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Social Capital, Corporate Social Responsibility, Economic Behaviour and Performance

Edited by **Lorenzo Sacconi and Giacomo Degli Antoni**

This book brings together an interdisciplinary group of leading experts to examine three major concepts: social capital, socially responsible behavior of economic agents and economic development. The volume studies the interplay of these issues by employing two original approaches. A micro perspective based on behavioural economic theory and game theory, focusing in particular on the relationship between social capital and corporate social responsibility (CSR) and how these support the creation of self-sustaining networks of cooperative relations. In addition to this, it provides a macro perspective on the relationship between social capital, norms of ethics and economic development.

Part I concerns new perspectives on the economic theory of institutions and explains CSR in terms of reciprocity, social preferences and conformity to social norms. Part II presents the approach to social capital and CSR based on behavioral game theory and network analysis. Part III illustrates experimental and empirical evidence concerning the economic effects of social capital and other-regarding preferences. Part IV discusses the macro approach to social capital and sustainable economic development.

This book is essential reading for all interested in social capital, corporate social responsibility, economic development and their mutual relationships as they are seen through the lens of the economic theory of institutions, behavioral economics and game theory.

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1

A Plea for Unconventional Economics

Bruno S. Frey

1. Neoclassics and unconventional economics

This chapter endeavors to convince the reader that *unconventional economics* is helpful to better understand issues concerned with social capital, corporate social responsibility and sustainable development. I hasten to add that this does *not* mean that standard neoclassical economics is superfluous and a waste of effort. Quite the contrary, neoclassics is important as a background theory into which the unorthodox elements can be introduced. Thus, the basic tenet of neoclassics, the strictly individualistic approach in which individuals seek to maximize their utility and are restricted by all sorts of economic (such as income or time) and institutional (such as the organization of industry or the governance of the state) constraints, is accepted and followed. Indeed, I presume standard neoclassics to be known by the reader both with respect to its fundamental features as well as to its specific theories and results.

I see the future of economics in approaches to the study of specific issues that deviate from what may be seen as the 'straitjacket' of orthodox economics as taught, for example, in graduate schools all over the world. I want to emphasize, that over the years many different economists have brought forth new ideas that are incompatible with standard economics, but I leave it to the respective authors to propagate them. The concrete unconventional ideas proposed here are only hinted at rather than thoroughly discussed. The goal is to provide a broad survey of what an unconventional economics might look like. I intend to present *concrete* unconventional ideas with respect to content and way of analysis. This is based on my conviction that methodological discussions normally are of no avail and have no noticeable effect on how economics proceeds in the future. The unconventional ideas presented here are the results of studies undertaken together with my co-workers. These ideas are presented because I happen to believe them to be interesting and potentially relevant.

Section 2 discusses *institutional innovations* for the organization of the public sector and of democratic institutions: flexible political units and flexible citizenship. Section 3 deals with three selected contributions from *Psychological Economics*: extrinsic and intrinsic human motivation, insights from happiness research and procedural utility. The last section concludes that unconventional economics may indeed contribute much to modern economics and should, therefore, be assigned a larger role in teaching and research.

2. Institutional innovations: Organization of the public sector and democratic institutions

There are many different areas in which new institutions can be devised with the purpose of making the public sector more efficient and responsive to the preferences of the citizens. Here, the discussion is restricted to two specific innovations. The first suggests flexibility with respect to political units, the second flexibility with respect to citizenship.

2.1. Flexible political institutions

Most politicians are convinced that the modern world requires larger political units. This has, for example, been one reason, though not the only one, for European unification. Many economists agree with this view, pointing out the existence of economies of scale. Other economists emphasize that the provision of public goods is more efficient when supply is decentralized because it allows preferences varying over the geographical space to be taken into account. Moreover, competition between political suppliers raises efficiency. These economists suggest federalism, in which the local units have taxing power and the right to allocate expenditures as they see fit.

The two proposals can only be combined by a compromise. The suggested size of a political unit is too small to fully exploit the economies of scale, and too large to fully exploit the advantages of decentralization.

The dilemma may be overcome by establishing *more flexible democratic political institutions*. They must be able to adjust to the 'geography of problems' instead of being restricted by traditional frontiers between political units. The idea of FOCJ¹ presents an alternative institution; an institution that is able to enjoy both the advantages of centralization and decentralization. FOCJ stands for 'Functional, Overlapping, and Competing Jurisdictions'.

The federal units proposed here thus have four essential characteristics:

Functional

A particular public service that benefits only a certain geographical area should be financed by the people living in that area, that is, there should

be no spillover. The various governmental units providing different functions can cater to regional differences in the populations' preferences or, more precisely, to its demands. To minimize costs, these units have to exploit economies of scale in production. As the latter may strongly differ between functions (e.g. between schools, police, hospitals, power plants and defense), there is an additional reason for uni-functional (or few-functional) governmental units of different sizes. This is the central idea of '*fiscal equivalence*', as proposed by Olson (1969) and Oates (1972). This endogeneity of the size of governmental units constitutes an essential part of FOCJ. However, fiscal equivalence theory has been little concerned with decision-making within functional units. The supply process is either left unspecified or it is assumed that the mobility of persons (and of firms, a fact rarely mentioned) automatically induces these units to cater for individual preferences.

Overlapping

FOCJ may overlap in two respects: (a) FOCJ catering to different functions may overlap; (b) two or more FOCJ catering for the same function may geographically intersect (e.g. a multitude of school FOCJ may exist in the same geographical area). An individual or a political community normally belongs to various FOCJ at the same time. FOCJ need not be physically contiguous, and they need not have a monopoly over a certain area of land. Thus, this concept completely differs from archaic nationalism with its fighting over pieces of land. It also breaks with the notion of federalist theory that units at the same level may not overlap. On the other hand, it is in this respect similar to Buchanan's (1965) '*clubs*', which may intersect.

Competing

The heads of FOCJ are induced to conform closely to their members' preferences by two mechanisms: while the individuals' and communities' possibilities to *exit* mimics market competition (Hirschman 1970), their right to *vote* establishes political competition (see Mueller 2003). It should be noted that migration is only one means of exit; often, membership in a particular FOCUS (as the singular of FOCJ is called) can be discontinued without changing one's location. Exit is not restricted to individuals or firms; as said before, political communities as a whole, or parts of them, may also exercise this option. Moreover, exit may be total or only partial. In the latter case, an individual or community only participates in a restricted set of FOCUS activities.

For FOCJ to establish competition between governments, exit should be as unrestrained as possible. In contrast, entry needs not necessarily be free. As for individuals in Buchanan-type clubs, jurisdictions and individuals may be asked to pay a price if they want to join a particular FOCUS and benefit from its public goods. The existing members of the particular FOCUS have to

democratically decide whether a new member pays an adequate entry price and is thus welcome.

Competition also needs to be furthered by political institutions, as the exit option does not suffice to induce governments to act efficiently. Citizens should elect the persons managing the FOCJ directly, and should be given the right to initiate popular referenda on specific issues. These democratic institutions are known to raise efficiency in the sense of caring well for individual preferences (for elections, see Downs 1957; Mueller 2003; for referenda Frey and Stutzer 2006).

Jurisdictions

A FOCUS is a democratic governmental unit with authority over its citizens, including the power to tax. According to the two types of overlap, two forms of membership can be distinguished: (i) The lowest political unit (normally the community is a member), and all corresponding citizens automatically become citizens of the FOCJ to which their community belongs. In that case, an individual can only exit via mobility; (ii) Individuals may choose freely whether they want to belong to a particular FOCUS, but while they are one of its citizens, they are subject to its authority. Such FOCJ may be non-voluntary in the sense that one must belong to a FOCUS providing for a certain function, for example, to a school FOCUS, and must pay the corresponding taxes (an analogy here is health insurance, which in many countries is mandatory but individuals are allowed to choose an insurance company). The citizens of such a school FOCUS may then decide that everyone must pay taxes in order to finance the particular school, irrespective of whether one has children. With respect to FOCJ providing functions with significant redistributive effects, a minimal regulation by the central government may be in order so that, for example, citizens without children cannot join 'school FOCJ', that do not, in fact, offer any schooling and have correspondingly low (or zero) taxes. In this respect, Buchanan-type clubs differ from FOCJ, because they are always voluntary while membership in a FOCUS can be obligatory.

Flexible institutions in history and today

Decentralized, overlapping political units have been an important feature of European *history*. The competition between governments in the Holy Roman Empire of German Nations, especially in today's Italy and Germany, has been intensive. Many of these governments were small. Many scholars attribute the rise of Europe to this diversity and competition of governmental units, which fostered technical, economic and artistic innovation (see, e.g. Hayek 1960; Jones 1987; Rosenberg and Birdzell 1986; Weede 1993). The unification of Italy and Germany in the nineteenth century, which has often been praised as a major advance, partially

ended the stimulating competition between governments and led to deadly struggles between nation states. Some smaller states escaped unification; Liechtenstein, Luxembourg, Monaco, San Marino and Switzerland stayed politically independent, and at the same time grew rich.

The above-mentioned governmental units were not FOCJ in the sense outlined in this contribution, but they shared the characteristic of competing for labor and capital (including artistic capital) among each other. However, history also reveals examples of jurisdictions even closer to FOCJ. The highly successful Hanse prospered from the twelfth to the sixteenth century, and comprised inter alia Lübeck, Bremen, Köln (today German), Stettin and Danzig (today Polish), Kaliningrad (today Russian), Riga, Reval and Dorpat (today parts of the Baltic republics) and Groningen and Deventer (today Dutch); furthermore, London (England), Bruges and Antwerp (today Belgian) and Novgorod (today Russian) were *Handelskontore* or associated members. It was clearly a functional governmental unit providing for trade rules and facilities and was not geographically contiguous.

There are also *contemporary examples* of institutions similar to FOCJ. In two countries, functional, overlapping and competing jurisdictions exist to some degree. They do not in all cases meet all the requirements of FOCJ specified above but they nevertheless show that democratic functional jurisdictions are viable.

Single-purpose governments, called *special districts*, play a significant role in the *American* federalist system. Their number has increased more quickly than other types of jurisdictions (Zax 1988). There are both autonomous and democratically organized as well as dependent special districts (e.g. for fire prevention, recreation and parks). Empirical research suggests that the former type is significantly more efficient (Mehay 1984). Existing jurisdictions tend to oppose the formation of special districts. In order not to threaten the monopoly power of existing municipalities, statutes in 18 states prohibit new municipalities within a specified distance of existing municipalities; in various states there is a minimum population size required and various other administrative restrictions have been introduced (see, e.g. Nelson 1990). Empirical studies reveal that these barriers tend to reduce the relative efficiency of the local administration (Deno and Mehay 1985; Di Lorenzo 1981), and tend to boost local government expenditures (Martin and Wagner 1978).

Many cantons in *Switzerland* have a structure of overlapping and competing functional jurisdictions that share many features of FOCJ. For example, in canton Zurich (with a population of 1.2 million, a size of 1700 km² and a tax revenue of CHF 2800 million) there are 171 political communes (with a tax revenue of CHF 3900 million), which in themselves are composed of three to six independently managed, democratically organized communes devoted to specific functions and raising their own taxes. Examples of such types of functional communes cannot only be found in the canton of Zurich

but also in the cantons of Glarus and Thurgau (for the latter, see Casella and Frey 1992). Cantonal bureaucracy and politicians have made various efforts to suppress this diversity of functional communes. However, most of these attempts were thwarted because the population is most satisfied with the public services provided. The example from Switzerland – which is generally considered to be a well organized and administered country – shows that a multiplicity of functional jurisdictions under democratic control is not a theorist's wishful thinking but has worked out well in reality.

2.2. Flexible citizenship

Traditionally, citizenship is a relationship between an individual and a state, in which an individual owes allegiance to that state and in turn is entitled to its protection.

Three aspects of this definition have to be noted:

- The actors involved are the citizens and the state. Today, citizenship is a unique and monopolistic relationship between an individual and a particular nation. It is strongly shaped geographically because most of the government services involved are only provided to residents, that is, citizens living within the boundaries of the respective state.
- The citizens have both rights and obligations. The rights refer to the political sphere (i.e. the citizens have the right to vote and to hold public office), to the economic sphere (i.e. the citizens have the right to become economically active as employees or employers), as well as to the social sphere (i.e. the citizens are protected against economic hardship within the welfare state).
- The relationship between an individual and the state goes well beyond an exchange of taxes for public services. Rather, the citizen 'owes allegiance' to the state. The citizens are expected to be public spirited and to exhibit civic virtue. The relationship is thus partly non-functional and relies on the intrinsic motivation (see next section) of the citizens and the community of people who share loyalty and identity. This aspect distinguishes the new type of citizenship proposed here from being purely a customer or member of an organization, as theoretically analyzed in the Economic Theory of Clubs (Buchanan 1965).

The process of globalization, which brings a decrease in communication and transportation costs, undermines the geographically based concept of citizenship for two reasons: first, with increasing mobility of individuals, a rising number of individuals are living in countries of which they are not citizens. Often, they live in a country only for a short period of time. Then they enjoy part of the rights of citizens, but do not have to carry the respective obligations. Second, the transaction costs for delivering government services to non-residents are decreasing dramatically. An example

is education, which can be increasingly supplied via the Internet to non-residents. Thus, government institutions are becoming more and more virtual (see Colander 2000).

The existing concept of citizenship can be generalized by making citizenship more flexible (see more fully Frey 2003).

Extending national citizenship

- *Temporary Citizenship.* An individual should be able to choose for a pre-determined period to become a citizen of a particular political unit, for instance because he or she is working and living in a country for a specific period of time.
- *Multiple Citizenships.* For persons simultaneously working and living in various countries, a good solution, might be to split up the citizenship into various parts. The rights going with the citizenship must be adjusted accordingly. In particular, the voting rights are to reflect the fact that a person chooses to split up citizenship among several nations. In the computer age, there is no problem whatsoever in allowing for fractional votes.
- *Partial Citizenship.* An individual might be a citizen of a political unit with respect to one particular function, while being a citizen of another political unit with respect to other functions. In referenda, the voting rights should accordingly only extend to issues referring to the respective function.

Citizenship in various types of organizations

A person may become a citizen of an organization other than the nation. The following possibilities are conceivable:

- *Levels of government.* Citizenship might refer to the national level – which is the rule – but also to a lower level, such as the region, province or commune (the latter being the case in Switzerland) or to a higher level, such as the European Union.
- *Governmental sub-organizations.* Individuals might choose to become a citizen of only part of a government, such as the diplomatic service, the military or the social security administration.
- *Quasi-governmental organizations.* There are many organizations close to the public sector in which individuals might become citizens. Universities are such an example. Indeed, the concept of the '*Universitätsbürger*' (university citizen) is well known in the German-speaking academic system. It obviously means much more than being an 'employee' of a university. Rather, it means that one is prepared to commit oneself to the academic life beyond considerations of short-term, purely personal benefits and costs.

- *Non-governmental organizations* (NGOs). Citizenship may be of organizations such as churches, clubs (e.g. the Rotary Club, the Boy Scouts or even sport clubs such as Manchester United or FC Barcelona), action groups (e.g. the World Wildlife Fund, 'Médecins sans Frontières' or the Red Cross) and functional organizations (e.g. ICANN, the 'Internet Cooperation for Assigned Names and Numbers'). Yet other organizations for which citizenship may be considered are profit-oriented firms. Citizens of firms have a special relationship, which goes beyond just being a customer or employee or stakeholder. Shareholders have the power to influence a decision according to their number of shares, while stakeholders have no formal voting right at all, but exert pressure outside of established channels, for example via the media or demonstrations. In contrast, each citizen of a firm has a vote according to generally accepted democratic principles. While these principles differ, they are not necessarily incompatible with each other. Citizenship in firm can exist quite well along with shareholder rights.

Citizenship in the broadest sense proposed here is based on voluntary contracts between the persons aspiring toward citizenship in a particular organization and the organization offering the possibility of citizenship. These contracts establish a special bond and are necessarily incomplete because it is impossible to state all the contingencies the future might hold.

An essential feature of citizenship is that an organization can expect a measure of allegiance and loyalty from its members. Citizens are prepared to abstain from exploiting all short-term advantages. 'Citizenship' means that the members have an intrinsically based motivation to support 'their' organization beyond personal calculations. This also means that citizens are prepared to cooperate in the provision of public goods, even when pure egoists would try to free ride.

3. Innovations from economics and psychology

Over the past decade or so, social psychology and economics have established increasingly close interactions. In previous times, there were certainly some economists interested in integrating theories and concepts from social psychology into their own discipline but they had no impact on the field. Only very few economists such as Duesenberry (1949), Easterlin (1974) or Scitovsky (1976) received some attention for a limited time, but their contributions did not become part of economic doctrine. The situation today is very different. Economics and Psychology – or as it is also sometimes misleadingly called Behavioral Economics – has become one of the 'hot' fields in economics and attracts scholars from the best universities. Accordingly, the state of knowledge has been surveyed various times (e.g. Frey and Benz 2007; Frey and Stutzer 2001, 2007; Mullainathan and Thaler 2000; Rabin 1998).

This section focuses on three areas – *Human Motivation and Crowding Theory* (subsection 3.1), *Subjective Well-being or Happiness* (subsection 3.2) and *Procedural Utility* (subsection 3.3). In these areas unconventional approaches have brought new insights and impulses into standard economic theory. There are certainly other fields where this could also be demonstrated, in particular behavioral anomalies or paradoxes.² But orthodox economics was not sustainedly affected by these insights after all. It seems, or that is at least what I hope, that the inputs into economics from social psychology with respect to motivation and well-being are able to have a more lasting effect.

3.1. Human motivation

Standard homo oeconomicus with extrinsic incentives

Standard economics has a generally accepted rational theory to explain human behavior. Individuals are assumed to maximize their own utility subject to a set of constraints, most importantly income. Preferences are taken to be constant. It follows that individuals react systematically to changes in relative prices. In particular, they reduce an activity (for instance the consumption of a particular good or service) when its cost (or price) rises compared to other activities, keeping other influences constant (*ceteris paribus*). Economists accordingly predict changes in behavior by observing the measurable changes in costs. Thus, for instance, when the cost of polluting the environment rises (for instance because a tax has been imposed on the exhaust of pollutants), individuals and firms are expected to emit less. They have a selfish incentive to change their behavior (in this case to switch to a car or a production process with less pollution). Econometric analyses with many different real life data have indeed demonstrated that this model of behavior applies under a wide set of conditions.

This model has successfully been extended to areas outside the economy. Economists have, for instance, made noteworthy contributions to decisions in the family, especially on marriage, the number of children, abortion and divorce (Becker et al. 1977), on drug addiction (Becker and Murphy 1988) or on religious practices (Iannaccone 1998). This ‘economic’ or ‘rational choice’ approach to the social sciences (Becker 1976; Frey 1999, 2001; Lazear 2000) has influenced other social sciences considerably, most notably political science (Public Choice), sociology and jurisprudence (Law and Economics).

One of the great advantages of this model of human behavior is that it is simple and robust and can therefore be applied to many conditions and areas of study. It provides an overarching, generally accepted theory to economics. In contrast, (social) psychology has identified a great number of detailed effects relating to human behavior. But it is, at least from the point of view of an economist, difficult to see which effect applies when, and what happens if the effects are contradictory. The absence of an overarching and generally

accepted socio-psychological theory does not help to determine which effect applies in one area but not in another one. Economists consider the use of a simple, and generally accepted, theory of human behavior a decisive advantage of their science, and it seems to me that social psychology could in this respect learn from economics.

The economic model of behavior is simple – sometimes *too* simple. Most importantly, it has been proved impossible to explain the empirical observation that individuals contribute considerably to a public good even though free riding is the rational choice (under anonymity and in one-shot situations). For instance, the expected punishment for tax evasion in most countries is so small that even risk-averse individuals should cheat much more than is actually observed (e.g. Alm et al. 1992).

Crowding theory with intrinsic and extrinsic incentives

To solve the puzzles mentioned, social psychology has proved to be of great help in the past and is likely to be so also in the future. Economists have long considered only *one* motivational force, namely *extrinsic incentives*, often – but not necessarily – in the form of monetary rewards. Social psychologists have taught us that it is useful to also consider *intrinsic motivation*. A pertinent example is tax morale. But as long as the two motivations are independent of each other, no major problem arises for economic theory. The dynamic relationship between extrinsic and intrinsic motivation in psychology, often called ‘hidden costs of rewards’ (Lepper and Greene 1978) or ‘self-determination theory’ (Deci and Ryan 2000), introduces a new element. When an external intervention strongly undermines intrinsic motivation, the relative price effect is counteracted and the outcome may be the *exact opposite* of the normal prediction by economists. This may be very relevant for economics. For instance, inducing employees to put in more effort by offering them higher compensation may backfire if the employees targeted are thereby also led to reduce their work morale, a specific kind of intrinsic motivation (see Frey and Osterloh 2002).

The systematic relationship between extrinsic and intrinsic motivation has been introduced into economics as ‘*Crowding Theory*’ (Frey 1992, 1997). It is taken into account that there may be ‘crowding out’ as well as ‘crowding in’. This import from social psychology has proved to be useful far beyond the analysis of pay for performance systems. An example is the siting of locally unwanted projects such as a nuclear plant where offering monetary compensation tends to *reduce*, rather than to increase, the willingness of the local population to accept it. Another important example is the compensation of managers geared to ‘performance’, which has led to an explosion of their incomes (Frey and Osterloh 2002, 2005). Considerable empirical evidence has been collected for many different areas (see Frey and Jegen 2001 for a survey). Such research should be of interest to social psychologists

because the applications extend to important real life situations, which have so far not been treated by them. However, such transfer of results from economics to psychology seems to be rather slow, if it takes place at all.

3.2. Happiness economics: Measuring subjective well-being

Macroeconomics, the analysis of economic variables such as production, employment or inflation, works with highly aggregate data. The skilful reduction of the multiple dimensions of these variables into a single one, by using the monetary evaluation by market prices, has allowed economists to develop empirically testable theories of economic growth and fluctuations. Aggregate income, or gross national product (GNP), has become a generally accepted measure of economic activity used by virtually everyone dealing with economic affairs. This is no small achievement and it might serve as an example to social psychology.

Since the beginning of the 1930s economists used utility as a unit to be maximized but thought that the concept was not measurable. Economic theory simply *assumed* that whatever individuals do is the result of maximizing their own utility. Following this approach, even suicide is a utility maximizing act: it is *revealed* to be superior to any other alternative because otherwise this voluntary act would not have been undertaken.

Insights from social psychology have strongly changed this view recently. Evidence has accumulated showing that not all behavior is in the individual's own best interest. But to make progress, a measure of utility independent of behavior is needed. Psychologists have convincingly demonstrated that it is indeed possible to approximate individual utility in a useful way by surveys on subjective well-being or happiness (e.g. Diener et al. 1999; Kahneman et al. 1999). This enables economics to leave the self-imposed straitjacket of solely revealed preferences and to analyze the determinants of well-being. This is of central importance for economics because it is agreed that the ultimate aim of economic activity is to promote individual happiness (Frey and Stutzer 2002a, 2002b; Frey et al. 2008).

Research on happiness has become a truly transdisciplinary endeavor. What has been aimed at in many other areas has here been achieved in a natural way serving as a shining example. Economists have, above all, learned that the use of self-reported data presents a most useful addition to the data sets prepared by statistical offices and normally used by them. They have, moreover, gained insights into how perceptions and expectations can be dealt with. An example is the rising aspiration level spurred by increasing income.

Some of the results of happiness research support the conventional economic views while others clearly contradict the standard assumption of economics. The standard assumption that the higher an individual's income is, the higher is his or her utility, but at a marginally decreasing rate, conforms to standard theory. In contrast, the fact that over time per capita

national income rises but reported subjective well-being stays about the same (Easterlin 1974) strongly *contradicts* conventional economics. Another instance refers to the evaluation of unemployment. Following the 'New Classical Macroeconomics' as well as other parts of standard economics, unemployment is voluntary. People choose to go out of employment because they find the burden of work and the wages unattractive compared to having leisure as an unemployed person and receiving unemployment compensation. In contrast to this view, but in line with much psychological evidence, happiness research has convincingly established that being unemployed causes significant stress and reduces well-being in a magnitude similar to divorce (e.g. Clark and Oswald 1994).

3.3. Procedural utility

Procedural utility means that people not only value actual outcomes, that is, the '*what*', but also the conditions and processes which lead to these outcomes, that is, the '*how*'. Procedural utility thus represents a completely different approach to human well-being than the standard approach applied in economics. The economic concept of utility as generally applied today is outcome-oriented: individual utility is seen as a result of benefits and costs associated with instrumental outcomes. In contrast, procedural utility refers to the non-instrumental pleasures and displeasures of processes.

Procedural utility is seen as an important determinant of human well-being that has to be incorporated more widely into economic theory and empirical research (see, more fully, Frey et al. 2004). So far, this has been largely neglected.

The concept

Economic analysis has focused on instrumental outcomes ever since the positivistic movement in economics in the 1930s. Without doubt, this was of paramount importance for the success of the economic approach to behavior in the social sciences. Obviously, individuals do care a lot about instrumental outcomes as reflected in the costs and benefits of available alternatives; economics has derived a powerful model of human behavior based on this insight.

Paradoxically, the positivistic movement in economics in itself did not imply such a focus on instrumental outcomes. In fact, since then economics has been deliberately vague about how human preferences are defined. In the 1930s, economists just gave up on the idea that utility could be observed directly and adopted the view that the only way to infer utility was from revealed behavior. But in principle, what individuals value could be anything. Economics is thus also potentially open to the idea that individuals enjoy procedural utility.

Procedural utility, however, presents a challenge to the concept of utility as it is *practically* used in much of economics. The existing theoretical cornerstones of economics, for instance, expected utility theory or game theory, generally define preferences over monetary payoffs. Thus, economics models as applied today often adopt a narrow view of human utility by focusing on instrumental outcomes. The notion that instrumental outcomes are not the only source of utility and not the only driving force behind behavior has become almost completely obsolete in economic analysis.³ Procedural utility, in contrast, means that there is something beyond instrumental outputs as they are captured in a traditional economic utility function. People may have preferences about *how* instrumental outcomes are generated. These preferences about processes generate procedural utility.

Building blocks

Procedural utility rests on three foundations, which deviate in important respects from the utility concept normally applied in economics:

- Procedural utility emphasizes utility as *well-being*. Utility is understood in a broad sense as pleasure and pain, positive and negative affect or life satisfaction.⁴ This reinstates the original economic idea that utility consists of everything that individuals value.
- Closely connected with this first point, procedural utility focuses on *non-instrumental* determinants of utility. It is not exclusively concerned with instrumental outcomes that are brought about by, for example, different decision-making procedures. Rather, processes and institutions under which people live and act are seen as independent sources of utility.⁵
- Procedural utility emerges because people have a *sense of self*. The concept thus incorporates a central tenet of social psychology into economics, namely that people care about how they perceive themselves as human beings and how they are perceived by others (see, e.g. Baumeister 1998 for a survey).⁶ Procedural utility exists because procedures provide important feedback information to the self. Specifically, they address innate psychological needs of self-determination differently. Psychologists have identified three such psychological needs to be paramount: autonomy, relatedness and competence. The desire for autonomy encompasses the experience to self-organize one's own actions or to be causal. The need for relatedness refers to the desire to feel connected to others in love and care, and to be treated as a respected group member within social groups. And the need for competence refers to the propensity to control the environment and experience oneself as capable and effective. Different procedures can be expected to provide different procedural goods serving these innate needs; in this respect they contribute to individual well-being irrespective of instrumental outcomes traditionally studied by economists.

Procedural utility thus can be defined as the well-being people gain from living and acting under institutionalized processes as they contribute to a positive sense of self, addressing innate needs of autonomy, relatedness and competence.

Procedural fairness as a special case

The general concept of procedural utility can be illustrated with one of the most prominent studies in the field of *procedural fairness*, which can be considered as the best investigated aspect of procedural utility (e.g. Lind and Tyler 1988). Lind et al. (1993) investigate a situation in which actual litigants are involved in an arbitration process. At the end of arbitration, the court orders an award; the parties can decide whether they want to accept this award or reject it and go to trial. Economists would typically study such a situation by considering the costs and benefits of accepting an award. Indeed, their likely predictions are borne out: award acceptance depends on instrumental outcomes like the ratio between the actual award and the amount originally demanded, or the litigants evaluation of whether the outcome was favorable or unfavorable (which can be seen as a good proxy for the expected net benefit of going to trial). But overall, the fairness of the arbitration procedure is found to be much more important for acceptance than instrumental outcomes. Litigants who judge the arbitration process as fair are much more likely to accept the court-ordered award, irrespective of instrumental outcomes. This result emerges because procedures convey important feedback information to the self, thereby affecting individuals' well-being. Procedures seen as fair are, for example, those that give individuals 'voice'. Being given a say in issues concerning oneself generates procedural utility because it addresses innate needs of self-determination such as autonomy and competence, and, because it is an important signal about one's standing in a group, it affects innate needs of relatedness.

Applications to institutions

The value of the concept of procedural utility can be illustrated by applying it to the economic analysis of institutions as undertaken by New Institutional Economics. This approach studies institutions as decision-making mechanisms that lead to different instrumental outcomes for the parties involved. The category of procedural utility, in contrast, allows one to highlight aspects disregarded by this kind of analysis, namely that institutions also directly contribute to people's well-being when they serve innate needs of autonomy, relatedness and competence. This, in turn, has potentially important implications for the design of institutions. If individuals' overall evaluation of a situation (in the sense of overall satisfaction or utility) depends on utility from instrumental outcomes as well as utility from the procedure used, one cannot just focus on instrumental outcomes

alone. An unfavorable instrumental outcome is more likely to be accepted if the procedure applied was 'good', and a favorable outcome might provide little overall satisfaction if the procedure that brought it about was 'bad'. The concept of procedural utility thus sheds new light on the study of institutions.

Sources of procedural utility

The sources of procedural utility can be classified into two broad categories:

- Procedural utility that people get from institutions as such. People have preferences about how allocating and redistributive decisions are taken. At the level of society, the most important formal systems for reaching decisions are the price system (market), democracy, hierarchy and bargaining (Dahl and Lindblom 1953). People may gain procedural utility from these institutions because they express judgments about the people involved. For example, a constitution that secures civil liberties like freedom of speech may greatly contribute to people's self-worth. In contrast, a constitution that denies offenders their political rights may be deeply disturbing to the people's sense of self, irrespective of instrumental outcomes. Institutions thus have a direct effect on individuals' well-being by addressing innate needs of autonomy, relatedness and competence.
- Procedural utility is involved with the interactions between people. People evaluate actions toward them not only by their consequences, but also by how they feel treated by other persons. Institutions shape such treatment significantly; they provide examples for people in interrelationships on how to treat each other in everyday interactions. For instance, labor law and company statutes are shaping the interaction between managers and employees. Or, the organization of the health care system is guiding the relationship between medical suppliers and patients. Institutions thus also have an indirect effect on individuals' well-being through motivation and through restrictions in the issue of how people are treated, thereby affecting their sense of self.

There is, of course, often a smooth transition between the two categories. Institutions, on the one hand, select and motivate people and guide them in how to treat their fellow workers, citizens and consumers. On the other hand, people who evaluate institutions, processes or authorities usually base their judgment on the treatment experienced by the specific people involved.

Procedural utility thus may emerge at different, and sometimes hard to distinguish, levels. Nevertheless, the multitude of sources does not mean that the concept could be applied arbitrarily. Whether procedural utility

emerges from institutions like the market mechanism, democratic decision-making or hierarchy as such, or whether it stems from procedural differences on a smaller scale, for example, from procedural differences within an organization, a political system or a legal framework, there is a common ground to all these channels of impact: individuals judge processes positively to the extent that they address innate needs of self-determination. Theoretical hypotheses can therefore be derived. With respect to procedural differences on a smaller scale, there is a clear understanding from the large literature on 'procedural fairness' or 'procedural justice' about what constitutes good procedure (e.g. Lind and Tyler 1988). As procedures on this level often involve how authority is exercised in organizations, public administrations or legal contexts, innate needs are mainly affected by relational information that procedures convey, such as assessments of impartiality, trustworthiness of superiors and authorities, the extent to which individuals feel they are treated with dignity and the extent to which individuals are given voice. When institutions on a larger scale are considered, like democracy or hierarchy, one can derive similar hypotheses. For example, democracy can be expected to have positive procedural utility effects because it enhances individuals' perception of self-determination. Hierarchy, in contrast, is likely to produce procedural disutility because it interferes with individuals' self-determination.

4. Toward an unconventional economics

This chapter has made a plea for unconventional economics. The deviations from standard neoclassical economics have been shown to be in two directions: proposing institutional innovations and introducing insights from other social sciences, in particular psychology. Flexible political units (FOCJ) and flexible citizenship have been given as examples of the first direction. Extensions of human motivations beyond extrinsic incentives, the measurement of utility in happiness research and introducing procedural utility are examples for the second direction. It must be emphasized again that these are only a few selected cases in an area in which the author has long been involved. For other instances of leaving the straitjacket of strict neoclassics, the corresponding literature has been referred to.

Despite these many interesting and relevant innovations in economics, there cannot be any doubt that conventional economics is still absolutely dominant. One reason is the introduction of homogenized doctoral programs that tend to follow the received doctrines and treat unconventional ideas lightly, and in many cases not at all. While such programs undoubtedly help to raise the average standard of what is considered 'good' or 'competent' economics, it is less helpful to bring together economics with other disciplines, and it threatens to lead to stagnation. The doctoral students accumulate an extensive capital stock of conventional neoclassical

knowledge, which they are unlikely to throw overboard later in their careers. A similar process takes place in contemporary economic research because the need to publish in refereed journals forces young (and potentially particularly innovative) scholars to play safe and to follow the conventions of the received doctrine. If they do not yield to the demands of the two to four referees – who almost by necessity agree only with the conventional neoclassical view – they find it nearly impossible to publish.

As a result of these two forces, standard economics is able to retain a dominant position. But there is a strong counterforce. Only those scholars who are coming forth with innovative ideas such as Schumpeter and Keynes in the past, or Akerlof and Sen in the present will be able to play a prominent role in future academic economics. This strategy not only requires ingenuity but also a willingness to take the risk of deviating from the crowd.

Notes

1. See, more extensively, Frey and Eichenberger (1999, 2004). A critical discussion is provided by Vanberg (2000) and Blatter and Ingram (2000). Kyriacou (2006) discusses and applies FOCJ to a topical issue, the management of ethnic conflicts.
2. The work of social psychologists, above all the article by Kahneman and Tversky (1979) and the collection of essays in Kahneman et al. (1982), for some time received considerable attention by economists, e.g. Schoemaker (1982), Machina (1987), Thaler (1991), Frey and Eichenberger (1994).
3. An exception may be the utility gained from gambling, which was already considered by Pascal (1670), and later by Marschak (1950) and by Von Neumann and Morgenstern (1944) to be incompatible with expected utility maximization. The most prominent economist, who has repeatedly argued that economic choice models should combine preferences for outcome with those for processes, is Sen (1995, 1997).
4. Kahneman has coined the term 'experienced utility' for this notion of utility, in contrast to traditional 'decision utility' (e.g. Kahneman et al. 1997).
5. Non-instrumental human motives of people who are self-aware and who self-reflect have previously entered economic analysis, for example in the form of identity (e.g. Akerlof and Kranton 2000), respect, self-esteem and pride (e.g. Khalil 1996; Köszegi 2002a, 2002b; Lea and Webley 1997), self-signaling, goal completion, mastery and meaning (e.g. Loewenstein 1999) or status (e.g. Frank 1985).
6. An alternative way of describing that individuals have a reflexive consciousness is that beliefs about oneself enter the utility function directly (e.g. Akerlof and Dickens 1982).

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