

## Preference, Value, Choice, and Welfare

This book is about preferences, principally as they figure in economics. It also explores their uses in everyday language and action, how they are understood in psychology, and how they figure in philosophical reflection on action and morality. The book clarifies and for the most part defends the way in which economists invoke preferences to explain, predict, and assess behavior and outcomes. Daniel M. Hausman argues, however, that the predictions and explanations economists offer rely on theories of preference formation that are in need of further development, and he criticizes attempts to define welfare in terms of preferences and to define preferences in terms of choices or self-interest. The analysis clarifies the relations between rational choice theory and philosophical accounts of human action. The book also assembles the materials out of which models of preference formation and modification can be constructed, and it comments on how reason and emotion shape preferences.

Daniel M. Hausman is the Herbert A. Simon and Hildale Professor of Philosophy at the University of Wisconsin-Madison. He was educated at Harvard and Cambridge Universities and received his PhD in 1978 from Columbia University. His research has centered on epistemological, metaphysical, and ethical issues at the boundaries between economics and philosophy. He cofounded the Cambridge University Press journal *Economics and Philosophy* with Michael McPherson and coedited it from 1984 to 1994. He is the author of *Capital, Profits, and Prices* (1981); *The Inexact and Separate Science of Economics* (1992); *Causal Asymmetries* (1998); and *Economic Analysis, Moral Philosophy, and Public Policy* (2006, with Michael McPherson), among other titles. He has published more than 130 essays in academic journals in philosophy and economics. In 2009, Professor Hausman was elected to the American Academy of Arts and Sciences.

# Preference, Value, Choice, and Welfare

DANIEL M. HAUSMAN  
*University of Wisconsin-Madison*



Cambridge University Press  
 978-1-107-01543-2 — Preference, Value, Choice, and Welfare  
 Daniel M. Hausman  
 Frontmatter  
[More Information](#)

**CAMBRIDGE**  
 UNIVERSITY PRESS

University Printing House, Cambridge CB2 8BS, United Kingdom  
 One Liberty Plaza, 20th Floor, New York, NY 10006, USA  
 477 Williamstown Road, Port Melbourne, VIC 3207, Australia  
 314-321, 3rd Floor, Plot 3, Splendor Forum, Jasola District Centre, New Delhi - 110025, India  
 79 Anson Road, #06-04/06, Singapore 079906

Cambridge University Press is part of the University of Cambridge.  
 It furthers the University's mission by disseminating knowledge in the pursuit of  
 education, learning and research at the highest international levels of excellence.

[www.cambridge.org](http://www.cambridge.org)  
 Information on this title: [www.cambridge.org/9781107015432](http://www.cambridge.org/9781107015432)

© Daniel M. Hausman 2012

This publication is in copyright. Subject to statutory exception  
 and to the provisions of relevant collective licensing agreements,  
 no reproduction of any part may take place without the written  
 permission of Cambridge University Press.

First published 2012

*A catalogue record for this publication is available from the British Library*

*Library of Congress Cataloging in Publication data*

Hausman, Daniel M., 1947–  
 Preference, value, choice, and welfare / Daniel M. Hausman.  
 p. cm.

Includes bibliographical references and index.

ISBN 978-1-107-01543-2 (hardback) – ISBN 978-1-107-69512-2 (paperback)

1. Consumers' preferences. 2. Preferences (Philosophy) 3. Value.  
 4. Rational choice theory. I. Title.

HF5415.32.H38 2012  
 658.8'343–dc23 2011030303

ISBN 978-1-107-01543-2 Hardback  
 ISBN 978-1-107-69512-2 Paperback

Cambridge University Press has no responsibility for the persistence or  
 accuracy of URLs for external or third-party internet websites referred to in  
 this publication, and does not guarantee that any content on such websites is,  
 or will remain, accurate or appropriate.

## Contents

<i>List of Figures</i>	<i>page</i> viii
<i>Preface</i>	ix
1. Preferences, Comparative Evaluations, and Reasons	1
1.1. What are preferences?	1
1.2. Overall and total comparative evaluations	3
1.3. Preferences, reasons, and folk psychology	4
1.4. Misconceptions concerning preferences	7
1.5. Conclusions	8
PART I: PREFERENCES IN POSITIVE ECONOMICS	11
2. Preference Axioms and Their Implications	13
2.1. The axioms of ordinal utility theory	13
2.2. Implications of the axioms for the understanding of preferences	17
2.3. Rationality and preferences	19
2.4. Preferences and self-interest	20
3. Revealed-Preference Theory	23
3.1. Actual revealed preferences and the revelation theorem	25
3.2. Critique of actual revealed-preference theory	27
3.3. Why not redefine preferences in terms of choice?	28
3.4. Hypothetical revealed preferences	31
3.5. Belief-dependent revealed preferences	33
3.6. Conclusions	33
4. Preferences, Decision Theory, and Consequentialism	34
4.1. Total subjective comparative evaluations	34
4.2. Using preferences to predict and explain choices: The standard model	36
4.3. Expected-utility theory	37

4.4. What does expected-utility theory accomplish?	40
4.5. Consequentialism and standard choice theory	42
4.6. Attributes and preferences	45
4.7. Conclusions	47
5. Game Theory and Consequentialism	49
5.1. Games and outcomes	49
5.2. Consequentialism in game theory	52
5.3. The default principle	52
5.4. Conclusions: The consequences of consequentialism	55
6. Constraints and Counterpreferential Choice	57
6.1. Sympathy and commitment	57
6.2. Commitment and counterpreferential choice	59
6.3. Constraints and counterpreferential choice	60
6.4. Many concepts of preference or just one?	62
6.5. Game theory and counterpreferential choice	65
6.6. Commitments and intentions	71
6.7. Conclusions	72
PART II: PREFERENCES, WELFARE, AND NORMATIVE ECONOMICS	
7. Preference Satisfaction and Welfare	77
7.1. Welfare and preferences	78
7.2. Why welfare is not preference satisfaction	81
7.3. Welfare and laundered preferences: The approximation rationale	83
7.4. Why the approximation view fails	84
7.5. Conclusions	87
8. Preferences in Welfare Economics	88
8.1. Preferences and welfare: An evidential view	88
8.2. The evidential view and the scope of cost-benefit analysis	93
8.3. Preference distortions and paternalism	100
8.4. Conclusions	102
PART III: PSYCHOLOGY, RATIONAL EVALUATION, AND PREFERENCE FORMATION	
9. The Psychology of Choice	107
9.1. Loss aversion, framing, and the endowment effect	108
9.2. Reversals, variance, and adaptation	110
9.3. Belief-desire psychology	112
9.4. Explaining and predicting preferences and choices	114
10. Constructing Preferences	117
10.1. How people evaluate alternatives	118
10.2. How people ought to evaluate alternatives	120
10.3. An example: Health-state values	120

	<i>Contents</i>	vii
10.4. Emotions and rational evaluation		124
10.5. Hume's challenge		126
10.6. Coherence		129
10.7. Conclusion: Theories of preference formation		130
11. Conclusions		133
<i>References</i>		139
<i>Index</i>		149

## Figures

P.1. Philosophers and social scientists	<i>page</i> x
P.2. Preference and welfare	xi
1.1. Promising and preferring	4
1.2. Reasons and causes	7
2.1. Ordinal utility	15
3.1. Darcy proposes	30
3.2. Games and hypothetical choice	32
4.1. The standard model of choice	37
4.2. Linear preferences	38
4.3. Means-end reasoning	40
5.1. A game form	50
5.2. A game with this form	50
5.3. Another game with this form	53
6.1. A prisoner's dilemma game form	66
6.2. A prisoner's dilemma game	66
6.3. A prisoner's dilemma with social norms	70
8.1. The evidential view	89
8.2. Net benefit	94
9.1. Loss aversion	108
9.2. The standard model vs. belief-desire psychology	113

## Preface

When my son, Joshua, was three years old, he reflected on what he would like to be when he grew up. He thought maybe he would be an “aphosopher,” or perhaps he would drive a gravel truck, or maybe he would “ride horses and shoot animals.” Out of all the adult careers he knew, he was trying to figure out which he preferred. He has since considered other alternatives, and he is not a philosopher nor a truck driver nor a killer cowboy.

This book is about preferences, principally as they are and ought to be understood in economics, but also as they figure in everyday language and action, as they are understood in psychology, and as they figure in philosophical reflection on action and morality. It clarifies and assesses one concept of preferences and its role in explaining, predicting, and evaluating behavior and states of affairs, particularly in economics. Its assessment of what economists do – that is, of the ways in which they invoke preferences to explain, predict, and evaluate actions, institutions, and outcomes – is largely positive. Its assessment of what economists say about what they do is less favorable, and it criticizes some misconceptions that distort the interpretations economists have offered of their practice. Along the way it articulates some of the relations between the version of rational choice theory that economists employ and accounts of human action discussed by philosophers. This book also assembles the materials out of which models of preference formation and modification can be constructed, and it comments on how reason and emotion shape preferences.

This is not an empirical study of what people prefer, what causes people to prefer what they do, or what consequences particular preferences may have. Rather than studying what people do and why they do it, I shall be looking over the shoulders of those, such as economists and psychologists, who undertake such studies. While looking over their shoulders, I will unavoidably be looking at what they look at, but my focus is on how they see things – particularly on the way in which concepts of preference enter and should enter into their vision. The following cartoon may make what I mean clearer (Figure P.1).

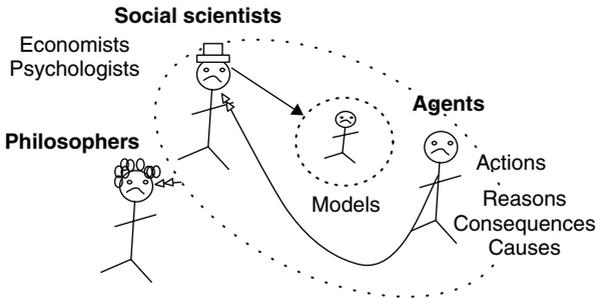


Figure P.1. Philosophers and social scientists.

In this overly simple little picture, social scientists, such as economists and psychologists, study agents, their actions, and the reasons, causes, and consequences of their actions. In studying agents, social scientists construct models. In those models, especially within economics, preferences do a great deal of work. Philosophers of the social sciences study how social scientists study agents. This book is an essay in the philosophy of the social sciences, devoted to exploring the interpretation of preferences and the role that preferences play in the understanding of action and in the appraisal of outcomes.

Preferences, like desires, play a large role in human life. People have preferences and desires about almost everything, and they incessantly express their preferences and desires in their speech and actions. Before they can talk, children reach for one toy rather than another or cry when a parent passes them into a stranger's arms. Animals also express preferences and desires, as my dog Itzhak does when he barks angrily as I prepare to leave the house.

Preferences and desires are not the same. The most important difference is that preferences, unlike desires, are *comparative*. To prefer something is always to prefer it to something else. If there are only two alternatives, one can desire both, but one cannot prefer both. Because they are comparative, preferences, unlike desires, require that one weigh alternatives. They are thus more cognitive, more like judgments, than are desires. Preferences, rather than desires, are the subject matter of this book.

A simple picture of choice and welfare, which is shown in Figure P.2, dominates mainstream economics. In this picture, the agent ranks the alternatives (represented here by different foods). Among the available alternatives, the agent chooses as far up the preference ranking as the constraints, such as prices or availability, allow. How far up the agent is able to go determines how well off the agent is. In positive economics, which explains and predicts choices and their consequences, this preference ranking governs people's choices. In normative economics, which considers which outcomes are best and what policies ought to be instituted, the objective is to move people up their preference

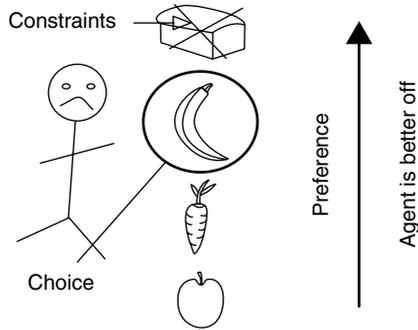


Figure P.2. Preference and welfare.

ranking. The principles of positive microeconomics are mainly generalizations concerning preferences and their implications for choice. The imperatives of normative economics specify how best to satisfy preferences. Preferences lie at the core of mainstream economic theory.

Psychologists are concerned about preferences, too, although different groups of psychologists mean different things by the term “preferences.” Psychologists who collaborate with economists or who criticize mainstream economic theories of choice use the term in the same way that economists do. Other psychologists assimilate preferences to desires and theorize about choices in terms of specific motivating factors such as drives, needs, wishes, hopes, obligations, character traits, emotions, and plans. When employing a general term for what motivates people, psychologists favor “desires” over “preferences.”

Preferences and desires also figure in philosophical theories of action, prudence, and morality. Philosophers have been especially concerned with the role of reasons in explaining actions and thus with the relationship between reasons on the one hand and beliefs, desires, preferences, intentions and so forth on the other hand. Philosophical accounts of prudence and well-being have often linked well-being to preference satisfaction, even though philosophers are more inclined to identify well-being with the satisfaction of rational and well-informed preferences than with the satisfaction of people’s actual preferences.<sup>1</sup>

This book examines a concept of great importance in everyday life, economics, psychology, and philosophy. It distinguishes the notion of preference in economics from other uses of the term, and it clarifies how, on the one

<sup>1</sup> When one turns from prudence to morality (about which this book will have little to say), there is philosophical disagreement concerning the role of desire or preference. On one interpretation of Kant, morality only begins when individuals acquire the capacity to act as they judge to be right, *despite* their preferences or desires. On Humean views, in contrast, desires determine actions, and voluntary action cannot be contrary to desire.

hand, preferences depend on beliefs, desires, emotions, intentions, reasons, and values and how, on the other hand, preferences affect choices and welfare.

Why should one care about this inquiry into preferences or, in general, about what the philosopher in the cartoon in Figure P.1 has to say? Social scientists might care if they think that the philosopher will help them accomplish their tasks. Philosophers care because they want to understand how people can learn about themselves, or because they seek theories of what makes for a good life. Those who are neither philosophers nor social scientists might be interested because (like social scientists) they want to understand the causes and consequences of their choices and the reasons why they make them. A philosophical examination of social scientific inquiry can also help people understand themselves better.

This book is structured as follows. Chapter 1 is an introduction that distinguishes the concept of preference with which the book is concerned from other meanings of the term. It also sketches one way to understand how the theory of rational choice bears on the theory of actual choice, and it identifies common misconceptions concerning preferences that are criticized in later chapters. The rest of the book is divided into three parts. Part I (Chapters 2–6) focuses on the role that preferences play in the predictions and explanations of mainstream economists. After a brief introduction to the formal theory of choice in economics, Chapter 2 criticizes two misconceptions concerning preferences: that they are matters of taste and that they can be defined in terms of self-interest. Chapter 3 criticizes a third misconception: that preferences can be defined in terms of choice.

Chapter 4 is more positive. It argues that preferences in economics are and should be *total subjective rankings* – that is, subjective comparative evaluations of alternatives in terms of all relevant considerations. In showing how economists employ this conception of preferences in their explanations and predictions, Chapter 4 lays out what I call “the standard model of choice.” Chapter 5 then shows how the standard model of choice is embodied in game theory. Chapters 4 and 5 show that – contrary to a fourth misconception – economists are and must be concerned with preference formation and modification. Chapter 6 concludes Part I by responding to objections to the standard model pressed by Amartya Sen.

Part II (Chapters 7 and 8) addresses the role of preferences in normative economics and in philosophical views of well-being. It argues against preference satisfaction theories of well-being. This criticism bodes ill for normative economics, which is apparently committed to the view that how well off one is depends upon how well satisfied one’s preferences are. But Chapter 8 defends relying on preferences as evidence concerning what benefits people.

Part III appraises the standard model of choice and argues that economists should devote more effort to modeling preference formation and modification. Chapter 9 describes empirical shortcomings psychologists and

behavioral economists have identified in the standard model of choice, and it considers their implications. The context-dependence of preferences is the central thread running through this discussion: choices depend on evaluations often made “on the fly” across multiple dimensions and with respect to a variety of criteria. Chapters 9 and 10 also discuss ways in which reasons influence preferences. Chapter 10 focuses on philosophical questions concerning how preferences ought rationally to be formed and revised. It argues that there is an unavoidable emotional element in rational preferences. Chapter 11 draws my conclusions.

This book is addressed to four audiences: economists, psychologists and other social scientists, philosophers, and interested nonacademic readers. I have kept the book short enough that material that readers do not find relevant to their particular interests will pass by quickly.<sup>2</sup>

I have been working on the issues addressed in this book for my whole academic career, and I cannot remember all the helpful criticisms and suggestions I have received. My apologies to those whose assistance I have failed to acknowledge. Those who have been of help over the past decade include especially Richard Bradley, Harry Brighouse, Paul Dolan, Phillip Ehrlich, Marc Fleurbaey, Catherine Hausman, David Hausman, Joshua Hausman, Robert Haveman, Daniel Kahneman, Charles Kalish, Catherine Kautsky, Cintia Retz Lucci, Philippe Mongin, Michael McPherson, Philip Pettit, Henry Richardson, Michael Rothschild, Russ Schafer-Landau, Andrew Schotter, Armin Schulz, Amartya Sen, Elliott Sober, Paul Thagard, Michael Titelbaum, David Weimer, Dan Wikler, James Woodward, and Erik Wright. My Romanell Lectures, delivered in February 2011, were drawn from this book, and I am indebted to the audiences for many helpful last-minute criticisms. Mikaël Cozic, Marc Fleurbaey, David Hausman, Joshua Hausman, Andrew Levine, Julian Reiss, Margaret Schabas, and Paul Thagard were kind enough to read the whole of the penultimate drafts of this book, and their criticisms have been invaluable. I am responsible for mistakes that remain.

Portions of the content of this book appear in previously published essays. Material from Chapters 1–4 appears in “Mistakes about Preferences in the Social Sciences,” *Philosophy of the Social Sciences* 41 (2011): 3–25. Chapters 2 and 6 are derived from “Sympathy, Commitment, and Preference,” *Economics and Philosophy* 21 (2005): 33–50. Chapter 3 derives from “Revealed Preference, Belief, and Game Theory,” *Economics and Philosophy* 16 (2000): 99–115, and “Mindless or Mindful Economics: A Methodological Evaluation,” which was published in Andrew Caplin and Andrew Schotter, eds. *Handbook of Economic Methodology* (Oxford University Press, 2008), pp. 125–51. Chapter 5

<sup>2</sup> For other useful general discussions of preferences, see Egonsson 2007, Fehige and Wessels 1998, Grüne-Yanoff and Hansson 2007, Hansson and Grüne-Yanoff 2006, and Lichtenstein and Slovic 2006a.

derives from “Consequentialism, and Preference Formation in Economics and Game Theory,” *Philosophy* 59 Supplement (2006): 111–29. Chapters 7 and 8 derive from “Preference Satisfaction and Welfare Economics,” *Economics and Philosophy* 25 (2009): 1–25, and *Economic Analysis, Moral Philosophy, and Public Policy* (Cambridge University Press, 2006), both of which were coauthored with Michael McPherson.