

Krieger-Boden, Christiane

**Research Report**

## New ethics for economics?

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# *Kiel* Policy Brief

## New Ethics for Economics?

Christiane Krieger-Boden

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## Introduction\*

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In autumn and winter 2011, more or less out of a sudden, the movement “Occupy Wall Street” arose and almost immediately attracted an amazing amount of public attention. Young people in New York, Baltimore, California, Madrid, Frankfurt and Zurich started bristling at a loss of decency and morals in economic processes, at growing inequality, at lacking justice regarding gains and merits, and at the destabilization of the globalized economy by unleashed financial markets. Meanwhile, the excitement surrounding the “Occupy” movement has abated largely. Still, certain renewed resentment against capitalism, in general, and against the rules assumed to guide our economic system, in particular, has risen in the public, and has echoed into the mainstream of economic science. Within the economic discipline, a hot debate on the paradigm of economic theory has unfolded. While this debate is not free of unspoken allegations and silent misunderstandings, e.g., as to what actually is the paradigm that should be debated, still it seems fair to state that the discipline is on the move, perhaps more fundamentally than ever within at least the last twenty years.

One aspect concerning both the critical public and the economic discipline is whether overstressing market rules and the associated norms in the recent past may have implied severe repercussions on the behaviour of people and thus also on economic processes. An overly simplified interpretation of market rules—as a decentralized cooperation device based on rational and purely self-interested individual behaviour—may imply to accept market outcomes as efficient solutions where everyone gains exactly to merits. It may then become easy to adopt a libertarian and tolerant attitude that at the same time exonerates from any responsibility outside own immediate concerns and rules out the whole issue of justice and morals as irrelevant. But if the baseline assumptions prove to not sustain such a happy-go-lucky attitude, then the accompanied dissociation from a more moral position may in fact disrupt the internal balance of a society and destroy the trust required for an extensive and welfare-improving cooperation. With the minds particularly of the more-fortunate being hardened against the needs of the commonweal, the misery of the less-fortunate and the challenges from global imbalances, in the end, a society may be caused to break apart.

Essential questions are hence what to expect from market outcomes based on pure market rules: Are they likely to guarantee an active opportunity for everybody to forge their own destiny (as a basic libertarian precondition) and to gain a fair amount according to their efforts? Do these rules work as supposed; are their baseline assumptions about human behaviour valid? In other words, are morals just a nice luxury to be cultivated by anybody who likes it and can afford it, whereas cooperation in societies can be organized efficiently in

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a rather mechanistic rule-driven way? Or, on the opposite, do outcomes probably simply follow a random walk rather than maximizing efficiency? To put it more strongly, can lucky individuals be said to just harvest windfall gains without much own merit, and unlucky individuals to simply stumble into poverty traps without much own fault? Are people right who complain about the injustice of these results? And are therefore morals an urgent corrective and a necessary precondition for cooperative and successful human societies?

The central terms to the issue of morals in economics are fairness and justice, both regarding the rules of the game and the result, i.e., the distribution of wealth and income. Generations of philosophers have tried to define the just way of living in an objective way, the most influential definitions for the ethics of societies and economies until up to date perhaps being the “Categorical Imperative” by Kant (1785)<sup>1</sup> and the “Justice as Fairness” approach by Rawls (1971).<sup>2</sup> It seems, however, that different approaches in the public and in the economic discipline arrive at different answers to these questions; and the consequences for morals are likely to differ, too.

The whole issue of human behaviour, cooperation and its results as well as of trust and morals has already produced a huge amount of literature. Rather than trying to systematically survey this whole literature, in the following, I will give a very condensed overview on the rationality debate and thereupon highlight just some of the complex relations between old and new normative consequences of this literature.

## The debate on rationality

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In economic theory, there is a strong controversy on the actual incentives that drive humans' decisions and form the basis for human cooperation; this controversy is essentially a debate on the rationality or irrationality of human behaviour, strongly influencing the view on the efficiency of market rules.

## The basic rational choice view

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Some scientists, usually economists in a neoclassical, libertarian and rational choice tradition, hold that an adequate institutional setting plus rule of law in many cases is likewise necessary and sufficient to put forth an interaction with mutually advantageous outcomes in business and in society. Then, self-regarding individuals, by following their own interests, arrive at efficient solutions.

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<sup>1</sup> “Act only according to that maxim whereby you can, at the same time, will that it should become a universal law” (Kant 1785).

<sup>2</sup> Rules are assumed to be just, if they are agreed upon behind the “veil of ignorance” about actual opportunities in the game, and if they allow for inequalities only as long as all individuals own guaranteed basic liberties, share fair and equal opportunities to gain in the game, and the game favours the worst-off most (Rawls 1971).

Basically, the rational choice view is a theoretical view that starts from a few axiomatic paradigms and yields theoretical models that claim to offer a fairly sensible analysis of the economic world:

- In this model world, the individuals view their surrounding objectively and are thus able to decide in their best interest, choosing the means appropriate to their ends.
- They are self-sufficient and dispose of their own free will, and they are autonomous and thus in control of what they do.
- As to the preferences of such individuals, they are self-interested only, and since their preferences are rational they maximize their welfare by ranking all alternative objects at choice transitively and choosing the most preferred.
- Rational individuals base their decisions on all information reasonably available.
- They calculate the expected utility of risky future outcomes of their decisions by weighting them consistently with the respective probabilities of occurrence, where such probabilities are drawn from past experience and where risk is usually considered by drawing on a Gaussian distribution or on some slightly more sophisticated derivatives from it.
- The ethical foundations complying with this individualistic approach imply that each individual is endowed with the same supreme intrinsic value, and that all individuals are to be treated equally regarding the maximisation of their welfare.
- Conversely, individuals are responsible for their own characteristics and actions, and cannot blame any deficient outcomes of their actions on their surroundings.

Even under these seemingly restrictive assumptions, individuals can be shown to cooperate—in the sense of interacting to produce a positive value added—, simply because such cooperation is in their best interest (folk theorem).<sup>3</sup> In fact, the undeniable libertarian charm of this market approach is to show that nobody needs to ask for the “benevolence of the butcher, the brewer, or the baker” in order to get one’s dinner (Adam Smith 1776), i.e., nobody needs to depend on other people’s humanity to enter into cooperation; instead one can count on the much more reliable basis of other people’s self-love.<sup>4</sup> Justice is served, if the basic rights on propriety ownership, free exchange, free transfer and free inheritance are guaranteed, and if everybody gains according to his marginal contributions. As long as no social externalities or other market irregularities are existent, this setting leads to a Pareto-efficient Nash equilibrium, where nobody can be made better off without making anyone else worse off. In a utilitarian sense, this is a perfectly just outcome. Morals are then not required

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<sup>3</sup> The folk theorem holds that such cooperation takes place given the following conditions are met: Agents play tit-for-tat, i.e., they first cooperate, and then subsequently replicate a counterpart’s previous action; games are required to be repeated endlessly to keep the veil of ignorance over the last action of the counterpart, and retaliation to defecting agents needs to be credible,

<sup>4</sup> Or as Manfred Krug, actor with GDR background, once put it in an interview, in Communist East Germany, he had to make friends with the plumber in order to make him repair his washbasin, whereas in Capitalist West Germany, he could simply pay the plumber—and choose his friends according to his likes.

as an individual performance, but are assumed to result as a by-product from the automatic work of the market forces, the “Invisible Hand”.

Individuals do cooperate in particular, if non-cooperation can be punished in a credible way, i.e., if there are no costs to punishment over the foregone benefits from cooperation. Under these assumptions, it is more likely to arrive at efficient Nash equilibria than otherwise. What is more, within the rational choice framework, it is also possible to analyse when and why such efficient solutions are rather *not* available, namely in the case of externalities and market irregularities, caused, e.g., by ill-behaved production technologies and utility functions, by information costs, asymmetric information and risk (calculable risk, that is, not incalculable uncertainty), by circular causation, cumulative acceleration, contagion and cascades. Any of these irregularities puts the Pareto efficiency and thus the utilitarian justice of the market results into perspective, however. In microeconomic theory, at least, irregularities and resulting market failures have been studied extensively, while they have perhaps somewhat been neglected in the context of macroeconomics and financial markets.

### Extensions upon rational choice

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In view of such irregularities, the rational choice approach has been extended in various directions, thus offering more differentiated views of the economy and society. For instance, the so-called institutional economics claim that existence, nature and strength of externalities and market irregularities depend much on the institutional setting, that is, on the specifications of constitutions and laws, of states with their tax systems and their specific infrastructure (e.g., for transport, education, health care, research, social insurance), and of further rules and conventions (North 1990). In a snapshot:

- If the institutional setting were such that there were no transaction costs, even externalities and market irregularities could be solved efficiently by bargaining among the actors involved (Coase 1960). Obviously, transaction costs do exist and externalities therefore cannot always be internalised by bargaining, but the institutional economics allow studying explicitly the settings under which the games take place.
- From there it becomes possible to suggest better rules of the game that eliminate or at least reduce market irregularities.
- Further extending on contract theory and principal-agent theory, it becomes even possible to endogenise institutional settings and to explain why better rules are often not implemented: Because self-regarding individuals take much endeavour in shaping institutions to serve their own advantage (Arrow 1963).

Also, the rational choice approach has been combined with the concept of bounded rationality according to which rational decisions take place within the specific limitations of each individual regarding available information, brain capacity, time, and capability for credible commitments (Simon 1957, Williamson 1981, Rubinstein 1998, Kahneman 2003).

With all these extensions, theory has departed considerably from the initial rather narrow rational choice approach and has come to put evermore in perspective the general efficiency and also the justice of market solutions. It describes the decision behaviour of individuals and their inclination towards cooperation much more realistically while still largely adhering to the core view of the economic agent as a (bounded) rational, self-regarding, welfare-maximising individual in a world of calculable risk.

### Reception of the rational choice view

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It should be noted that the rational choice approach in first instant was not meant to offer a complete and realistic description of human behaviour, but rather to put an argument to its extremes, where efficient cooperation can be shown to require no more than such a powerful and potentially destructive motive as pure self-interest. Still, as, e.g., Sen (2009) notes, from this origin, a surprisingly narrowed view on rational choice has become rather popular throughout large parts of the economic sciences. The mere elegance of the approach, the ease by which it can be extended to various problems even outside pure economics—also some surprising and counter-intuitive insights from opposite exercises, where good, non-selfish intentions can be shown to result in bad, even disastrous outcomes—may have undergirded this popularity. It led some scientists and some politicians to interpret and propagate the rational choice ideas as libertarian norms to society rather than as features of an analytical tool.

Accordingly, in recent decades—perhaps most ostentatiously after the collapse of the socialist experiment—, a highly rationalist and even mechanistic view of human behaviour has increasingly prevailed in the public narrative and coined policy decisions on economic reforms, breeding a small-time ideal of making money as a virtue in itself.

### The behaviouristic and psychological view

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While also approving of many of the ideas from institutional economics, contract theory, principal-agent theory, and bounded rationality, other scientists such as behavioural economists, psychologists and brain researchers adopt a completely different perspective of human cooperation in stressing its explicit social and emotional nature. They argue that cooperation first and foremost requires trust, and trust requires a set of common ethical foundations making societies sustainable and business prosper. In this view, a failing of cooperation, as for instance in the case of failing states, can be seen to be rooted in a lack of such common ethical foundations. In this view, other-regarding individuals behave cooperatively due to a preference for strong reciprocity, which is rooted in their dependence on other-persons' appreciation and judgements.

The behaviouristic and psychological approach seeks to adopt a more positive rather than axiomatic view on individuals, based on empirical results from experimental labs and from brain research. In fact, this building on experiences from lab experiments has also been a



major point of criticism to this approach, since such experiments, conducted mostly with students in a sort of playground situation, have been accused of telling nothing about the behaviour of “real” people in “real” situations (Levitt and List 2007). But the behaviouristic approach also seeks to build its perceptions of human behaviour on psychologist’s findings on the mechanisms of decision procedures, and even on brain researcher’s findings on the flows of neurons and on the forming of synapses and networks in the brain.

### Psychology of the mind

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Psychologists have substantiated how decision-making is based to a considerable degree on a largely automatically working mind machine that can be described as follows:

- In dealing with new events or ideas it is always quick at hand, comparing and checking any news with stored memories, convictions and prototypes, offering a whole shotgun of associations, intuitions, and emotions (Kahneman 2011, Gigerenzer 2007, Thaler and Sunstein 2008).
- This part of the mind eagerly and unconsciously strives for cognitive ease, for familiarity and maintenance of status quo, for easy explanations—ascribing such explanations erroneously even to random fluctuations—, for conclusive narratives, for a coherent view making sense of the world.
- Although also controlled by a more rational but slow and “lazy” part of the mind, the intuitive machine mightily rules the sensation, recognition and perception of particular events, highlights their significance, prioritizes them for cognitive processing and for memorising them, and interprets their importance. Individuals have even been shown to be unable to decide at all without emotionally coining the alternatives at stake (e.g., Damasio 2000).

On the upside, this impressive mind machine has developed amazingly fast, simple and efficient heuristics—gut-feelings or rules of thumb—to solve a situation (such as mind-reading from faces, taking guesses from availability, mindless action such as operating a car).

- Such heuristics are particularly efficient when individuals are adequately skilled and extensively trained (such as fire-fighters “intuitively knowing” from long experience when the burning house will tumble down in a minute, Kahnemann 2011).
- Such heuristics may even be superior to the sophisticated assessment of trade-offs between various alternatives at choice, particularly as far as they have been developed as part of the evolutionary process (Berg, Gigerenzer 2010).<sup>5</sup>

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<sup>5</sup> A nice example of a simple heuristic seems to have been developed during the evolutionary process: To catch something safely, e.g., a ball, the catcher needs not calculate or “intuitively know” ballistic trajectories; it suffices to always keep the ball in the same angle of the eye during its flight through the air and adjusting one’s own velocity while moving towards the direction of the ball (Gigerenzer 2007).



On the downside, however, the automatic mind machine has been found to be subject to numerous severe illusions, biases and fallacies: It tends to be susceptible to influences from

- priming (exposure to repeated stimuli),
- anchoring (exposure to completely arbitrary quantities), and
- framing (presentation of choices in different designs).

It tends to fall prey

- for underestimation of unknown information and thus for overconfidence in own judgements,
- for uncritical adoption of easily available out-of-thin-air ideas,
- for adherence to affirmative evidence and neglect of negative evidence,
- for substitution of complex problems by simple ones,
- for strong loss aversion and hindsight on lost sunk costs in evaluating future choices.

Even worse, the mind machine does so without being aware of it, and also with little scope of being educable to such fallacies.

Some of these fallacies have explicitly been considered in prospect theory (Kahneman and Tversky 1979), which in direct contrast to the rational-choice based expected utility theory states that individuals (i) value their utility not in total but as gains or losses compared to a past reference point, (ii) value losses about twice as gravely as gains of similar amount, and (iii) attach declining marginal sensitivity to increasing gains and losses.

The one specific fallacy of tenaciously and eagerly ascribing causal pattern to random fluctuations may have contributed to particularly momentous and devastating economic developments, namely by blind-minding many observers to the problem of uncertainty rather than risk in economic decision-making. Uncertainty, unlike risk, is incalculable by definition, and, as many critiques of the rational choice paradigm argue, it is at the same time much more preponderant than calculable risk, particularly so on financial markets, and particularly so in an increasingly globalized world (Mandelbrot 1963, Mandelbrot and Hudson 2004, Taleb 2007). Under uncertainty, even excellent explanations of past incident out of various explanatory determinants are silent about actual prospects for the future.<sup>6</sup> In fact, the more information is entered into the explanation of the past incident, the less reliable this may be for a forecast (Gigerenzer 2011).

### The “social synapse”

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Brain researchers and behaviourists have also found that the formation of the brain evolves in a permanent exchange with other brains via behavioural signals, the so-called “social synapse” (e.g., Cozolino 2006).

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<sup>6</sup> Just think of the turkey that has been brought up, fed and sheltered caringly by humans from his first days giving him the empirically significant impression that humans were invented particularly to his specific service—what a surprise on Thanksgiving Day (Taleb 2007)!

- This is to say that whatever humans believe, think, feel, learn and do is always closely related to what their surroundings, their peer group, believes, thinks, feels, learns and does. In lack of clear knowledge, individuals adapt their view of the world to a considerable degree to the views of others, and they tend to decide in a way complying with others. This may be seen as just another heuristic derived from the process of evolution: In a world that is difficult to grasp, with high uncertainty, where “the wild predator” could lurk anywhere, sticking to the flock and closely following each of its turns may become essential for fish, birds and humans.
- Part of the group-building process among humans is the invention and permanent mutual affirmation of a common narrative of the group and its norms (Akerlof and Shiller 2009).
- Within this process, some single individuals with an independent and forceful personality may succeed in exerting a decisive and lasting influence on the group as a whole, in whatever direction they choose—for better or for worse—, mainly by arguing in a firm and consistent habitude (Sherif 1937, Asch 1995).
- As a result of all interactions, a group-specific identity emerges (e.g., van Lange 1999, Akerlof and Kranton 2010), together with group-specific behavioural prescriptions and a group-specific sense of fairness and of reciprocity (e.g., Bolton and Ockenfels 2000, Dufwenberg and Kirchsteiger 2004, Falk and Fischbacher 2006, Fehr and Gächter 2000, Fehr and Schmidt 1999, Levine 1998, Rabin 1993).
- The eagerness which any such group identity is followed with by its members, even into destruction and death, can hardly be exaggerated, as historical experiences show (think of the Nazi movement and the German population’s approval of a “total war”, or think of the mass suicide of Jim Jones and his People’s Temple in Guyana in 1978).
- Ethical foundations in this view are not paradigmatic, they can no longer be thought of as being exogenous, but rather they become endogenous—in the form of social norms. They emerge from the process of permanent social interactions within a group by positive reinforcements of imitative as well as retaliatory behaviour, and they are sustained by various forms of empathic, cooperative and competitive behaviour.
- Group identity also influences the attitude towards other individuals: Still, each individual may bear its own intrinsic value, but matter-of-factly its benefit will be considered and valued by others according to closeness to their own group identity.
- Such group identities, as the case may be, could include a particular appreciation for altruism (cf. the warm glow effect of Andreoni 1990, or the maintenance of social image of Benabou and Tirole 2006), but, conversely, they could also include a specifically disdainful and brutal view of others, particularly of those that do not belong to the own group (think of gangs or the mafia, think of xenophobia, anti-Semitism and genocide).
- What kind of narratives and what kind of ethical foundations will make their way within a group, a nation-society or the global community of mankind may depend considerably on random-walk path-dependent evolutions—just like the movements of shoals or of bird flocks. It may vary and alter between different groups and societies as well as between different points in time (zeitgeist).

According to this behaviouristic and psychological view, individuals do cooperate not only in cases of evident self-interest. In fact, behavioural economists claim to explain cooperative versus defective behaviour in a much broader amount of cases such as, e.g., one-shot anonymous games (e.g., see the debate by Gintis 2006, Seabright 2006, and, on the opposite, Ross 2006, Binmore 2006). It is not the rational risk-weighted expected utility of choices that lies at the roots of this cooperation but rather, as another kind of heuristic, the preference of individuals for fairness, justice and strong reciprocity. Most observers assume that humans own a strong innate sense of justice (e.g., Sandel 2009, Sen 2009). This sense is not so homogenous as to result in a universal and consistent judgement across all people about what is right and wrong, since there are different views of fairness, e.g., a libertarian, utilitarian, egalitarian view (Sen 2009). Still, some popular intuitions about fairness and justice in everyday moralizing of people appear to exist, and some of these intuitions deviate considerably from the utilitarian concept of justice that rational-choice oriented economists usually assume:<sup>7</sup>

- People usually exhibit a high preference for equality, even if it is costly to them. In view of inequalities, they demand at least that everybody should have fair and equal opportunities of gaining benefits. To be judged as fair, achievements usually need to be based on own efforts, not just on an advantageous starting position, on mere chance, or on positive social externalities.
- More generally, people think it fair to always keep a balance between give and take (mental accounting), and to live up to the social norms, to what should and should not be done (Akerlof and Kranton 2010).
- People favour strong reciprocity. This includes the so-called Golden Rule: “Do as you would be done”, closely related also to the “tit-for-tat” heuristic, which is said to be empirically observable throughout various ethnicities, cultures and religions. In case of violated fairness and frustrated expectations, people react upset and strongly favour punishment of non-co-operators, even if the cost for this punishment exceeds any benefit at stake (i.e., they fall prey to the sunk-cost fallacy).
- There is a common-held view that some very basic goods must never be treated as commodities and must not be for sale, such as humans (as slaves), children (e.g., for adoption), the right to vote, citizenship or transplantable organs (Sandel 2012).
- People often tend to judge other persons’ behaviour on a deontological base rather than a utilitarian one (Haferkamp et al. 2009). This is the reason why murder is distinguished from manslaughter or even unintentional homicide, and is valued differently (Enste, Hüther 2011).
- People tend to respond strongly to case stories on losses (“identifiable victim effect”, Jenni, Loewenstein 1997); they tend to favour the status quo and a considerable amount of parochialism.

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<sup>7</sup> Haferkamp et al. (2009) have found considerable differences in the thinking of economists and economic laymen. Whereas the latter in particular look for motives, the former look for results and efficiency.

## Street Calculus



Source: <http://imageshack.us/photo/my-images/98/streetcalculusbx8.jpg/>

Taking together all these findings—that individuals decide on the basis of incomplete and even oddly biased information, that they strongly respond to peer pressure and follow some widespread popular intuitions on fairness, that they act under condition of wild uncertainty, yet with unadulterated overconfidence in their own judgements, and that they dispose of only vague intuitions on which means might be required to meet their ends—in this behaviouristic and psychological view, inefficient outcomes of cooperation under the rules of unregulated markets are much more likely to occur than in the extended rational-choice view, let alone in the narrow rational-choice view. Accordingly, within this kind of cooperation, individuals in many cases are far from being the knowing and active creators of their own success or



failure. Thus, e.g., the catapult start of a so far unknown singer into the league of pop stars may be due to some small favourable circumstances at a key stage, to a number of random coincidences that are nevertheless taken as causal, and to information cascades and peer processes expedited via cooperation of the media and the customers, while true performance of the singer may actually “be indistinguishable from dozens or hundreds equally talented whose names you’ll never hear” (Kahnemann 2011). Similar references may be drawn from the success of star athletes, star actors, and even star CEOs. Sky-rocketing payments to such individuals may thus include a considerable amount of windfall profit that comes undeserved by a respective performance. On the opposite, failing individuals can also hardly be fully blamed themselves for their misfortune. Even worse, some malevolent actors may even cater to people’s frailties and exploit those (Thaler, Sunstein 2008).

As to institutions, they are coined by ethical foundations as they themselves also coin ethical foundations. In case of deficient solutions, this requires not only searching for better institutions, but also asking for better underlying ethical foundations, and asking for the relations between both. It needs been regarded a major political issue how to impact both, and the change of narratives may play a key role in this context (Akerlof and Shiller 2009). Also, some “social engineering” may yield new institutions that take the specific frailties of humans into account. In an approach, labelled as libertarian or asymmetric paternalism (Thaler, Sunstein 2008; Camerer et al. 2003), a number of so-called “nudges” (Thaler, Sunstein 2008) have already been suggested, a major feature of these being to establish default options with opt-out opportunities rather than opt-in opportunities. Such nudges are particularly legitimized, if there does not exist any true neutral default option, i.e., if any default implies a certain value judgement.

The general upshot of the behaviouristic and psychological approach is quite straightforward and in clear opposition to that of the (pure) rational choice view: Not everybody receives what he deserves, and justice does not come as an automatic by-product of the market process. As a consequence, some kind of morals seems to be likewise unavoidable and affordable for cooperation in a successful society, and a neglect of morals, under the (false) impression that they are not required, may lead to a dysfunctional society. Also, since individuals are exposed to a lot of severe fallacies without much chance of avoiding these by their own effort they may require some sort of specific “paternalistic” shelter. Of course, insights like this stand on unsteady ground themselves since they may also be subject to group-thinking, zeitgeist drifts and various kinds of fallacies.

### What new normative landmarks to derive?

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In spite of such straightforward conclusions on the need of morals for a functional and welfare-enhancing society, the new findings from the behavioural/psychological approach are far from delivering similarly straightforward strategies for implementing this conclusion. Instead, there are lots of bits and pieces to these new theories, which do not all match so far,

and the best one can aspire to is to cut a few paths through this newly arisen normative jumble. In the following, I will first discuss the role of trust and confidence for a functional society, and why therefore some fields of economic activity are perhaps more heavily in need of ethical foundations than others; I will then have a very short look at what kind of ethical values may be at hand and discuss some (partially also problematic) consequences from a higher prevalence of moral attitudes in society and economy.

### The role of trust and confidence

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According to the behaviouristic approach, trust and confidence have a particularly favourable role to play in enhancing economic activities by undergirding human cooperation.

- In the pure rational choice approach, trust is only a rather technical term describing the acknowledgement of a stable and reliable institutional setting, a favourable assessment of future development perspectives and a positive credibility rating of potential cooperation partners.
- In a more differentiated view a deep-rooted natural mistrust of humans against strangers outside their own well-known tribe is conceded and humans are seen to be not very well-suited for the modern type of world-wide cooperation among such strangers (Seabright 2010). According to this view, trust comes from developing firm and reliable institutions such as market rules and government to override the initial mistrust, in order to make a somewhat extended cooperation happen at all.
- But the behaviouristic and psychological approach goes one step beyond, regarding trust as an emotion-based attitude based on common ethical foundations creating the confidence even faith in the fairness of institutions and in the honesty of cooperation partners. Trust, and the ethical foundations sustaining it, is thus considered a useful, even necessary precondition for cooperation.

The background to the latter view is that people seem to behave differently depending on whether they are framed by a market and competition context or a social context, as has been shown in experiments (e.g., Ariely 2008, Camerer and Fehr 2006). In a market and competition context any goods and services provided require clearly defined equivalent compensation, but under a social context and in abundance of trust, resources and favours are readily offered to others without the certitude of warranted reward (though often with vague expectation of some reward at some time), driven by some moral perceptions or ethical foundations. The “currencies” applied for exchanges in a social context include trust, intrinsic motivation, reputation, security, betrayal aversion, perspective-taking, and gratitude, at the background of personal relationships (e.g., Hong and Bohnet 2007, Singer et al. 2004). Selling such goods, by contrast, is argued to degrade and corrupt them (Sandel 2012).

Inter alia, a specific sense of professionalism could sustain trust: Where reputation is valued higher than income and wealth, producers, be it carpenters, scientists, doctors, lawyers or financial consultants, may take pride in the quality of their work, in the quality of their

products or their services to their customers. This allows them to draw non-pecuniary satisfaction out of their work, and allows their customers to directly trust in products and services, saving them huge amounts of transaction costs usually required to verify trustworthiness. Whether and how much such social currencies are treasured, may vary between different social groups and different points in time, depending on the social preferences and on the social environment from which they emerge (e.g., Bohnet and Zeckhauser 2004).

The problem is that morals and intrinsic motivation in a cooperative, social context are always in danger of being crowded out by a selfish-oriented and self-reliant market context: On the one hand, people tend to abandon voluntary unrewarded cooperative attitudes as they realise that others receive pecuniary rewards for it (e.g., Heyman and Ariely 2004, Vohs et al. 2006). On the other hand, people lose the ability for trustful cooperation in the interest of the commonweal, if they are not trained by permanent practice (Sandel 2012). Absence of trust then makes individuals defect cooperation even if it is in their own objective interest.

Thus, when the market-optimistic zeitgeist of the 1980s and 1990s induced a wave of market-oriented deregulations in many fields of economic activity this often lead to a complete turnaround of attitudes, and often without the customers taking notice. In many cases, of course, the market context is perfectly appropriate, and the deregulations yielded efficient results to the advantage of customers (think perhaps of telephone markets). But in other cases the efficiency of these turnarounds may be doubted.

- Suppliers in health care provision, for instance, seem to have become ever more tempted, perhaps even forced, to argue their patients into diagnostics or therapies that are at best needless and at worst hazardous, in the endeavour to improve the profitability of their surgeries or hospitals, but to the detriment of patients and the health insurance systems.
- Similarly, financial advisers turned to talking their clients into investments that much more served to increase the returns of their financial institutions and raising their own bonuses than to accommodate the interests of their clients. Overly risky decisions the clients took in response and the severe damage to trust and refusal of cooperation that followed the resulting inevitable disappointments are believed to be the major reasons for the recent worldwide economic crisis: Investors lost confidence in assets, creditors in debtors, employees and retirees in their future incomes, consumers in their consuming potential, banks in other banks, governments in other governments, and perhaps worst of all: citizens lost confidence in the ability of the economic system and governments to overcome the crisis. From a happy-go-lucky attitude sustained by perhaps overly optimistic pro-market narratives, public opinion plunged into a frustrated scepticism nourishing rather pessimistic narratives with some explicit anti-capitalistic resentment.

### Fields of social context versus fields of market context

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More generally, the economic activities most susceptible to social context and most vulnerable to losing it may be those that are characterised by being



- (i) particularly irregular and complex, featuring high degrees of uncertainty and asymmetric information, and being
- (ii) also essential to customers, concerning their existence, health or even life;

or in other words, it may be those activities that face severe principal-agent problems, where the well-informed expert as the agent is in conflict of interest between his own pecuniary interest and the best interest of his ill-informed but highly concerned customer as the principal. One way to solve the problem would be strengthening market forces, revising rules and institutions, tightening the probability of being caught short-changing a customer, and increasing penalties in order to reduce related benefits. But behavioural economists argue that agents are not as susceptible to such incentives as the rational-choice approach suggests, even in market-context situations, as agents do not simply go for their own pecuniary benefit but rather balance it delicately against their desire of maintaining a favourable self-perception (Mazar, Amir, Ariely 2008). In cases of principal-agent problems, the behavioural approach would therefore recommend, quite conversely, weakening market forces, dissolving the conflict of interest as far as possible and restoring social context.

The economic activities mostly concerned would perhaps include financial markets (at least those identified as being systemic, including Rating Agencies), health care, education, and many kinds of public facilities (e.g., energy and traffic networks, fire fighting, and geriatric care). Actually, all of these activity fields used to be highly administered before the 1980s/1990s, perhaps out of some traditional insight in the complexity of these fields. Yet social context may be considered useful even in broader arrays due to its transaction costs saving feature vis-à-vis rules, laws and contracts that are far from being perfect, leaving scope to circumvent or even undermine them. To exclude all imperfections would be burdensome or even impossible, and could raise the transaction costs for cooperation up to prohibitive amounts whereas trust generated by morals in a social context may offer a shortcut solution, a heuristic, for these imperfections (Roemer 2010): Ethical foundations could help filling the gap that imperfect rules inevitably leave, if individuals were made responsible—if not in a legal, at least in a moral sense—to follow the spirit of the rules rather than only the letters. By contrast, transparent economic activities are certainly best organised by competitive markets.

But if social context is so useful in many regards, what would the behaviouristic approach then suggest for restoring it, once it has been overthrown by market context? This is likely to be a difficult task. It may require re-regulation to eradicate as far as possible the problematic conflicts of interest, primarily by separating the expert's incentives from the kind of advice he is offering, that is, by paying him a fixed income and no incentive bonuses. Pay schemes could be optimized taking into account that pecuniary incentives that are too strong might destroy intrinsic motivation and might even put employees under counter-productive stress (e.g., Ariely 2010, Gibbons 1998, Prendergast 1999). By nudges, default options may be reversed (e.g., in the case of organ donations, from the default "donations are not allowed unless specifically permitted" to the default "donations are generally allowed unless specifically denied"); such default reversion may even change the view of people on certain problems, as far as defaults are understood to be the most generally accepted options. Also, it

might be useful to create some new or to reinforce some existing organisation forms such as cooperatives that are less profit-oriented, or stewardship-oriented organisations (Seagal, Lehrer 2011). Professional certificates and professional oaths might help to further strengthen professional responsibility, while unprofessional work needs to be reprimanded, and unprofessional providers need to be punished by losing reputation (Ariely 2012). This could in particular be organised by associations of professionals of the same craft, building on a set of ethical foundations.

Still, to make no mistake, even in a social context, difficult conflicts of interest could persist, as experts try to maximize their reputation instead of their pecuniary reward. Moreover, some experiments have shown that the cosy atmosphere of a particularly long-lasting and trustful social relationship between doctor and patient or between financial agent and client does, as expected, lead the patient / client to a particularly trustful cooperation, but also, unfortunately, does lead the doctor / financial agent to a more careless, flippant attitude towards enriching himself at the cost of the former (Schwartz, Lure and Ariely 2011). Consumer protection and consumer counselling provided as a public good may strengthen customers as the weaker part in asymmetric market relations. It may, however, also cause a more irresponsible behaviour of the customers.

More generally, to restore trust may also require developing new narratives alongside with the new rules, based on new or rediscovered ethical values, particularly in Western countries. A return to a broader perception of success in life may be called forth, particularly by stressing on individuals' responsibility towards communities and their reputation within these. Persuasion, particularly via the media, and education, particularly at schools, colleges and universities, could play a role in disseminating a new narrative on ethical values for the community—some demurs as to this optimistic view of persuasion will be explained in a minute, however.

### Assessment of ethical foundations

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If there are thus some fields of economic activity identified in need of ethical foundations, one might ask whether there exist different kinds of ethical foundations, where some are more and others are less apt to avoid the negative consequences of market norms and of group solidarity while preserving the positive consequences. This, however, is a question that is difficult to answer from the largely scientific, positive point of view of an economist.

To deal with actual questions of justice and fairness, however, a fully established, abstract ideal seems neither feasible nor necessary (Sen 2009). Instead, based on people's innate sense of justice, one may opt for a rather pragmatic concept of justice: People are well capable of making choices, if put in a situation with clear and limited alternatives, following a procedure of intelligent public reasoning on these alternatives, allowing for competent critical objections while avoiding any narrow-minded parochialism (Sen 2009). Actually, the procedure of continuously querying facts that appear self-evident may be method and theory in one (Sandel 2009).

Limiting the analysis thus to the positive side of the problem, it may still be possible to determine and describe some broad value orientations prevailing in human populations around the world. According to van Egmond and de Vries (2011) for instance, these can be classified into four different clusters, the roots of which may be traced back as far as to Plato, Kant, Hegel, Toynbee etc. These types of value orientations are described in a two-dimensional space reaching in one dimension from an idealistic to a materialistic disposition—that is from giving to taking, from a religious to a worldly attitude—, and in the other from a collectivistic to an individualistic disposition—that is from an outward, world orientation to an inward, self-contained orientation, from an other-regarding to a self-regarding attitude. These dimensions may combine to yield

- idealistic citizens with firm religious beliefs and vivid engagement for social and environmental problems, let's dub them "social workers" here, or
- idealistic homestead visionaries with an inclination towards art work, spirituality and asceticism, dubbed "artists", or
- sceptic hedonists with an inclination towards individual well-being, career ambitions and a tolerant live-and-let-live attitude, dubbed "merchants", or
- materialistic go-getters with a solid belief in the technical feasibility of a better world based on science- and technology-driven innovations, dubbed "engineers".

None of these value orientations, however, are good or bad in themselves, and they may peacefully coexist in a society, as long as none of them overshoots in a process of amplified radicalisation. Such overshooting, by contrast, may lead to catastrophic outcomes: It may result in religious or ideological fundamentalism, in the emergence of esoteric sects and spiritism, in fundamentalist or nationalist capitalism, or in Nazism or state communism. But the more balanced such value orientations are within a society where each of them has a fruitful role to play, the more will that society be sustainable (van Egmond and de Vries 2011). One can easily imagine the type of "merchants" to organise the market-context fields of the economy and the type of "social workers" to organise the social-context fields of the economy, while "artists" and "engineers" contribute their inspiration and knowledge, respectively. In recent years, Western countries may have grown somewhat out-of-balance favouring an overly "merchant"-oriented spirit and may profit from regaining a stronger "social worker's" spirit. Other parts of the world may be more endangered by religious-fundamentalist or nationalist imbalances.

### The two sides of solidarity

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As said above, behavioural research has substantiated that individuals tend to form groups and communities and that they tend to identify strongly and emotionally with these groups and with the belief systems, social preferences and social norms that these groups develop. Also, they tend to distinguish strongly between "us" and "them", between insiders and outsiders of the group (Sen 2006). Within the sheltered room of the group, a huge amount of

trust and solidarity is granted, accompanied by good-will action, other-regarding behaviour and strong cooperation.

- This is the positive side of group solidarity: People tend to support each other, even without immediate reward, though usually with the expectation to be supported, too, whenever required. Thereby, each member takes responsibility for each and every other member, to jointly share the risks of life. Group solidarity is characterized by an amazingly small degree of free-riding and by pervasively high contributions even by low-income members (e.g., Andreoni 2006). This kind of mutual solidarity is less granted to and less expected from individuals outside the group. Of course, each individual belongs to lots of different and overlapping groups and communities, reaching from small groups like families, groups of friends, enterprises, clubs, groups of same life styles, to larger communities like religious communities, professional communities, cities, regions and nations, communities according to similar ethnical, cultural or class origin, unions or alliances of nations, and up to the global community of humankind. The extent to which people act in solidarity within these groups and communities, to which they cooperate in producing group-specific public goods and to which they abstain from free-riding, is likely to be graduated and to depend decisively on the size of these groups, on the intensity of interpersonal relationships or the degree of anonymity, particularly, as this determines the trust in being supported oneself by the respective group. The extent of solidarity, however, also depends on specific social context and may vary between different kinds of groups and different points in time.
- On the negative side, group solidarity comes at a cost: In order to safeguard the internal coherence, groups tend to dissociate themselves from outsiders and to strongly favour insiders over outsiders (Sen 2006). This may even go as far as to jointly force an explicit dislike or even hatred of others. Dissociating behaviour may create sharp divisions among social groups such as social difference, discrimination and even racism. These social divisions, in turn, may generate severe costs to society, for socially excluded groups may develop their own group identity by various kinds of anti-social behaviour (e.g., gang violence, crime, terrorism). In extreme cases, dissociating behaviour could even set off pogroms, civil wars between population groups and wars between countries. The underlying patterns of discrimination are often remarkably persistent and unresponsive to economic and legal incentives, unless accompanied by social incentives.

Conclusions to be derived from this are: There might be an urgent need for early intervention in education policies (e.g., Heckman 2000) to provide a favourable tolerant social context. The more open-minded each particular group of a society has learned to behave, the more open-minded can all the other groups behave, too. By contrast, outsider mistrust by one group sows outsider mistrust by others. It is essential to initiate by the former virtuous circle instead of the latter vicious circle by using education and persuasion. Another concept may be to reduce anonymity and increase lucidity and familiarity: By forming smaller, less-anonymous units of communities, internal cohesion is easier to accomplish and the need to safeguard coherence by outside-oriented aggression is released. To this end, for instance, it may be useful to enhance local democracy, that is, to enhance the status and the

competences of the local level of civil society and local administration. People tend to show a higher extent of emotional identification with their local community, and more willingness to become active (Precht 2010).

### Change of attitudes and mind dictatorship

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The enormous variety of existing ethical foundations proves the plasticity of the human brain and of human attitudes to adapt to new foundations. On the side of the behavioural economics, this has raised a new enthusiasm—alongside with the new awareness of human fallacies—about a potential to change human attitudes by way of persuasion and education, to make society and economy a better and more caring place, and to direct people's minds towards responsibility for communities and the needs of the less-fortunate. Hence, the idea goes, people need not be stuck once and for all with some given problematic attitudes, e.g., racist or macho-paternalistic or overly materialistic ones, but rather these attitudes can be changed via re-inventing the group-specific common narrative, and peer groups and forceful personalities have an important role to play in such change. Indeed, such change has been observed in the past, e.g., in the case of gender relations, or in the historical move from hierarchical-authoritarian subject-societies to democratic citizen-societies.

However, mankind has also experienced numerous attempts from various directions of misusing the plasticity of attitudes in order to give birth to some kind of "New Man". Many of these attempts have failed dramatically, at least in the longer run, often leaving thousands or even millions of dead, injured, traumatized and deformed persons and devastated and exhausted societies and economies. These outcomes highlight the danger of such campaign strategies in the extreme. The failure of such strategies also indicates that the said plasticity of attitudes seems to have its limits, that not all directions of change may work, but rather there might be a certain core to human behaviour resisting any changes.

So one always needs to be aware that well-intentioned persuasion and education campaigns may overshoot into moral crusades and that some ideas of self-perceived do-gooders may run into a mind dictatorship menacing the liberties of others (Saint-Paul 2013). No objective judgement, however, is available to distinguish between those goals that are worthy of persuasion and education and those that are not, since none of all the irrational individuals, not even policymakers and their scientific consultants, is able to step outside his/her own subjective mind and context. Yet again, this is no argument to simply dismiss the whole findings and ideas of behavioural economics. Rather, the approach offers new insight on the way humans are, including all potential dangers from overshooting that cannot be avoided by closing the eyes to them.

The crucial issue therefore may be to weigh any such dangers consciously rather than taking them unconsciously. Required may be more resilient policies, and this may require to probe the necessity of any policies carefully according to solid evidence of the reason, according to appropriateness of the means, and according to the concord of the people involved.

## Ethical diversity and the ambiguous relations to globalization

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There is a further, broader issue related to this group behaviour, manifesting itself in a severe conflict of goals in the one large on-going project of humankind, globalization, a project that seems to promise the catching up of lots of many backward economies worldwide, and in the end the complete overcoming of poverty once and for all.

- On the one hand, the tremendous benefits to be reaped from globalization can hardly be overestimated as has been substantiated not only by (rational-choice based) economic theory, but also by numerous empirical research results. A globalized world exploiting the comparative advantages from the division of labour along the lines of global value chains and taking advantage of lots of scale economies is able to reach much higher production levels and thus wealth levels than otherwise. Globalization fuels competition that helps to contain the profits of the few, and that forces an innovative atmosphere, where every competitor always needs to look for new products and new market niches.

A free exchange of goods and persons also promotes the exchange of education and knowledge, which may induce further knowledge, new innovations and thus growth in many countries. Along with income, also employment increases, not the least to the advantage of some poor countries. The catching-up of India and China would hardly have been possible without globalization. Moreover, better mutual information between different parts of the world also promotes mutual recognition, compassion and aid in cases of misery and poverty in some countries, particularly in emergencies and disasters. Finally, intense economic integration via globalization is expected to reduce violent conflicts and warfare, because any aggression against another country will backfire on the own country, at least in terms of economic drawbacks.

- On the other hand globalization is more and more felt to come at costs, not only by way of the recent economic crisis with its devastating consequences, but also regarding the menaced maintenance of an own culture, of own values, of the right to self-determine own rules. The menace is (behavioural-approach based) suspected to come from the competition- and efficiency-enhancing effect of globalization: Increased competition might enforce hard decisions on countries regarding the strictness of market context, ruling out other forms of cooperation that build on social context. Anti-protectionist principle-of-origin rules may gear strongly into internal rules of a state or community and may also put working conditions under strain thereby increasing inequality tremendously.

Also, globalization in the form of increased circular migration may erode particular institutions of welfare states such as pay-as-you-go social pension schemes, for it might become increasingly difficult to define who is to be part of the underlying societal contract and who is not. It is even expected that intensified competition might impose strong pressure towards compliance on countries and communities curtailing their scope for own decisions and undermining their processes of democratic decision-making. As a consequence, the coexistence of various and multi-faceted cultures and social models might turn out to be unsustainable (Rodrik 2011, Driskill 2012).



A worldwide common canon of ethical values to dissolve this conflict of goals is certainly not to be expected in the near future, apart perhaps from the global acceptance of the well-defined human rights in the UN Charter (even such global acceptance is an ambitious goal rather than actual reality). Also, such worldwide harmonization of ethical foundations might not even be desirable, as such foundations may not necessarily always be “good” but go astray. Rather, the multiplicity of such values across the world may ensure that the world always still holds a place of refuge when the ethical foundations in one part of the world have overshot to dangerous extremes and collapsed.

Accordingly, communities such as, e.g., nation states—as the currently perhaps most extensively institutionalised and most widely accepted societal entities—should be able to establish their own canon of values and provide their own common good (e.g., the Continental-European welfare state model versus the Anglo-American liberal individualistic approach versus various authoritarian and interventionist societies). A moral competition between these values should reveal which work well and which do not. Any communities might seek to secure and stabilize the provision of their common good (for instance, social security within the welfare state) in a world of increasing mobility by strengthening mutual responsibilities between the individuals and the community. For instance, they might contain free riding on common goods as far as possible among those individuals that by voluntary decision regard themselves citizens of a given community (perhaps some people would think twice about withdrawing taxes if they would run the risk of losing their citizenship and all protection related to it). In turn, this would include continuing to define community citizenships and differentiating between citizens and non-citizens, which might run counter to the general principles of globalization.

Even beyond that, some observers argue in favour of protectionist measures to safeguard certain national “sanctuaries” that are suspected not to be competitive on international markets (Rodrik 2011). Also, it is argued that nations need to be allowed to protect their citizens against becoming losers of globalization. These arguments, too, run counter to the general principles of globalization. Questionably, they seem to re-open a re-venant debate—thought to have been settled long ago—on protection in international trade such as industrial policies, import substitution, infant industry tariffs, and the more.

## Conclusions

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The worldwide economic crisis has once again raised questions about morals in society and economy. Market outcomes based on pure market rules are no longer trusted to guarantee an active opportunity for everybody to forge their own destiny. A certain renewed resentment against capitalism, in general, and against the rules assumed to guide our economic system, in particular, has risen in the public, and has also echoed into the mainstream of economic science. Questions concerned are whether market rules work as supposed and whether their baseline assumptions on human behaviour are valid, whether market outcomes probably are



rather chance-driven than efficient and whether morals could therefore be a useful corrective to market forces. And indeed, a new line of economic thinking, the behaviouristic and psychological approach, comes up with some new results that are in clear opposition to those of the traditional, rational-choice view: Not nearly everybody receives what he deserves, and justice does not come as an automatic by-product of the market process. As a consequence, some kind of morals seems to be likewise unavoidable and affordable for cooperation in a successful society, and a neglect of morals, under the (false) impression that they are not required, may lead to a dysfunctional society.

In particular, to restore and strengthen trust after the economic crisis, more is required than just a better fine-tuning of standard policy instruments, namely the search for an ethical foundation of behaviour to unleash the forces inherent to ethical and even altruistic behaviour. But politicians and scientific experts need to become aware that they are in no superior position to objectively decide on the righteousness of any policies—as anybody else, they may be carried off by certain zeitgeist drifts and convictions. Policies to be designed under these new approaches, therefore, need to become more resilient regarding failures that originate from all the illusions, fallacies, biases and tricks of the human mind. The necessity of any policies is to be probed carefully regarding the solid evidence of the reason, regarding the appropriateness of the means, and regarding the concord of the people involved. Some cautious rules to be derived:

- Use education and persuasion but beware of letting them overshoot into moral crusades.
- Use nudges, particularly if there does not exist a truly neutral default option, but respect the liberties of dissenters.
- Safeguard some own highly esteemed values within social communities but beware of a fall-back to traditional protectionist reflexes.
- Foster solidarity behaviour within social groups but beware of overly aggressive behaviour of such social groups against outsiders.
- Support consumer protection and consumer counselling as a low-invasive intervention in favour of customers as the weakest economic agents—since everybody is a customer, this economic category comes closest to the political category of a citizen. But beware of the negative effects on people's self-responsibility.

The new findings from the behavioural/psychological approach are far from delivering straightforward strategies for implementing policy measures. Rather, there are lots of bits and pieces to these new theories, which do not all match so far, and a higher prevalence of moral attitudes in society and economy may also have severe problematic consequences.

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Editorial team: Margitta Führmann  
Helga Huss  
Prof. Dr. Henning Klodt (responsible for content, pursuant to § 6 MDStV)  
Dieter Stribny

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