large number of small shops or boutiques, each of them different from the others, as with gift shoppes in a rich suburb.<sup>18</sup> Here, individual peculiarity can actually serve a purpose: one of the attractions of a little boutique in such a niche market is that it is different from its competitors. This allows the shop to gain consumer loyalty and in fact explains why the boutique has a scintilla of power and independence in the market. This also adds an atom of unpredictability.

But competitive pressures push a small “Mom & Pop” grocery stores to be extremely “bottom line” in their orientation. One might think that the personality of the owners would play a big role in determining behavior, but market competition gives them little leeway. A small grocery store of the sort you see in many urban neighborhoods has little room to wiggle. It is pushed to sell pretty much the same products at pretty much the same prices as similar stores. Its owners may have escaped from the supervision of some bureaucratic boss, but they find themselves subject to that of market forces. A lot of their ability to act like unique human beings arises from their *failure* to keep the customers coming in droves. That can give them “dead time.”

Even more than individual companies, it is markets dominated by *profit-seekers* that are predictable. When Beanie Babies became a hit, a lot of firms jumped in with imitations and tried to break the Ty corporation's intellectual property rights. It was also quite predictable that the fad would end (since they almost always do) and that many of these imitators would go bankrupt or have other kinds of financial problems.<sup>19</sup>

But what of individual consumers, the original topic? Are they highly constrained or are they free to "be themselves"? The answer is unequivocal: Yes and no. They are limited by their incomes and wealth, their personal abilities and disabilities, and by the social and natural environments they live in. This implies a certain amount of predictability for their behavior. But within these constraints, they are "free to choose" and thus unpredictable.

The key fact that makes them predictable is not having unified and healthy psyches or being totally immune to societal influences (as the Ekon assume). Rather, it is the *law of large numbers*. The many differences between individuals are made invisible when we bring together thousands or millions in a setting such as a market for standardized goods or the voting booth. And enough of them act enough like rational goal-seekers that the standard economic model of humanity will work well enough (well enough for economics work).

But remember our old friend Bill (and hope that he remembers that friendship!) He owns large amounts of financial assets.<sup>20</sup> He thus receives abundant income. He may have hired some of his friends (or rent-a-friends) to form his entourage. Again, his receipt of scarcity rents allows him to be peculiar. This luxury of freedom is also granted to those without any responsibilities or debts, especially when jobs are abundantly available. In his case, this freedom may make him totally unpredictable to economists. This can be crucial, because he can afford to participate in markets having few other participants, so that the law of large numbers does not apply.

"No Man is an island, entire of itself" – John Donne.

### **Individualism.**

Let us pretend that individual preferences are coherent and consistent over time. The Ekon's rejection of other visions of people means that their view of human beings implies faulty predictions in non-market situations. So, is it worth it for *homo economicus* to vote in an election?

### **Voting.**

Dr. Spearman's model says *no*. The benefit to any individual from voting is nil. After all, how often does one vote have any effect on the results of an election? Even if the vote looks like it is going to be close, Jazmine's vote can easily be cancelled out by Snidely's. The cost of voting, on the other hand, is clearly *positive*: Jazmine has to figure out which candidates to vote for and which ballot propositions should be nixed. Then she must walk or drive to the polling place (often taking time off from work or sleep), sign forms, and stand in a cramped booth to vote.

*Homo economicus* would thus say: "the expected costs exceed the benefits, so I'm not going to vote." I know one economist who agrees so strongly with this analysis that he does not vote.

This view says nothing about the lack of choice in elections: too often we choose the lesser of two weevils, Twaddle-Dee versus Twaddle-Dumb. It says nothing about the utter complexity of many issues, which can be dismaying, disgusting, or depressing. It says nothing about the fact that the politicians often lie. It says nothing about the fact that they fill the room with syrupy clichés and inane sound-bites. It says nothing about the voting machines being fixed. It says nothing about the way that districts have been apportioned to keep the “Ins” in. It says nothing about the underhanded efforts by a political party to keep other parties’ voters away from the polls. These facts simply add to Dr. Spearman’s result. These problems are not required to his prediction that people won’t vote. If we add them in, it suggests that the percentage of the population that actually votes is negative!

This prediction fails the test: in the U.S. and many other countries, *many people actually vote*. Sometimes, it’s even a majority of registered voters. Spearman’s model says that these voters are *irrational*. But the fact that his model flunks the empirical test instead says that his vision of human nature – *homo economicus* – is excessively individualistic. *Homo economicus* embraces economic or **possessive individualism** and may go further to become opportunistic or sociopathic.

However, the broad economic view that people are self-interest seeking, wanting more of what they like, does not rule out the assumption that people might vote. The Ekon can simply *assume that people get pleasure from voting*. This type of thinking again suggests that the *homo economicus* model is extremely empty. Smart people can always think up after-the-fact rationalizations to save the model. There seems to be no type of evidence that would ever drive us to drop the model. Epicycles can be added *ad infinitum* – and *ad nauseum* – to save it.

**Definition: Individualism** refers the way in which people determine their goals and identify themselves as individuals. Individualism totally emphasizes personal aims, as opposed to those of any group or of society as a whole. Individualists characterize themselves as humans only according to their own actions, attributes, and assets. They do not have social values such as fairness, and do not identify with the interests of larger groups of people. (This definition is based on <http://www.alleydog.com/glossary/>.)

The sort of individualism that economists assume is **possessive individualism**, defined below. This is the same as *free rider personality* (see **chapter 1**). But it is not the only kind of individualism. Consider a *spectrum* of different kinds. The first might be seen as “more individualistic” than possessive individualism, since it involves actively hurting others.

1. **Survivalism or Opportunism**: Snidely not only sees his assets and personal attributes (looks, intelligence, etc.) as valuable, but sees those of others as a *threat*. He measures his success relative to that of others (even when he’s not involved in positional competition described below). He tries to undermine the power of others, competing aggressively. He is not a passive free-rider as much as an active combatant. He breaks the law if he thinks he can get away with it. He is rude, unless it serves his purposes to act polite.
2. **Possessive individualism**: To the political theorist C.B. Macpherson (1911–87) this kind of individualist (here, Bill) sees an individual as essentially the proprietor of his own person and capabilities, while owing nothing to society for them.<sup>21</sup> He sees his possessions and personal attributes as the measure of success, without any obligation to “give back” to society. He does not compare himself to others as the survivalist does. In the tradition of political philosopher John Locke (1632–1704), he does not steal or violate others’ rights under current law. Even

though he wants as much as possible for himself, he is a free-rider rather than a thief.<sup>22</sup> He is polite but uses this behavior to attain his personal goals. It is a necessary evil.

3. Democratic individualism: Jazmine sees her attributes and assets as being to a large extent a product of society. Thus, she acts to pay society back. She sees her worth as an individual as best measured by the respect and honor received from others. She attains her individual goals by working cooperatively with others. She volunteers to work for her community organization (for little or no pay) because she sees that group as promoting her interests, including her personal freedom. She also insists that she and her neighbors have democratic control over the organization, to ensure a balance between her contribution and her benefits. She is polite because she sees both her and her community as gaining from social harmony. It's a good in itself, something that's good to have even if there are no obvious direct benefits.

This last kind of individualism is very hard to sustain in a society like that of the U.S., which cultivates and rewards possessive individualism. It thrives best on a small scale, as in families. The existence of a more democratic type of individualism within families and households is so hard to deny. So economists typically treat each entire household or family as if it were one unified possessive actor. For example, economic Nobelist Gary Becker assumes that the head of a household acts as a benevolent despot, maximizing benefits for the group.<sup>23</sup>

Collective action (such as voting) is more likely to be successful if people fit with a less individualistic description of one of the following sorts:

1. Identification. Zelda partly defines her identity by her membership in a larger group. She cares only about her own actions, attributes, and assets, she defines their *worth* to her according to the values of the group she identifies with. For example, she may or may not see herself as good looking, but the definition of "beauty" that she uses comes from her peers, other young and single women.
2. Personal collectivism. In that case, an individual would simply follow the herd, imitating others. What Ahmet wants and likes depends on what others in his peer-group want and like. His actions, attributes, and assets are only valuable because they contribute to the group, which in turn gives his value.

Obviously, the above needs more work.

In the real world, people do not simply care about what gives themselves pleasure or what may turn out to be useful to them in the longer run. They also care about others. As economic Nobelist George Akerlof and economist Rachel Kranton point out, individuals *identify* with the goals of the groups they belong to.<sup>24</sup> "Because of its explanatory power," they write, "numerous scholars in psychology, sociology, political science, anthropology, and history have adopted identity as a central concept." The idea that individuals identify with groups is hardly a new idea except to economists.<sup>25</sup>

This moves us beyond *homo economicus* and possessive individualism, toward *homo sapiens*. Individuals' identities, whether chosen or taught, form a central part of their *personalities*. That in turn distinguishes them from mere choosing machines.

More specifically, Zelda might think that "what is good for women in general is good for me" (*ceteris paribus*, of course!) Alternatively or in addition, she might identify with her ethnic, age, or language group. Most importantly for the issue of voting, she could identify with her nation as a whole.<sup>26</sup>

That is, she might not simply do “what is good for herself” in the narrowest possible meaning of that phrase. She might think “what if *everyone* decided not to vote just because the costs exceed the benefits? That would undermine American democracy!” Or she may simply say “voting is the right thing to do!” If she acts following the rule that what is good for her to do is the best if *everybody else* did the same, then she’ll vote.<sup>27</sup> Her decision would be strengthened if she sees herself – or others characterize her – as a leader or a role model for others.

Testing Economic Individualism: The *dictator game* is an extremely simple game used in experiments. There are two players, who do not know each other and do not communicate before or during the game. One, the dictator, determines how to split a cash prize between himself and another person. The other, the “responder,” receives what is left of the prize that the dictator does not take. The latter’s role is entirely passive and has no effect on the outcome of the game.

This game has been used to test the assumption that people are totally individualistic. A possessive individualist dictator would hog all of the prize and give absolutely nothing to the responder. As with other experiments in this genre, including the “ultimatum game,” Henrich and his colleagues. (2004) discovered from a wide cross-cultural study that the dictators usually give positive amounts to the responders.<sup>28</sup> So economic individualism model flunks the empirical test.

This discussion refers only to the *benefits* of voting. The costs remain (as suggested by the *ceteris paribus* clause of the previous paragraph). If she simply does not have the time to vote, she won’t do so, no matter how important she thinks it is. All the problems with limited choices, corrupt politicians, electoral manipulation, and the like can discourage Zelda from voting. These factors usually help explain why the percentage who actually vote varies between elections. In addition, economic and political events can fortify or deplete the individual’s identification with the nation.

The problems with elections might make her *angry*, so she might decide that she *must* vote, however. Of course, *homo economicus* never gets mad – or sad, glad, or afraid. This model of humanity does not have emotions.

Like a car’s MPG, the degree of public-spiritedness varies among individuals.<sup>29</sup> Some of the possibilities appear in the box on individualism above. We see some people never voting, while we do not see all people voting in each election.<sup>30</sup> *Some* people are always seeking the best possible reward for themselves and no-one else, even in situations where it seems inappropriate. Some of them are born – or raised to be – alert to all individual economic incentives without putting any social values into practice. Others just squeak by and must eke out a living: they have little choice but to act as if they were individualistic maximizers.

The assumption that everyone is an individualist is intimately linked with the view that individual preferences simply fall from the sky, so that their development and determination can never be understood by economists. But individuals are products of their biographies in society, their pre-natal environments, and their genes. They are thus profoundly affected by the family, the neighborhood, and the ethnic group they belong to. This helps determine what they see as good for both themselves and for the groups that they identify with. To cite an extremely obvious example, Americans are much more likely to identify with the U.S. than with any other nation, just as most English love the U.K.

### *Markets.*

Despite the unreality of the assumption that we are total individualists, we should not jettison the standard economic view of markets completely. In fact, market institutions themselves encourage people to be individualistic in their decisions.

The act of buying something centers completely on using one's own money to fulfill one's own goals. If Ahmet does not buy the Lamborghini Murciélago roadster (with 9 MPG in the city!) that he has had his eye on, it is hardly a tragedy to him if nobody else buys one. There is no reason at all why he should feel any kind of moral obligation to buy just so others will do the same.

It is true that his self-identification with a group plays a role. He may be thinking of that car because he identifies himself as a with-it (hip) young man who drives fast cars and puts the Playboy philosophy into practice – or (more likely) as a middle-aged man who needs to deal with a mid-life crisis. Similarly, as Akerlof and Kranton point out, people have themselves tattooed partly because of their identification with a group.

So individual identity helps determine *what people want*, filling the major gap in economic theory mentioned above (i.e., why people prefer potatoes to poi). On the other hand, it does not negate the fact that in many or most cases, people respond to high prices by avoiding the more expensive goods. Even if Jazmine's self-identification pushes her to get a tattoo, a high price for such self-mutilation will discourage her from it.

Morality and social values do play a role in markets, however. Many refuse to buy fur coats or products sold by Wal-Mart. Ahmet might decide to pass on the Lamborghini (and even take public transportation instead) in order to slow the process of global warming. He may say, "if everyone acts like me, my sacrifice will be even more effective."

But, as seen in **chapter 10** in the longer and deeper discussion of markets, such decisions are very unlikely to have any effect unless a full-scale boycott campaign is organized. Without such a collective effort, the individual is isolated. If totally cut-off from similarly-minded people, Ahmet can easily decide that "it doesn't matter what I do." He may fatalistically decide that it is better to drive a fast car. After all, global warming is hitting, so time is short. Thus, the dictum "eat, drink, and be merry, for tomorrow we shall die" (originated by the famous Egyptian economist Imhotep, circa 2630 BCE) seems more true than ever.

This discussion suggests that it is wrong to assert, as Adam Smith did in his 1776 Wealth of Nations, that the individualistic *homo economicus* (with its propensity to truck and barter) creates markets. Rather, markets create the individualistic *homo economicus*.

Even more likely, it is a combination of the two. Each and every individual has *some* drive toward self-preservation along with some sympathy with the interests of others.<sup>31</sup> These instincts can come in conflict with each other. Market institutions push people toward the greedy side of the street, while defining "self-interest" in possessive terms. It is not surprising that almost no philosophers saw people as individualistic (the way economists do) until just a few centuries ago, when market forces began to become increasing important in Western society.<sup>32</sup>

### ***Not Required.***

Finally, the idea that individuals do not care about what others do when they make their purchase decisions is not really needed to allow economists to use a relatively standard analysis of demand when discussing the consumer goods market. That is, economists need not assume total individualism. They need not assume that the only thing that affects demand for a product are purchasing power, the price, and the qualities inherent in the product itself.

In a classic article, our friend Leibenstein<sup>33</sup> used relatively simple economic theory to analyze the following three kinds of effects in markets:

1. The Bandwagon effect: if Snidely sees that some item – like a PlayStation 3 – is popular, he is *more* likely to join the trend and buy one for himself. If this happens with enough consumers in the market, there is a bandwagon effect.<sup>34</sup>
2. The Snob effect: if Ahmet sees that large number of other purchasers are buying a luxury like a Lamborghini, that will make it *less* attractive to him. He doesn't want to be associated with the “unwashed masses.” A full-scale snob effect occurs when a significant number of consumers think this way.
3. The Veblen effect: if Zelda sees a fancy item – such as Imperial Majesty perfume – is extremely expensive, she wants more of it.<sup>35</sup> The *high price* makes it *more* attractive to her. Following the analysis of American Institutionalist Thorstein Veblen (1857–1929), she engages in *conspicuous consumption*, to prove to others that she is really classy by buying something those poor benighted ones cannot afford.

In addition, these days we see the phenomenon of the high-tech “early adopter”: Bill buys a new electronic product – for example, a 52 inch Yalos Diamond LCD TV set – even though he knows that significantly less expensive versions will be available in a few years as the economies of large-scale production set in. It proves that he's hot caca compared to those who can't afford it.

All three of these “effects” reject the assumption of economic individualism. They involve a kind of externality, because others' decisions affect that of each individual. However, for the first two, the results are pretty much as in standard economics: the quantity that people demand of a product falls as the price goes up (under Leibenstein's reasonable assumption). There are some minor differences, but they are no big deal: the concern how weakly or strongly the market demand responds is to changing prices.

The third effect can cause an increased quantity to be purchased as prices go up – going completely against the standard story (the “law” of demand). But the number of markets where the Veblen effect applies is clearly very small. In almost all cases, we can safely ignore it.<sup>36</sup>

None of the textbooks reviewed mention the three types of effects listed above. Intermediate-level texts also omit them.<sup>37</sup> These books seem to cling to the assumption of the individualism of consumers, even though it is not necessary to their analysis except in a few cases. There seems to be ideology sitting on their shoulders as the authors write.

### **Incentives.**

Gwartney's third guidepost of "the" economic way of thinking is that "incentives matter – choice is influenced in a predictable way by changes in incentives." But the discussion of individualism suggests that this predictability has been exaggerated.

It is clear that incentives matter. If Snidely, the used-car salesman, receives a commission for selling cars, he is more likely work hard to sell them, perhaps to the extent that he makes himself obnoxious to customers. If Zelda, a taxi driver, is paid by the mile she will likely drive faster or take longer routes. If paid by the hour, she may drive more slowly. All else constant, if the price of video games goes up, fewer will be purchased in almost all markets.

But this discussion – and Gwartney's – assumes that there is only one kind of incentive. In their *Freakonomics* (p. 21), Levitt and Dubner point to three kinds, "economic, social, and moral." I was a bit surprised to find this list in a book co-authored by a professional economist (Levitt). We economists are trained to focus almost completely on the first kind. The second and third types suggest that the profession is finally moving away from the standard assumption that individuals are always individualistic.

The main kinds of incentives are extrinsic and intrinsic. Typically, economic incentives are purely extrinsic, while moral incentives are purely intrinsic. Social incentives represent a mixture.

#### ***Extrinsic and Intrinsic.***

*Extrinsic* or economic incentives are only the type that Gwartney sees. These are "contingent rewards": some person or institution outside of Ahmet decides if he has done a reasonably good job and if he should be paid (or not). If Ahmet thinks that he is to be paid for washing his father's car, he is more likely to do it (*ceteris paribus*). Such extrinsic rewards need not be purely economic or pecuniary, however. His father might give him a gold star or some other symbolic reward. Or a hug.

Extrinsic rewards need not be inside an actual market. His boss in the corporation's bureaucracy may reward him for doing unpaid tasks for the company by making him "employee of the month." A community may honor him with a party.<sup>38</sup>

On the other hand, Ahmet can receive – or more accurately, give himself – an *intrinsic* or moral reward for washing the car. His upbringing as a member of the family may involve the notion that everyone has moral obligations to the family unit. This is the kind of moral rule of thumb mentioned above.

He may believe that in a family, each individual has to pull some of the weight. It is part of the family's tradition (developed, perhaps, from democratic discussion between his parents). In any event, he will do the chore simply because it is *the right thing to do*. And doing the right thing makes him feel good (all else constant).

#### ***Crowding Out.***

Swiss experimental economist Bruno Frey argues that the use of extrinsic rewards can *crowd out* intrinsic rewards.<sup>39</sup> That is, if Ahmet is paid to wash his father's car, that may discourage him from doing it again in the future for its own sake (i.e., because it is the right thing to do). If, for example, his father later shifts back to seeing the task as part of

“each member of the family contributes to it for free” attitude, this may cause resistance and even malingering on Ahmet’s part.

Worse, this crowding out can easily spill over to undermine the intrinsic motivation to do related tasks. For example, if his father starts to pay him to wash his car, Ahmet may insist on being paid for *all* chores. This seems a likely part of the way in which the social environment formed by the marketplace shapes individual attitudes and preferences.

Levitt and Dubner present two clear examples of the crowding out effect (p. 23-4). A day-care collective imposed a fine on those parents who picked up their children late after school. Simple economics says that people would respond to the extrinsic incentive; fewer would be late. But instead there were *more* latecomers: they could avoid the guilt normally associated with being late for their children by paying a relatively small fee.

I have asked my students “what is the best way to get people to give blood?” They almost always answer: “pay them.” But they are always surprised by the true answer: paying people who give blood usually discourages blood donation. The pain was worth a moral gain (the feeling that one has done a favor to our fellow human beings), but it wasn’t worth a minor economic one.<sup>40</sup>

This kind of crowding out has been found in many experiments and in life outside the lab. Frey reports that Swiss communities were more willing to accept the placement of toxic waste dumps in their neighborhoods when the government did not offer to bribe them to do so.<sup>41</sup>

These stories should not be read as saying that extrinsic incentives *never* work. Rather, they say that the use of markets, bureaucracies, and similar systems relying on extrinsic rewards (discussed in [chapter 8](#)) undermine the alternative systems such as tradition and democracy, which rely much more on intrinsic rewards. This in turn means that extrinsic rewards (either in markets or hierarchies) become more and more necessary.

So, once established, markets or top-down command systems tend to snowball and then take over.<sup>42</sup> After this happens, Gwartney’s total emphasis on extrinsic incentives applies (unless there is a big popular effort to turn back the tide). There are then enough people for which extrinsic incentives apply.

When there is a critical mass of people following extrinsic incentives – and in more and more spheres of their lives – then the standard economic story of markets works. So, the general ideas of supply and demand work *once market institutions are well-established*.

### **Marginal Thinking.**

It is possible that the Ekon’s vision might apply for small – marginal – changes. In fact, Gwartney’s fourth guidepost for his version of the “economic way of thinking” is that “individuals make decisions at the margin.” The idea of marginal thinking was introduced in [chapter 5](#). It is crucial to understand and remember – that is, if you want to comprehend how economists think and/or get a good grade in an economics class. That comprehension is a necessary step toward being able to talk back to economists.

<p><u>The Maximization Rule</u>: Suppose Zelda thinks that there is going to be a natural disaster soon and wants to hoard Spam<sup>®</sup> just in case. <i>How much</i> should she hoard? She will buy cans of Spam<sup>®</sup> as long as the perceived benefits of having one extra can exceeds its cost. That is, she buys an extra</p>
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can if – and only if – its perceived benefits exceed the cost of a can. She buys one if the *marginal* benefits are greater than the *marginal* costs. (Economists use more complicated rules, but this captures the basic idea.)

A marginal change reflects the mathematical idea of a *derivative*. For a small but still positive change, the perceived marginal benefits (**MB**) would be  $\Delta\text{Benefits}/\Delta\text{Cans}$ . Suppose that a “jolly” is a unit of pleasure received by Jazmine (assuming that such things can be measured). Pretend that Jazmine expects to receive 9 jollies from owning 4 cans of Spam<sup>®</sup> and 15 jollies from owning 5 cans. In that case, the **MB** of going from owning 4 cans to owning 5 is 6 jollies per can. If she starts with 4 cans, she expects 6 extra jollies from increasing the number of cans owned by 1.

cans of Spam <sup>®</sup> owned	total benefit: total jollies expected	} marginal or extra benefit = 6 jollies per can.
4	9	
5	15	

For infinitesimally small changes, the **MB** is the derivative  $\partial\text{Benefit}/\partial\text{can}$  (the extra expected benefit received divided by the extra number of cans bought). Here is another reason to review calculus before taking an economics course! By the way, for a good grade, memorize and apply the maximization rule even if you don’t believe it. The Ekon use it over and over again.

Assume that the extra benefits **MB** and extra costs (Marginal Cost, **MC**) move in a way that brings them steadily closer to each other as the quantity purchased rises. If Zelda applies the maximization rule, she gets as close as possible to the point where the **MB** equals the marginal cost, *without* going beyond. If, by mistake, she buys a can which has a lower marginal benefit than it costs, she should try to sell that can (unless it is too expensive to do so).

As noted, economics has little or nothing to say about why Zelda likes Spam<sup>®</sup> or where her perceived benefits come from. We also may not be able to assume that **MB** and **MC** converge.

### ***The Big Picture.***

Marginal thinking is they kind of thing that lower or middle management are engaged in any business. These people take the “big picture” for granted and deal with small changes: given the price of our product and technical conditions we face, how much should we produce?

Those in top management in business and in government agencies seldom do marginal thinking. They are involved in *strategic decision-making*. Instead of looking at small changes, therefore the emphasis is on the entirety of the business and long-term planning. In biz lingo, one kind of strategy is called a *business plan*. One example of a business plan can be seen for razor-blade merchants: they give away razor holders but then charge much higher prices for the razor refill cartridges. The hope is that the freebie will get the customers hooked on the style of cartridges.

More generally, strategic thinking of this sort asks questions such as: if we introduce this new product, how can we use any or all of our existing productive capacity? how does the marketing campaign for the product build on previous efforts and link up with our ongoing ones? how can we use this new product to gain market domination or at least a larger share of the market?

When Marginal Thinking Fails. Suppose that you wake up in the middle of a deep dark forest and you don't know where you are. To escape this quandary, most people's natural instinct is to follow a version of the marginal rule: if you're given any choice, walk a small distance downhill. If this rule is applied repeatedly, eventually you'll reach civilization (as we know it). The problem is that you may have awakened in a natural bowl in the hills. After applying the rule, you are still stuck. The moral: you need to try to grasp the big picture.

The Ekons avoid this problem by sneaking in the assumption that this situation never occurs. This assumption is true, of course, except when it isn't.

If Zelda plays chess by thinking in a marginal way, she will never become a Grand Master (Mistress?). She would restrict her thinking to only consideration of the potential benefits of each move and any potential down-sides. But thinking strategically, she would project several moves into the future.

It is true that this thought process might be seen as balancing potential benefits and costs. But what distinguishes the strategic vision is that she has to consider how her opponent might respond to each move – and then how she would respond to that and how the opponent responds... Zelda thus has to consider the psychology (attitudes, biases) of the opponent. *Intuition* would likely play a big role in her decisions.

Strategic thinking goes beyond marginal thinking to consider other matters.<sup>43</sup>

- A marginal improvement may not mean that a business attains its highest possible profit because *indivisibilities*. If Ahmet is thinking of installing an extra PC in his graphics design shop, that might raise his profit by allowing him to serve more customers. But the business might do even better by switching completely over to using Macs, because they have a reputation of doing a better job with graphics. This is called an indivisibility because of the way in which the different kinds of computers work together: this is close to an either/or choice, because of the costs to the support staff and the difficulties of networking that arise when there are two distinct operating systems. A mixed system performs poorly compared to either pure system.
- There may be *irreversibilities*. Once Zelda's automobile company has built a new factory to build SUVs, it may be extremely costly to switch over to producing a hybrid gas-electric vehicles, because an entirely different technology is involved, perhaps along with new and different machinery. Such switching costs are one reason why United States industry took a long time to switch its industry from the English system to metric. Individual people over a certain age (such as yours truly) are taking an even longer time, due to *internal* switching costs.
- There may be *network effects*. One of the main reasons why companies purchase Microsoft Word<sup>®</sup> for word-processing is because (almost) "everyone else uses it." The existing prevalence of its use means that a company can gain from being able to exchange files with other companies (as part of a network). Further, it can utilize the skills that employees have gained while working for other companies. This phenomenon means that Microsoft tried to get a "critical mass" that would allow it to dominate the market. In fact, attaining this tipping point allowed its MS Word product to shove WordPerfect<sup>®</sup> aside, even though many industry experts saw that as a superior word-processor at the time (providing stellar quality support for users).

Individual purchases of consumer goods such as Spam<sup>®</sup> and cheese rarely involve such complicated strategic thinking. But there are exceptions. If Jazmine is stockpiling Spam, she does have to be concerned about the possible costs of buying too much (because of any costs of selling it back). More importantly, when we are making life plans – such as what kind of career to embark on – we have to think more strategically than marginally. Strategic thinking may also be more relevant when buying a car or a house.

Stranger than Fiction! In my teaching, I have often used Spam<sup>®</sup> as an example an *inferior good*, that is, a consumer good which people want less of as their incomes rise. (On the other hand, we want more of a *normal good* as our incomes rise.) As I learned from my students, this generalization is not accurate at all for those recently from the Pacific islands. This reflects a history of receiving canned meat from the US Navy during World War II, which replaced the tradition of eating pig meat. (It has absolutely nothing to do with “long pig” and the long-dead tradition of cannibalism in the South Pacific, since the Spam<sup>®</sup> fad is centered in the Northern Pacific.)

But many people lack the power to do strategic planning. In the armed forces, the lower ranks do marginal thinking: a colonel might how many troops should we use in this battle to win? On the other hand, the generals do the strategic thinking. They might ask: is that battle – or the war itself – even worth fighting?<sup>44</sup>

Economic and other kinds of insecurity may lead some to an extreme risk-taking version of planning. Snidely, who faces extreme debts, may gamble in hopes that he can save his bacon. In Henri-Georges Clouzot’s 1953 movie “The Wages of Fear,” desperate men volunteer to drive trucks filled with nitroglycerine over winding mountain roads to earn money to survive.<sup>45</sup> In the real-world economy (you thought I forgot it, didn’t you?), some savings & loan banks took gigantic risks in the late 1980s to escape insolvency.<sup>46</sup> This seemingly survivalist behavior may seem irrational, but to an economist it is perfectly rational given the circumstances. (Despite the value-laden terminology, economic rationality isn’t really a good thing, is it?)

Finally, the kind of small-picture, marginal, thinking that economics assumes might arise because people *believe* they have no power to act any other way. This might be an accurate picture of reality, as with privates in the army. In addition, the inevitable uncertainty – both the “known unknowns” and the “unknown unknowns” – of the future make it extremely difficult to grasp the big picture and think strategically. Finally, psychological depression (pathological pessimism) may easily prevent big-picture thinking.

### ***In Economics***

Sophisticated economists do not restrict themselves to marginal thinking. Unlike the Ekon, they know about the kinds of issues sketched above. Further, for many years *general equilibrium* models were central to the vision taught to graduate students. These refer to very simple models in which several or many markets are analyzed as interacting with each other. They provide a big picture rather than simply dealing with small changes in single markets.

*Game theory* models, which many see as replacing general equilibrium models as the jewel in the economics profession’s crown, is also not marginal in its orientation. Instead, it visualizes individuals as making decisions in a strategic way. Some games, the prison-

ers' dilemma, the dictator, and the ultimatum games were mentioned above. Of course, the "games" are much simpler than chess or war.

### **Maximization.**

Even if we assume that individual preferences are clearly determined and consistent, and that considering only marginal decision-making is adequate, some of the basics of the Ekon's view of choice are severely flawed. Back in 1898, Thorstein Veblen (the famous American Institutional economist) criticized the now-dominant school of economics as portraying an individual as:

a lightning calculator of pleasures and pains who oscillates like a homogeneous globule of desire of happiness under the impulse of stimuli that shift him about the area, but leave him intact.<sup>47</sup>

This criticism is reasonable, since real-world people are hardly robots that follow mechanical programs to process information in order to attain maximum utility. Nor can we collect information about all of the products we buy easily and cheaply.

Jazmine may find that it is very difficult to find the best deal on the products she buys. There may be a large number of seemingly equally-good objects out there that are available to buy. This makes it excessively difficult for Jazmine to find them all, judge them all, and then to make the final decision. Hidden differences in quality may be hard to find and understand. The welter of ads may be extremely confusing (even if they supply needed information).

That is, she may not be able to process all of the information needed to truly maximize the attainment of her goals. On top of that there may be serious problems of uncertainty, i.e., the totally unpredictable nature of future events and results.

*Sensory processing difficulties* hit those people with attention deficit disorder (ADD), sensory integration dysfunction, or autism spectrum disorders hardest. They have an extremely hard time filtering out all the unnecessary data – and prioritizing all that they receive. For example, while eating lunch at the cafeteria, Bill may be unable to avoid hearing what's being said at other tables than his own. He may have a very hard time finding the canned peas in the grocery store because of the jumble of signs and bright colors. He may become over-stimulated, finding it extremely difficult to make decisions. He may even run screaming from the store.<sup>48</sup>

Others (such as yours truly) may have very poor memories and find it too costly to write down needed data, so that price comparison between stores is impossible. These problems also face the rest of the human race, but usually to a smaller extent.

In addition, many people do not know exactly what it is that gives them enjoyment, though they usually have some good guesses. What gives us jolts of joy may be determined only *after* we spend to money. Zelda may not know what "good wine" is until after she has tried a large number of different types and brands and has taken a course on the subject. Further, as noted, it may be hard to separate short-term pleasure (drinking booze) from long-term results (a hangover).

### *Satisficing.*

Economic Nobelist Herbert Simon developed an alternative to the utility-maximization model, the idea of *bounded rationality*.<sup>49</sup> This is similar to Leibenstein's notion of selective rationality discussed above, except that it assumes that each individual has clear goals. But despite all of the internal and external barriers, people *make choices anyway* (including that of not doing anything). They are forced by circumstance and the costs of making decisions to *satisfice* rather than maximize.

The difference between maximizing and satisficing can be explained by different attitudes toward marriage. Ahmet – a maximizer – waits to find the absolutely perfect mate before he gets married. A satisficer like Zelda, on the other hand, “settles” for a spouse who is “good enough.” (This is usually seen as a bad thing.)

Satisficing means that Zelda decides on a target, which, if achieved, will make her pleased enough to keep her satisfied in general. It does not mean that she throws her standards with the bathwater. Suppose she is looking for a new dress. Part of her search is a set of criteria that must be met (its fit, look, texture, and price). If these are not met, she won't buy.

If Zelda does not achieve her target immediately, she may change or even lower her standards. She would do that only if she is tired or other costs of shopping add up. Alternatively, she would keep looking. She shops until she finds one that meets her criteria. It won't maximize her utility, but she won't worry at all about the fact that there may be better dresses at lower prices at yet another store.<sup>50</sup>

Satisficing might be seen as simply a version of maximizing behavior when the process of shopping involves a cost. However, that misses efforts to reduce the cost. For example, people use rules of thumb. Jim, who does not like to shop at all, may find a grocery store that he thinks is honest, convenient, and relatively inexpensive. Then, after the necessities (milk, bread, Spam<sup>®</sup>, etc.) have been handled, he purchases those items which he wants that are “on sale”<sup>51</sup> or particularly attractive at the price. Because this rule of thumb usually works well enough, he sticks to it.

Of course, for the really big decisions where a mistake can be very costly, such as marriage or buying a wedding dress, maximization seems the best way to go. For smaller things like a quart of milk, it is often not worth one's time and effort to shop around.<sup>52</sup>

This kind of description of human behavior seems much more accurate than the idea of maximization. Psychologist Barry Schwartz's *The Paradox of Choice* presents evidence indicating that most people are satisficers.<sup>53</sup>

Even more striking, he and his colleagues found that satisficers are typically *happier* than the would-be maximizers are. (Happiness is discussed below.) The former do not find themselves worrying too much while shopping – and then regretting the choice that they actually made. The maximizers may not actually end up maximizing their satisfaction, given the costs of worry and regret. In fact, Herbert Simon suggested that given uncertainty, lack of information, and limited computing power, satisficing may allow the maximum attainment of one's goals.<sup>54</sup>

### ***In Markets.***

Even though the assumption of consumer maximization seems totally bogus, it is not necessary. Dr. Spearman's model assumes that the maximizing consumer will try to get absolutely the best value for the money. As reasonable human beings, we reject this assumption. But the model tells us the *general direction* that most of us – even the satisficers – will go. In addition, the presence of some maximizers in the market contribute to the market acting the way the model predicts. In some markets, only the presence of the “rational” minority is needed for the supply and demand model to work.

We may not make exactly the right choice. If we do, we may not do it right away. But we're trying to do as best we can. This is enough for the usual stories of consumer demand. All that the model of consumer demand that is behind the demand curve requires is that individuals consider the available alternative products and their own ability to pay.

### **Experimental Economics.**

As noted, economists should be studying the actual behavior of individuals, including bringing in research by other social scientists. But it is only recently that economists have started performing *experiments* to see how and why people really make choices and what they want. Gwartney and McConnell ignore recent experimental economics completely.<sup>55</sup> They do not mention economist Vernon Smith or psychologist Daniel Kahneman, the 2002 winners of the economics Nobel for their work in this field. Thus, these textbooks – and more importantly, their readers – miss some of the most exciting research in microeconomics of recent decades.

Krugman does mention this issue, in a special box “for inquiring minds.” Its placement indicates the low importance he puts on experimental economics. In my experience, most students will not read the box unless explicitly requested to do so. And it appears quite far into the book (p. 244), when students have already absorbed much of the economics world-view about human rationality. Most professors will not write exam questions about special topic boxes.

### ***Let's See Your Mug.***

In his most famous experiment, Kahneman and his colleagues gave one group of people an attractive coffee mug. A second group received nothing. The first group could then choose to keep the mug or to trade it for money. The others are asked what compensation they wanted to be deprived of a mug. Kahneman found that those without mugs valued them at about one half of what those who had been given mugs did.<sup>56</sup>

Standard economics tells us that Ahmet's decision is not affected by the fact that he owns or doesn't own a mug. There should be *absolutely no impact* on the price that he assigns to the item. However, these experiments say that people place a higher value on objects they own relative to objects they do not. This *endowment effect* tells us again that the orthodox view of individual choice is flawed.

### ***More Anomalies.***

Economic experimentalists Bruno Frey and Reiner Eichenberger provide a useful list of ways that human decision-making systematically differ from the standard model of *homo economicus*.<sup>57</sup> Leaving out the more complicated ones, these are:

1. What one has now is valued over objects that are not currently part of one's collection of assets (the endowment effect discussed above).
2. Individuals often do not make decisions based on the hoped-for final result of their actions but instead on the basis of their current *status quo* or some other known point of reference (such as what others own or do).
3. Almost all economists assume that people make decisions (such as buying a compact disc) according to the total of all the benefits given up due to an action, i.e., the *opportunity cost*, including both money costs and time that could be used for other purposes. But in practice, people often put much too much weight on the out-of-pocket (money) cost, even when it is only a fraction of the total cost.
4. Recent experiences, especially spectacular ones, are given too much weight in individual decision-making.
5. People are often *overconfident*, convinced that they know what is going on better than they actually do. For example, many more athletes seem to believe that they will win competitions than actually can triumph.
6. The way a decision-making process is formulated or "framed" (the way that information is presented) affects the decisions made.

Together, these "behavioral anomalies" (compared to the rational decision-maker made famous by economists) suggest that the profession needs to retrench and rethink.

Further, all but #5 (and some not listed) suggest that individuals care a lot about *precedent*. Some, especially #2, suggest that individuals base their decisions partly on what others do. This fits with Duesenberry's theory of the consumer treadmill discussed below. These anomalies also suggest that customs and democracy (discussed in **chapter 8**) can have a big role in economic life.

### *... and Markets.*

As with satisficing, these experimental results undermine only the more baroque or ideological ideas of economists. The basic ideas of consumer demand – and of supply and demand – still work. The *homo economicus* model is not really necessary to the understanding of most of the markets that we citizens encounter. In general, all we need to know is that people respond to a rise in the price of mugs – or whatever – by buying fewer of them. (This uses a *ceteris paribus* clause of course: I assumed implicitly that the price of the mug is the only thing changing in the market. Did you catch me?)

However, there are important exceptions: in *behavioral finance*, it turns out that such quirks may help explain the craziness of financial markets. Some economists assume that financial markets are "efficient," meaning that they process all available information efficiently. This means that stock prices correspond as close as possible to the *fundamentals*, such as the ability of a company to produce income for its stock-owners. But we sometimes see periods such as the 1990s, when the stock market becomes totally irrational.

Behavioral finance research makes the views of economist and stock-market investor John Maynard Keynes seem much more apt. He argued that much of the speculation that takes place in the stock market can be likened to betting on a beauty contest.<sup>58</sup> Individual traders almost always lack sufficient information about what a company's stock price and

dividends will be in the future. (Those who have the most information – the insiders – are legally prevented from trading.) After all, the future always involves a large dose of unpredictability (uncertainty) that cannot be avoided.

Snidely and other plungers may thus decide to base their decisions mostly on *what other people think*. They guess that if others think a stock will go up, it will indeed go up. Returning to Keynes' analogy, Snidely bets that Miss Mississippi will win the Miss America contest, even though he may not like her looks. This kind of behavior, if common enough, encourages group-think and herd-like behavior so often seen in the stock market.

### *Fairness Revisited.*

**Chapter 1** mentioned that one reason why economists do not like the concept of fairness is because it is so vague. But some have done experiments that allow a *positive* or real-world understanding of the meaning of “fairness” (or distributive justice) based on experiments that test actual human behavior. For example, economist James Konow reports that it:

... requires that a person's ... income ... vary in proportion to the relevant variables which he can influence (e.g., work effort), but not according to those which he cannot reasonably influence (e.g., a physical handicap).<sup>59</sup>

People typically see the giving of some benefit to someone as “fair,” for example, if they actually *did something* to earn it rather than because of something they have inherited in some way. This seems akin to the socialist “to each according to contribution” principle.

Of course, there will be argument about the exact nature of individual contributions to society's production. Thus, this kind of result will not solve the age-old philosophical debates over the meaning of “fairness” and “justice.” Other economists have proposed other standards of distributive justice that people follow in practice.<sup>60</sup> But this research does add some real-world grounding that might consistently predict human behavior.

### **Unlimited Wants?**

Gwartney maintains that our desires are “unlimited.” But this is simply *an assertion*, perhaps a statement of faith. Among economists, it is a cliché. Thus, in her novel *Moo*, Jane Smiley portrays Lionel Gift, a distinguished professor of economics, as a man whose “first principle was that all men, not excluding himself, had an insatiable desire for consumer goods.” In the book's plot, this explains Gift's motivation. (He deliberately teaches his students to rat on each other in prisoner's dilemma games.) This motive plays a big role in the novels we call “economics textbooks.”

But given economist's empty understanding of what people want, there is no scientific basis for the assertion that wants are unlimited. Nonetheless, the assumption that “unlimited wants” apply can be *useful*: it can help us understand the role of constraints in economics. That is, if a rat is in a cage, the bars are only relevant if it wants to escape.

Assume Zelda wants as much as possible of all things that give her pleasure. Then, the constraints that arise due to scarcity (discussed in **chapter 4**) become extremely important in determining what she actually chooses. If, on the other hand, if Zelda (or the rat) is satisfied with whatever she gets (perhaps because of her religious training), we don't get any

insights at all of the sort that interest economists. It may be true that wants can be totally satiated, but it is not useful to the economist.

The assumption of unlimited wants might thus be a *useful lie*, something that makes it easier to understand the world. This is akin to Friedman’s view that the truth or falsity of an assumption is irrelevant (compared to the predictive ability of the whole model) encountered in **chapter 3**. However, unlike for him, the usefulness of a lie (compared to the cost of being unrealistic) can only be seen as a judgment call. It depends on our values and world-view.

That is, the assumption could easily be ideological. It might be part of the kind of “golden lie” that Plato saw as necessary to maintain the *status quo* in his utopian Republic (by justifying the power and status of the ruling Guardians). The need to avoid such ideology suggests that economists should look for theoretical justifications for the “unlimited wants” assumption.

***On the Treadmill.***

The unlimited wants assumption makes more sense if it only applies to *small changes*. So we can use the economist’s assumption of marginal thinking: Ahmet wants more than he currently has. This is much more likely to be true than the notion of unlimited wants in absolute terms (i.e., that Ahmet will never ever be satisfied and will always be striving for “more”). This limited notion of marginally-unlimited wants can be explained by the economics, psychology, and sociology of **happiness**.

**Definition:** in economics, **happiness** refers to *subjective well-being*, most often as measured by a survey. Each person is asked a questions such as “Taken all together, how would you say things are these days – would you say you are very happy, pretty happy or not too happy.”<sup>61</sup>

As economist Robert Frank notes, “People’s responses [to this question] are informative. They tend to be consistent over time and are highly correlated with assessments of them made by their friends. Positive self-assessments are strongly linked with behaviors indicating psychological health. Thus, people who report high levels of subjective well-being are more likely to initiate social contacts with friends and more likely to respond to requests for assistance from strangers. They are less likely than others to suffer from psychosomatic illnesses, seek psychological counseling or attempt suicide.”<sup>62</sup>

The following table shows an international comparison of subjective well-being in 2002, from the International Social Survey and sorted by the over-all degree of happiness (the first column).<sup>63</sup> It shows the top ten in the happiness sweepstakes. The last column shows a kind of unhappiness.

(35 countries total)	Happiness	Family satisfaction	Job satisfaction	Not Tired	Work Stress
Mexico	5.58	5.96	5.80	2.53	2.70
Japan	5.56	5.52	4.89	1.90	3.38
Northern Ireland	5.56	5.74	5.31	2.46	3.45
Austria	5.54	5.80	5.51	2.07	3.55

Chile	5.54	5.81	5.16	2.89	3.07
<b>United States</b>	<b>5.52</b>	<b>5.67</b>	<b>5.34</b>	<b>2.71</b>	<b>3.25</b>
Switzerland	5.51	5.73	5.61	2.01	3.07
New Zealand	5.48	5.60	5.14	2.48	3.49
Great Britain	5.43	5.62	5.06	2.68	3.55
Brazil	5.42	5.31	5.11	2.68	2.82

The U.S. is #6 in overall happiness, but #9 in family satisfaction, #7 in job satisfaction, and #8 in “not tired.” It is #16 away from having the best (lowest) level in work stress.

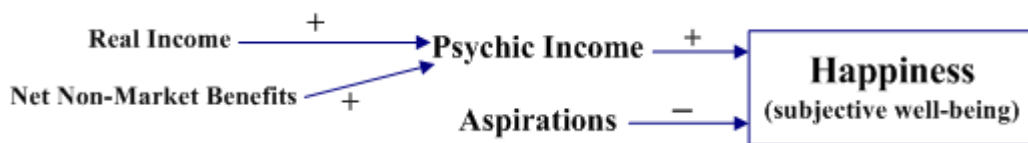
The assumption that wants are unlimited are – on the margin – with the phenomenon of most people believing that slightly more income, or slightly more wealth, will get them “out of the woods” so they can relax and enjoy life.

But this belief in turn conflicts with survey evidence about actual individual experience: as economist Richard Easterlin points out, an average individual’s subjective judgment of her or his own well-being does not change much at all during the years from youth to old age, *despite* increases in income during those years. The only big jump in happiness with income occurs when exiting from poverty.<sup>64</sup>

Similarly, when comparing countries, a rise in national income has little or no connection with measured happiness among countries. Poorer countries can sometimes exhibit greater happiness than richer ones.<sup>65</sup> The box above shows that Mexico and Chile do better than the U.S. in the happiness sweepstakes. A box below indicates that for both the U.S. and France, two of the rGDP-richest countries, happiness stagnated at the same time that *per capita* rGDP rose.

In explaining these anomalies, one possibility is that real economic benefits have not increased as much as indicated by such measures as rGDP which the Ekon use to distinguish rich from poor countries. That is, as seen in **chapter 3**, the Genuine Progress Indicator for the United States has not increased very much if at all during the period since the 1970s. However, this explanation, like the GPI itself, has not been embraced by many economists.

Economists focus on an individual explanation: as Jazmine’s income rises, typically her *aspirations* rise too. All else constant, this rise in goals hurts her happiness.<sup>66</sup> A simplified chart can be used summarize this issue for any given individual:



The terms of this chart again involves multifaceted components. “Psychic income” would include not only money income but also non-pecuniary benefits such as free access to a park or a public library (net of non-market costs). It is thus akin to an alternative measure

of economic output such as the GPI. Alternatively, it might be measured by the benefits received from the individual's capabilities (discussed later, in [chapter 7](#)). In a box below, economist Stefan Schneider calls it "economic well-being."

On the other hand, aspirations, like dreams, likely cannot be represented by a number. They are a central part of individuals' complex personalities, reflecting their identification with larger groups, among other things. This again creates a gap between *homo economicus* and *homo sapiens*. But this chart helps us understand Easterlin's paradox.<sup>67</sup>

This picture of psychic income, happiness, and aspirations is of course too simple. All three of these concepts relate to the specific nature of individual personalities. What some interpret as psychic income may not seem that way to others. At the same time, the translation of that income into happiness would vary between individuals.

Why Happiness is Not a Good Policy Goal: Though surveys of how happy people say they are say something about how successful economic policy-makers have been (among other things), it would be a mistake for those policy-makers to try to ramp up some measure of happiness.<sup>68</sup>

Not only are there measurement problems, but it misses a crucial point about happiness (seen in the diagram in the main text). In the economics literature, happiness concerns not only what people have or get, but also their aspirations and expectations. So Zelda can be "happy" because her aim is low. She can be very happy despite being quadriplegic or living in a concentration camp. On the other hand, Ahmet might be unhappy despite winning big in a lottery, because his expectations have been raised so far by the process of entering and winning, so that the actual money is an anticlimax to him.<sup>69</sup>

Thus, happiness could be increased by lowering expectations and aspirations. Alternatively, the policy-makers could follow the lead of Aldous Huxley's dystopian Brave New World: everyone could be given *soma*, a happiness drug. Either of these would undermine individual motivation to do anything new, different, or better, including the purchase of new products and innovation.

However, the last sentence applies only under the current set-up, where both income and aspirations are so often stated in money or market terms. We may want to change the specifics of people's lives in a way that redefines both of these. For example, as discussed in [chapter 4](#), William Morris advocates a reorientation of society toward a focus on skilled craft production.

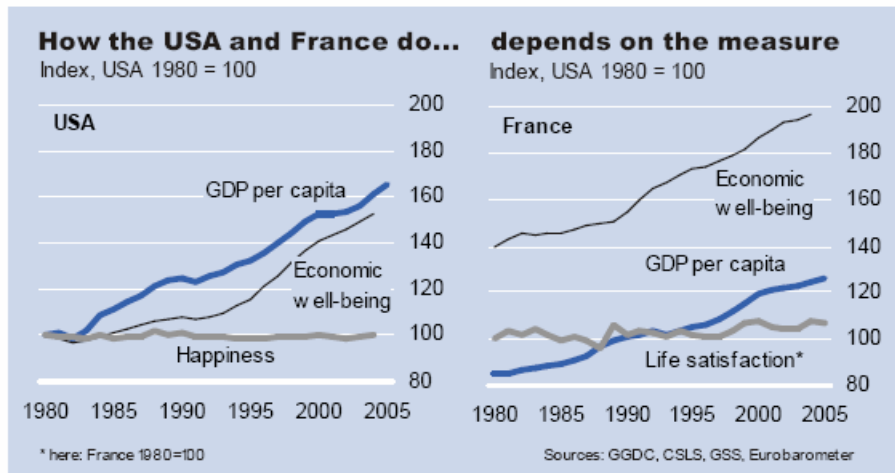
In his view, people get used to a higher standard of living – and then use it as a new benchmark for judging their success. This *habituation* or *adaptation* in turn undermines the effects of the extra gallon of gladness that arises from rising income.

Snidely gets a job as a lawyer, significantly raising his income. But then he finds that a taste of better things undermines his happiness by spurring him to want even more. He identifies with his job: now he *must* have that Beamer, since *all* young lawyers have them! If he cannot afford the car, his happiness can fall.

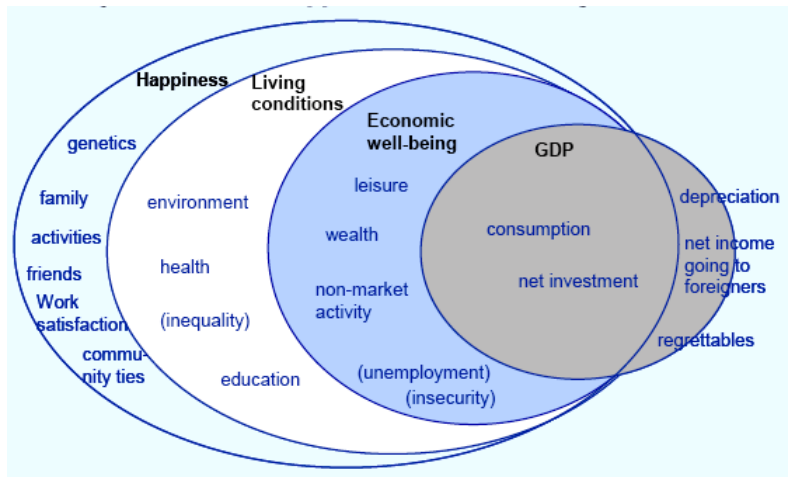
Happiness and other Measures. Stefan Schneider of the Deutsche Bank presented the following graphs that show the importance of happiness measures.<sup>70</sup> "Economic Well-Being" is a broader measure of the benefits arising from the economy, including the impact of leisure time and non-market production and hurt by insecurity and unemployment. Finally, happiness (life satisfaction) is subjective well-being, as defined above. These three – and a fourth, "living conditions" – are defined in the graph in the next box.

In the comparison, the U.S. does much better than does France in terms of (real) GDP *per capita*.

But France does significantly better in terms of economic well-being. But, in terms of happiness (or life satisfaction), both seem stuck on the floor. As noted, for the rich countries, after a certain point, economic growth does not seem to promote happiness.



**Defining Terms.** Schneider’s second graph (shown below) allows conceptual comparison of (real) GDP, economic well-being, living conditions, and subjective happiness. “Living conditions” are similar to the GPI or the U.N. Human Development Index, discussed below.



Numbers in parentheses are subtractions from economic well-being or living conditions.

To Schneider, “Economic well-being is a broader concept [than rGDP], but still restricted to material aspects. It is influenced by parts of GDP, by non-market activity, leisure and wealth. Unemployment and income inequality tend to reduce economic well-being. The Centre for the Study of Living Standards sees the highest economic well-being in Norway, France and Belgium.”

“Individual living conditions also include non-material aspects such as health, life expectancy, education and the state of the environment. The Weighted Index of Social Progress sees Sweden, Denmark and Norway on top, while the Happy Planet Index sees Colombia and Costa Rica among the leaders.”

Gross National Happiness? The Himalayan country of Bhutan uses a measure of Gross National Happiness, reflecting Buddhist values. Crucial to this measure are equitable and sustainable socio-economic development, persistence of cultural values, preservation of the natural environment, and good governance. But this is not a measure of happiness as much as a version of the Human Development Index that the United Nations calculates (see [chapter 7](#)).

Snidely is on a *hedonic treadmill* of getting and spending.<sup>71</sup> Every time he thinks he is about to grasp the carrot, it moves away.<sup>72</sup> This keeps him struggling for more income, status, and power. As several economists and psychologists suggest, being on this treadmill is akin to drug addiction: after awhile, attaining more income and the like provides no extra pounds of pleasure at all, just *the avoidance of pain*. So being stuck on this treadmill pushes Snidely to act *as if* his wants were unlimited.

What Brings Us Happiness? Breaching the topic of happiness – another new and interesting field in economics ignored by our Ekon – brings up another question. If it is not money income (corrected for inflation) that brings happiness, what does?

Economist Richard Layard summarizes research results pointing to seven factors: mental health, a secure and loving private life, satisfying and secure work, a safe community, political, social, and economic freedom, and moral values.<sup>73</sup> Psychologist Ed Diener summarizes the recipe for happiness as “good mental health and good social relationships.”<sup>74</sup> (In other words, attaining happiness is as easy as cake!) Though this will hardly end the philosophical debate about the meaning of happiness, it suggests that subjective well-being is promoted by the factors of the sort that show up in the Human Development Index (see [chapter 7](#)) and measures of economic production broader than the rGDP. This in turn suggests that Ekon need to widen their perspective and to stop seeing marketed goods and services as the only or main source of contentment.

### ***Keeping Up.***

This treadmill – one basis for the unlimited wants assumption – is also a *sociological* phenomenon: in addition to the adaptation to a new, higher, level of income, social competition among individuals drives them to want more and more. As noted above, such social forces help make our tastes what they are. Following the lead of thinkers such as Veblen, economist James Duesenberry argued that in rich countries like the U.S., an individual’s “drive toward higher consumption” can be explained in terms of a theory that rejects the Ekon’s individualistic axiom.

Paraphrasing his analysis, in our society, the normal individual drive to attain self-esteem is expressed as a effort to get higher-quality goods and completely new ones. This drive also encourages people to seek higher social status. This in turn reinforces the urge to purchase higher-quality and new goods because high social status requires high material standards. All of this is encouraged by the *demonstration effect*, seeing the consumption goods and services that our friends, neighbors, and peers enjoy, along with the advertising for those goods.<sup>75</sup>

To use the language of cliché, this is the effort to “keep up with the Smiths” – and with our friends and peers at work. It reflects part of one’s self-identification as “middle class” or something similar. We also try to attain the living standards and status of the richer folk and the stars on TV. All of these influences, by the way, combine to define happi-

ness in terms of purchased goods and services (as do the Ekons). Further, the individual's goals are best served if these products are publicly visible.

This attitude appears in the half-joking bumper slogan: "He who dies with the most toys wins." People are not truly individualistic here: they don't think simply about "number one" (and the personal pleasure given by that Beamer) but how they are doing *relative to* others.<sup>76</sup> The Beamer gives Snidely social status.

The constant barrage of advertising and the rise of other's living standards likely raises Zelda's aspirations. All else constant, in addition to the direct costs of contemptible, craven, cheesy, and crass commercials, this demonstration effect lowers Zelda's degree of happiness, motivating her to grasp for more income and more consumption goods.

The Effects of Advertising. According to the Ekon, what effect does advertising have on consumer decisions? Gwartney (p. 501) does not really address this question at all, but seems to assume that advertising has *some* effect. McConnell (pp. 478-9?) is similar. Krugman (p. 401) allows ads to have a possible effect: "Consumer rationality is a useful working assumption; it is not an absolute truth." (Amen!) Goodwin, as usual, provides a more nuanced view (pp. 230, 240-1). In earlier editions of McConnell's textbook, the significantly longer and more serious discussion of the pros and cons of advertising suggested a possibility which fits well with that of Duesenberry: advertising pollutes the culture, encouraging people to think of life and success totally in terms of the products owned and received.<sup>77</sup> Much of advertising's effect is cancelled out by advertising by other companies, but the general tone of our culture is affected.

Duesenberry's model is not merely speculation: it has done very well at predicting the behavior of individual spending for the economy as a whole over time, as well as or better than its competitors.<sup>78</sup> The Ekon's ignorance – or deliberate forgetting – of Duesenberry's research seems to be the result of an ideological bias. Right from the start, Friedman justifies his alternative hypothesis in these terms: unlike that of Duesenberry, his model "follows directly from the currently accepted pure theory of consumer behavior" (which assumes individualism, given tastes, etc.)<sup>79</sup> The profession's sharing of this kind of attitude has also favored the theory of Franco Modigliani.

On the microeconomic level, Angela Chao and Juliet B. Schor showed that status-seeking had a clear impact on the demand for cosmetics.<sup>80</sup> Schor's 1998 book, The Overspent American (Basic Books) is about the effects of being stuck on the consumer treadmill, as are several of her other books. All of this research sets the stage for our understand of the nature of fads, something beyond the Ekon's comprehension.

### ***Impact.***

The drive toward higher consumption can be likened to a weightlifting contest. In this kind of contest, only the best three can win medals. Further, only the winner of the gold medal may achieve star status, with lucrative product endorsements and the like. The lifters are judged *relative to* each other. Assume that there are no rules against using anabolic steroids and other "performance-enhancing" drugs – or that existing rules are not enforced well. For each of the athletes, therefore, the incentive is to take steroids. If the better athletes see this happening, even they will do so. After all, they do not want to fall behind. (This is the demonstration effect again.)

Even if there are rules against drug abuse, they are often hard to enforce. This kind of rivalry encourages opportunism: people are pushed to break the rules if they believe they can get away with it (if expected costs are less than benefits).

Because almost everyone takes pretty much the same amount of the drug, the relative positions of the weightlifters will not change significantly. There are still only three winners. Unfortunately, most if not all of the lifters suffer from medical side-effects of steroids.<sup>81</sup> Economist Fred Hirsch (1931-78) argued that such competition to attain *positional goods* – goods like “who wins the contest” which cannot be increased in number – can lead to similar serious problems in society.<sup>82</sup>

Axeling over to another sport, this seems the basis for a striking 1994 case in athletic crime: it helps explain the clubbing of figure-skater Nancy Kerrigan’s knee by a henchman of rival Tonya Harding.

In recent decades, the economic equivalent of steroid use has been consumer borrowing. This, plus relatively easy access to credit and the lenders’ pushing of loans encouraged excessive indebtedness of households.

We enjoy a positional good because it puts us above others in some sort of status hierarchy. Those at the bottom do not enjoy it. But as people struggle to rise or at least to avoid falling, it produces behaviors very much like those produced by the assumptions unlimited wants.

### ***Other Reasons.***

There are other reasons why we might reasonably make the unlimited wants assumption. Not everyone is involved in the middle-class status battle. Others *seem* as if they have unlimited wants because they are struggling to survive. They are stuck in an economic trap, i.e., poor. (See **chapter 7**.) They are always squeezed by the limits set by their incomes, their current debts, their family obligations, and the quantity and quality of paid jobs available. This *pushes* them to act like *homo economicus*, to save and scrimp, often to act in the most individualistic way (outside of their immediate families). However, even these people sometimes deviate from the kind of unlimited consumerism that economists assume, because they fall into serious illness, depression, drug addiction, or worse.

The big question is where unlimited wants come from concerns the very rich, as seen in this fictional dialog fragment between the detective (Jake Gittes) and the nefarious nabob, Noah Cross, in the movie “Chinatown”:

**Jake Gittes:** Why are you doing it? How much better can you eat? What can you buy that you cannot already afford?

**Noah Cross:** The future, Mr. Gitts [sic], the future.

Why anyone would want to accumulate wealth and power forever seems beyond this economist’s ken. It is due to a genetic defect? or failures of nurture? Or is it even true? These questions, alas, cannot be answered in this book.

One fact that is generally found is that the rich do not give to charity as much as poorer folks, in proportion to their income.<sup>83</sup> It is true that the poorer folks often give to their own churches (if they are religious) perhaps because of their participation in religious

communities and their relative control over them. But the rich also give most to foundations that they control. Further, they receive bigger tax breaks for such giving (because they can avoid paying a higher tax rate than that applied to lower incomes). So their seemingly endless urge for wealth is not based on the wish to make charitable donations.

### **Normative Note.**

Before ending, a major normative advantage of the Ekons perspective – the *homo economicus* assumption – should be mentioned. That is, treating Snidely’s (or any other consumer’s) tastes as beyond any economic understanding can allow the Ekons to hold great respect for him. Each consumer is an “unmoved mover,” a lilliputian god. Of course, he or she must still figure out how to live under conditions of scarcity and the competition with other consumers over the distribution of the product.

This vision is normatively superior to alternative attitudes that might be engendered by other views. For example, a person might suffer from the “Oedipus complex,” “inferior” genes, “mob psychology,” “an addictive personality,” or the “culture of poverty.” These views encourage paternalistic attitudes, dismissing individual wants and statements as misguided, childish, or worse.

However, the link between any theoretical perspective and sociopolitical attitudes is never a one-to-one mapping. As seen in **chapter 13**, some Ekons dismiss democracy and the collective expression of individual wants. They often also treat people as being *merely* consumers of goods and services (and creatures of the market) rather than as the complicated social and political animals that we are. To these authors, we are not workers or citizens. They grant an exemption from paternalistic value-judgments only when people are buying and selling.

### **Key Concepts.**

### **Questions for Economists.**

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<sup>1</sup> However, the partial enforcement of some laws gives the police an extra tool against suspects: they can threaten the perp with prosecution under one law in order to get cooperation under another.

<sup>2</sup> Curiously, that extremely useful maxim does not appear in the economics textbooks that form the raw material of this book. In fact, I have never seen it in any introductory textbook.

<sup>3</sup> The former refers to direct effects, while the latter refers to the successful realization of long-term plans. These may not coincide due to the costs of planning ahead and the difficulties involved with implementing such plans. These include lack of information, uncertainty, imperfect capital markets, and liquidity constraints.

<sup>4</sup> The distinction between pleasure, a means to an end, and (true) happiness comes from Aristotle’s *Nicomachean Ethics* (350 BCE), ch. 1 (available at <http://classics.mit.edu/Aristotle/nicomachaen.html>, as of 12/13/06). His “happiness” refers to a situation where subjective and objective well-being coincide, which I refer to as “health.”

<sup>5</sup> The admission of the truth of these statements is the basis for “the theory of revealed preferences.” See Paul Samuelson. 1937. “A Note on Measurement of Utility,” *Review of Economics and Statistics*.

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<sup>6</sup> Nichols, Donald and Clark W. Reynolds. 1971. Principles of Economics (Holt, Rinehart and Winston).

<sup>7</sup> For a recipe, see [http://www.sptimes.com/2002/06/26/Taste/The\\_Twinkie\\_transform.shtml](http://www.sptimes.com/2002/06/26/Taste/The_Twinkie_transform.shtml).

<sup>8</sup> This triune split in human consciousness was seen earlier in Plato's Republic, ch. 13. His "Superego" was instead the wish to be honored by others.

<sup>9</sup> There may be an internal "voter's paradox." It prefers stealing now to doing so later, which, in turn, is preferred to never filching. Ego prefers strategic delay to impulsive theft; mindful of the consequences of being caught, it will settle for never robbing over smash-and-grab. Superego prefers never swiping over delaying, since delay means that theft may never occur; instant gratification is the least-favored option.

<sup>10</sup> Kenneth Button, ed. 1989. The Collected Essays of Harvey Leibenstein: vol. 2 X-Efficiency and Micro-Micro Theory. New York U.P.

<sup>11</sup> It could suffer from what he called X-inefficiency (see **chapter 7**). He called his view the "micro-micro" perspective, looking at the microeconomics of individuals inside the microeconomic unit. What I apply here might be called micro-micro-micro, because it involves the conflicts within individuals. See also Jon Elster, ed. 1985, The Multiple Self. Cambridge U.P.

<sup>12</sup> If the rules are clearly being enforced, no commandments are needed. But people often follow the rules even when not being watched.

<sup>13</sup> See Akerlof and Kranton. 2000, p. 728. cited below.

<sup>14</sup> See Goodwin, ch. 2 §2 and ch. 10. See also LaVoie, Marc. 1994. A Post Keynesian Approach to Consumer Choice. Journal of Post Keynesian Economics. 16(4) Summer, pp. 539-62.

<sup>15</sup> Anthropologist Marvin Harris (1927-2001) explains these cultural differences by the different economic and ecological environments faced by people. But note that it is *not* the environment faced by an individual but instead that faced by a society as a whole. See his 1974 Cows, Pigs, Wars, & Witches: the Riddles of Culture Random House.

<sup>16</sup> In the Journal of Marketing, (32(3), July 1973) Lawrence Tarpey criticizes Kelvin Lancaster's Consumer Demand: A New Approach for ignoring the pre-existing marketing literature concerning one of his key points. This is just one of many lamentations of this sort.

<sup>17</sup> Much of his behavior was even worse, as when he encouraged bigotry against Jews and Blacks.

<sup>18</sup> Because each is unique, it has a very small monopoly. But because there are stores that are vaguely similar, there is competition.

<sup>19</sup> On the other hand, Microsoft used its "start me up" advertising blitz to successfully create a fad surrounding its Windows 95 operating system. Once it was established, network economies insured that it would beat out its competitors. So that fad lasted. Network economies are explained below.

<sup>20</sup> They are kept scarce by government policy, which keeps interest and dividend rates from falling to zero.

<sup>21</sup> 1962, The Political Theory of Possessive Individualism: Hobbes to Locke. Oxford U.P., p. 3.

<sup>22</sup> Like the modern Egon, Locke in effect took individual property rights for granted (or justified by "natural" law), so that theft is distinct from free-riding. But if the property-rights system is a public good, theft is a form of free-riding. See **chapter XX**.

<sup>23</sup> 1981. A Treatise on the Family Harvard University Press. For more on this subject, see Goodwin, ch. 15, §4.

<sup>24</sup> 2000. Economics and Identity. Quarterly Journal of Economics. 115(3) August, pp. 715-53.

<sup>25</sup> One economist who emphasized the role of identification was Nancy Folbre, 1994. Who Pays for the Kids: Gender and the Structures of Constraint. Routledge.

<sup>26</sup> This is *not* altruism (the practice of placing the welfare of others before one's personal goals, of making personal sacrifices for others). Rather, it involves seeing the goals of others as part of one's own goals.

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<sup>27</sup> This is a practical version of the Golden Rule or German philosopher Immanuel Kant's (1724–1804) categorical imperative. It assumes, of course, that Zelda sees American democracy as a good thing.

<sup>28</sup> See Joseph Henrich, Robert Boyd, Samuel Bowles, Colin Camerer, Ernst Fehr, and Herbert Gintis. 2004. Foundations of Human Sociality: Economic Experiments and Ethnographic Evidence from Fifteen Small-Scale Societies. Oxford U. P.

<sup>29</sup> Note that public-spiritedness need not be a good thing, if the perceived public interest is objectively bad (e.g., aggressive militarism) in some sense.

<sup>30</sup> Abandoning the individualism assumption, Timothy Feddersen and Alvaro Sandroni develop an economic model in which “Participation in large democratic elections is influenced by voters’ sense of civic duty. ... [This] predicts variations in expected turnout and marginal of victory as a function of costs to vote, levels of disagreement within the electorate, importance of the election, and agents’ incentive to do their part.” (A Theory of Participation in Elections, American Economic Review 96(4) Sept. 2006, p. 1281.) I can see no way in which these intuitive conclusions require formal mathematical modeling.

<sup>31</sup> The political philosopher Jean-Jacques Rousseau suggested that these were the two human main motives in his 1754 Discourse on the Origin of Inequality. See <http://www.constitution.org/jjr/ineq.htm>. “There is another principle which has escaped Hobbes; which, having been bestowed on mankind, to moderate, on certain occasions, the impetuosity of egoism, or, before its birth, the desire of self-preservation, tempers the ardor with which he pursues his own welfare, by an innate repugnance at seeing a fellow-creature suffer. ... I am speaking of compassion, which is a disposition suitable to creatures so weak and subject to so many evils as we certainly are: by so much the more universal and useful to mankind, as it comes before any kind of reflection; and at the same time so natural, that the very brutes themselves sometimes give evident proofs of it. Not to mention the tenderness of mothers for their offspring and the perils they encounter to save them from danger, it is well known that horses show a reluctance to trample on living bodies. One animal never passes by the dead body of another of its species: there are even some which give their fellows a sort of burial; while the mournful lowings of the cattle when they enter the slaughter-house show the impressions made on them by the horrible spectacle which meets them.” Contrary to popular opinion, Rousseau did not see people as a “blank slate” to be written on by society.

<sup>32</sup> The concept of “individualism” seems to have used first by the English philosopher Edmund Burke in 1790. See “Types of Individualism” by Steven Lukes (2003) in The Dictionary of the History of Ideas at <http://etext.virginia.edu/cgi-local/DHI/dhi.cgi?id=dv2-66>.

<sup>33</sup> 1950. Bandwagon, Snob, and Veblen Effects in the Theory of Consumers’ Demand. Quarterly Journal of Economics. 54, pp. 183-207.

<sup>34</sup> I chose this example because there were actual shootings at the time this device was introduced to the market in 2006.

<sup>35</sup> It was \$215,000 per bottle in February 2006, according to Forbes.com.

<sup>36</sup> In any event, it is been reported in the press that rich people shop at discount outlets such as Costco and Wal-Mart just as much as the middle class does. Not only does this make it easier to afford Imperial Majesty perfume, but it is easy for the rich to afford Costco membership fees.

<sup>37</sup> See Hal R. Varian. 1999. Intermediate Microeconomics: A Modern Approach. 5<sup>th</sup> ed. W.W. Norton and Frank Cowell, 2006. Microeconomics: Principles and Analysis. Oxford U.P.

<sup>38</sup> Of course, some extrinsic rewards are more effective than others.

<sup>39</sup> Frey. 2001. Inspiring Economics: Human Motivation in Political Economy. Edward Elgar, chapter 5. See also his 1997 Not Just for the Money: An Economic Theory of Motivation. Edward Elgar.

<sup>40</sup> See Richard Titmuss. 1970. The Gift Relationship: From Human Blood to Social Policy (George Allen & Unwin). In addition, paying for blood attracts donors whose blood is of low quality, due to drugs, alcohol, or disease. This adverse selection problem is discussed in chapter X.

<sup>41</sup> Inspiring Economics, ch. 6 (with Felix Oberholzer-Gee and Reiner Eichenberger).

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<sup>42</sup> For my neighbors in southern California, “to snowball” refers to the fact that a ball made of partially-frozen water (i.e., snow) that is rolling down a hill will usually pick up most of such water and grow in size.

<sup>43</sup> These issues are discussed more in Goodwin, chapter 8 §3.

<sup>44</sup> Of course, the hierarchy is set up to discourage this kind of thinking at the lower levels. No army can operate successfully if large numbers of privates start thinking strategically. The only way they can get to think strategically is by climbing up the ranks, i.e., acting in ways rewarded by the higher-ups.

<sup>45</sup> It was unsuccessfully re-made as “Sorcerer” (1977).

<sup>46</sup> See Frederic Mishkin. 2004. The Economics of Money, Banking, and Financial Markets. 7<sup>th</sup> edition, Pearson/Addison Wesley, p. 275-6.

<sup>47</sup> 1898. Why is Economics Not an Evolutionary Science. Quarterly Journal of Economics. 12. “Leaves him intact” refers to the fact that economic events do not change his preferences or tastes. This issue was discussed above.

<sup>48</sup> The relative prevalence of ADD and the like among males may explain why they typically like shopping so much less than women do.

<sup>49</sup> 1957. Models of Man: Social and Rational. Wiley.

<sup>50</sup> This story ignores the fact that she actually *likes* to shop, which might lead her to buy the absolutely best dress available.

<sup>51</sup> Her assumption that the store is honest means that these are not bogus sales, as when a company raises prices by 11% and then cuts them by 10% and calls it a “sale.”

<sup>52</sup> Because their organizations have vast information collection and processing capability, the leaders of corporations and other large organizations are unlikely to use pure satisficing methods for strategic decision-making. However, as discussed in **chapter 6**, uncertainty about the future pushes them to follow some rules of thumb (conventions).

<sup>53</sup> 2004, Harper’s.

<sup>54</sup> quoted in Schwartz, p. 79.

<sup>55</sup> On page 16, Gwartney does mention experiments, but only those of the 1950s (that validate his own point of view).

<sup>56</sup> Kahneman, D., J.L. Knetsch and R.H. Thaler. 1990. Experimental Tests of the Endowment Effect and the Coase Theorem. The Journal of Political Economy. 98(6) Dec. pp. 1325-48. See <http://www.princeton.edu/pr/pwb/02/1021/7a.shtml>.

<sup>57</sup> See Frey’s Inspiring Economics, p. 21-2.

<sup>58</sup> 1936. The General Theory of Employment, Interest, and Money. Harcourt, Brace & World, pp. 156f.

<sup>59</sup> James Konow, 1996. A Positive Theory of Economic Fairness. Journal of Economic Behavior & Organization. 31: 13-35., page 14. Emphasis his.

<sup>60</sup> James Konow surveys this literature in his 2003 article Which Is the Fairest One of All? A Positive Analysis of Justice Theories. Journal of Economic Literature. 41(4) December pp. 1188-1239.

<sup>61</sup> Psychologist Ed Diener provides a useful summary at <http://s.psych.uiuc.edu/~ediener/faq.html>.

<sup>62</sup> “Prospering May Not Make People Happier, but It May Make Them Happier.” New York Times. October 26, 2006. <http://www.nytimes.com/2006/10/26/business/26scene.html>.

<sup>63</sup> reported in David Blanchflower and Andrew Oswald. 2005. Happiness and the Human Development Index: The Paradox of Australia. Australian Economic Review 38(3), p. 310.

<sup>64</sup> As Carol Graham notes in her survey of the literature on happiness, “Deprivation and abject poverty in particular are very bad for happiness.” See her The Economics of Happiness. Forthcoming in Steven Dur-

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lauf and Larry Blume, eds. The New Palgrave Dictionary of Economics, 2<sup>nd</sup> edition. See [www.brook.edu/views/papers/graham/2005graham\\_dict.pdf](http://www.brook.edu/views/papers/graham/2005graham_dict.pdf).)

<sup>65</sup> See Easterlin, 1974. Does Economic Growth Improve the Human Lot? In P.W. David and M.W. Reder, eds. Nations and Households in Economic Growth: Essays in Honor of Moses Abramowitz. Academic Press. Summarizing Easterlin's results, Luigino Bruni and Pier Luigi Porta say that "Within a single country, at a given moment in time, the correlation between income and happiness exists and it is robust: 'In every single survey, those in the highest status group were happier, on the average, than those in lowest status group' ... In cross-sectional data among countries, instead, the positive association wealth-happiness, although present, is neither general nor robust, and poorer countries do not always appear to be less happy than richer countries. In other words: 'if there is a positive association among countries between income and happiness it is not very clear. ... The results are ambiguous' ... But the most interesting result came from the analysis of time series at the national level: in thirty surveys over 25 years (from 1946 to 1970 in the US) per capita real income rose by more than 60%, but the proportion of people who rated themselves as 'very happy,' 'fairly happy' or 'not too happy' remained almost unmodified." (2006. Happiness and Policy. JRC/OECD Workshop Series.

<sup>66</sup> See Alois Stutzer 2004. The Role of Income Aspirations in Individual Happiness. Journal of Economic Behavior & Organization, 54(11), pp. 89-109

<sup>67</sup> 2003. Income and Happiness: Towards a Unified Theory. Economic Journal. 111 (July), 465-484. See also Layard, lecture 2 at <http://cep.lse.ac.uk/events/lectures/layard/RL040303.pdf>. Happiness: Has Social Science a Clue? (The Lionel Robbins Memorial Lectures 2002/3 March 2003 at the London School of Economics.)

<sup>68</sup> Some of these points are suggested by Robert Frank's article, cited above.

<sup>69</sup> These examples are from Robert Frank, op cit.

<sup>70</sup> Measures of Well-Being. Deutsche Bank Research, September 8, 2006, at [www.dbresearch.com/PROD/DBR\\_INTERNET\\_EN-PROD/PROD000000000202587.pdf](http://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD000000000202587.pdf)

<sup>71</sup> "The world is too much with us; late and soon, / Getting and spending, we lay waste our powers; / Little we see in Nature that is ours; / We have given our hearts away, a sordid boon!" – William Wordsworth, "The World Is Too Much with Us" (1807),

<sup>72</sup> See, for example, Juliet B. Schor. 1998. The Overspent American: Upscaling, Downshifting, and the New Consumer. Basic Books, and her 1991 The Overworked American: the Unexpected Decline of Leisure. Basic Books.

<sup>73</sup> Layard, lecture #3 See <http://cep.lse.ac.uk/events/lectures/layard/RL050303.pdf>.

<sup>74</sup> See Diener, cited above.

<sup>75</sup> This is a paraphrase of James Duesenberry. 1949. Income, Saving and the Theory of Consumer Behavior. Harvard U.P., republished in 1967, pp. 25-32. I added a more future-oriented outlook than in the original.

<sup>76</sup> In her survey of the happiness literature, Graham continues: "... after basic needs are met, other factors such as rising aspirations, relative income differences, and the security of gains become increasingly important, in addition to income."

<sup>77</sup> Campbell McConnell, 1975. Economics: Principles, Problems, and Policies. 6<sup>th</sup> ed. McGraw-Hill.

<sup>78</sup> The main theories of aggregate consumer demand do equally well when tested statistically. See Francis Green. 1979. The Consumption Function: A Study of a Failure in Positive Economics. In F. Green and P. Nove, eds. Issues in Political Economy, 33-60.

<sup>79</sup> 1957 A Theory of the Consumption Function (National Bureau of Economic Research and Princeton U.P.), p. 6.

<sup>80</sup> 1998. Empirical Tests of Status Consumption: Evidence from Women's Cosmetics. Journal of Economic Psychology. 19(1), February, Pp.107-131. See also Ori Heffetz, 2004. Conspicuous Consumption and the

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Visibility of Consumer Expenditures (unpublished ms., Cornell University) at <http://forum.johnson.cornell.edu/faculty/heffetz/>. He shows that a simple Veblen/Duesenberry-type “signaling by consuming” model can significantly play a role in explaining estimated total expenditure elasticities of demand in a cross-section of US households.

<sup>81</sup> In one Saturday Night Live skit, back when the show was funny, this scenario is portrayed: the lifters lift so much that their arms fall off.

<sup>82</sup> 1976. Social Limits to Growth. Harvard U.P. See also Frank, Robert H and Philip J. Cook. 1995. The Winner-Take-All Society: How More and More Americans Compete for Ever Fewer and Bigger Prizes, Encouraging Economic Waste, Income Inequality, and an Impoverished Cultural Life. Free Press.

<sup>83</sup> Kathleen D. McCarthy, Director of the Center for the Study of Philanthropy, reports that “Statistically, people in the lowest income brackets tend to donate as much, if not more [in terms of percentages] of their household income as people with much higher salaries, until you reach the very highest brackets where tax deductions provide significant incentives. ... [In] 1995, donors in the lowest income bracket ... [gave] 4.3% [of their income], and those in the \$10-20 thousand dollar range were giving 2.8%, as opposed to their wealthier counterparts whose giving dipped to 1.8% of household income.” <http://www.pbs.org/newshour/forum/january98/philanthropy4.html>. Arthur C. Brooks reports that “Among Americans with above-average incomes who do not give charitably, a majority say that they ‘don’t have enough money.’ Meanwhile, the working poor in America give a larger percentage of their incomes to charity than any other income group, including the middle class and rich.” See <http://www.arthurbrooks.net/statistics.html> and his 2006 book, Who Really Cares: The Surprising Truth about Compassionate Conservatism: America’s Charity Divide – Who Gives, Who Doesn’t, and Why It Matters. Basic Books.

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