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# Markets, Power and Social Norms

Kaushik Basu

*The fundamental theorem of welfare economics, which states that, given some conditions, individual selfishness can lead to social optimality, is one of the most misused theorems in economics. Many policies are justified by citing this theorem, or rather folklore versions of it. Several technical reasons as to why the price mechanism may fail to function efficiently are well known.*

*This paper focuses on some more basic and 'social' qualifications of the fundamental theorem. First, it is argued that the popular assumption that individuals maximise utility "everywhere" is a meaningless one; and it can precipitate the Russell paradox. It is then argued that social norms play a crucial role in the functioning of markets. Finally it is shown that social norms, customs and even political power structures can be sustained in an atomistic market through a network of interpersonal conjectures and sanctions. It has been suggested that for understanding real-life economics it is necessary to bring institutions and power relations into our formal models. The method followed in the present essay may be viewed as one way of attempting this.*

## INTRODUCTION

A FUNDAMENTAL theorem in economics, which dates back to Adam Smith and has been periodically refined ever since, states:

If every individual maximises his own selfish utility, then, given certain conditions, society will automatically attain optimality.

This must be the most passionately debated, widely used and equally widely misused theorem in economics. Social scientists have been remarkably innovative in interpreting it. Ardent believers in the *laissez-faire* have never been too fussy about the proviso, "given certain conditions". Hardened interventionists notice little else but the proviso and insist that this renders the theorem totally inapplicable.

The tendency to misinterpret this fundamental proposition arises from the pervasive belief that its acceptance commits one to a specific ideological position. But this theorem, like most theorems in positive economics, is ideology free. Its acceptance does not commit us to any particular normative school. This is a direct implication of a well known law of David Hume.

The market mechanism has an important role to play not only in capitalist economies but also in socialist ones. The truth of this is especially felt in many Third World countries where the natural tendency has been to fix prices, have licences and block imports. This cannot be changed by doctrinaire arguments like "everything should be left to the market" which have been recommended and at times imposed on Third World countries in the name of the fundamental theorem of economics. In order to use the market to the advantage of society it is important to be aware of its limitations.<sup>1</sup>

For those who believe that individual rationality is invariably efficient, a drive through Delhi's Chandni Chowk area can be instructive. Overtaking from the wrong side, grazing past other vehicles, stepping on the accelerator at the sight of a zebra crossing to frighten away pedestrians, drivers here can be accused of anything but the lack

of individual rationality and enterprise. And the outcome of this naked display of self-interest is chaos. At least in this situation there is much to be gained by supplementing the 'invisible hand' of a multitude acting rationally with the visible hand of the traffic warden.

Several reasons why the price mechanism may fail to function efficiently are well known. These include the existence of externalities, non-convexities and discontinuities. In what follows I shall however focus on some more basic and 'social' qualifications of the fundamental theorem which have been overlooked in its popular statements. This is important because it is the popular folklore versions of the theorem which underlie much of our policy-debates and prescriptions.

First, the role of social norms and ethics in the market-place is discussed. It is argued that the efficacy of the free market has a prior requirement, namely, that individuals in society adhere to certain basic common norms. That is, each individual's feasible set within which he applies his selfish calculus is, to start with, curtailed by certain norms (for example, a person chooses his best career from within the set of careers which does not entail stealing). Secondly, it is shown that some social norms, customs and even power structures can be sustained in an atomistic market through a network of interpersonal conjectures and sanctions. Such conjectures can sustain desirable and undesirable institutions and thus have the ability to bolster or undermine the market. It has long been argued that for understanding real-life economics, especially that pertaining to under-developed countries, it is necessary to bring institutions and power relations into our formal models. The method that I follow in this essay may be viewed as a way of attempting this.

Some of the ideas discussed here have been formalised in the existing literature; and, given the recent advances in game theory, it seems likely that more and more of this

kind of economics will become tractable. In the present paper, however, an informal style of presentation is adopted.

## NORMS

Some time back in the *London Magazine*, Adewale Maja-Pearce (1984, p 61) recounted an incident in Lagos:

Two neighbours were having an argument. Things got out of hand and a window was smashed. Somebody called the police. They showed up half an hour later, parked the car at the bottom of the road and called the men over. They told them to start bidding. One of them reached 200. It was more than the other could match. The first man paid and went. The other was beaten so badly that it was all he could do to crawl back to his house.

These policemen's zeal for utility maximisation is clearly beyond doubt. Yet to describe their behaviour as contributing to social optimality requires a kind of stubbornness which fortunately only a few possess. Non-maximising behaviour in some domains is not only a fact but is essential for the functioning of the price mechanism<sup>2</sup> and, more generally, society. Policemen may maximise utility when they go on their week-end shopping but if they do the same on duty, as in the example above, it can be disastrous for society.

Before delving into the question of norms, I want to draw attention to a philosophical error in some popular statements concerning human rationality. In particular, the popular assertion that each individual maximises utility *everywhere* may be a meaningless one. Before asserting that an individual maximises utility, it is necessary to state clearly the domain over which the utility function is defined and the domain is not well-defined by uttering the magic word "everywhere". It is known today that it was the implicit acceptance of the existence of a universal set, i.e., a set containing *everything*, that led to the celebrated Russell paradox. Using some basic set theory it can be shown that there

is no such set which contains *everything*.<sup>3</sup>

Formal general equilibrium theory avoids this pitfall. Individual utility functions are defined on a well-specified domain, namely, the non-negative orthant of an  $n$ -dimensional Euclidean space. And the feasible sets are budget polyhedrons or the familiar budget triangles in the 2-dimensional special case. It then shows that if human beings maximise utility—meaning, they choose optimally from within their budget sets—then (given certain conditions) society attains Pareto optimality. This result would get jeopardised not only if individuals failed to maximise correctly within their feasible sets but also if they applied the maximisation calculus to choices outside their feasible set.<sup>4</sup> The reason why in a formal general equilibrium model, an agent does not steal another agent's initial endowment is simply because such an act is not in his feasible set. Whether such an act enhances his utility or not is immaterial. If in fact we expand individual feasibility sets so as to allow them to choose not only consumption bundles (i.e., points in their budget sets) but also between stealing other people's commodities and not doing so, it is not clear that Pareto optimality will still be attained. In fact my guess is that it will not, because in such a society—as in reality—a part of the labour force would have to be withdrawn from productive activity to create a police force. This is where social norms become crucial. It is a method of policing individual activities without having to maintain a police force.

What we do not always appreciate is how much of our markets depend on our adherence to some basic social norms. The scope for cheating is present in virtually all economic exchanges. This is because there exists a time-lag, however brief, between each agent performing his side of the exchange. Thus a barber first cuts hair and is then paid for his services; at a cinema, the customer pays first and then gets to see the film. In each case there is scope for default by one party. Such exchanges involve person  $i$  giving  $x$  to person  $j$ , followed by  $j$  giving  $y$  to  $i$ . The question is why does  $j$  perform his part after  $i$  has performed his? There can be two reasons. Self-interest: He may lose more in the long run because he either gets into legal difficulties or loses customers because of his reputation for default. Norms: It may be a part of his norms not to renege on contracts. Norms which make an agent perform his part of the exchange irrespective of profit considerations, once the other agent has performed his part, will be referred to as *contract-adherence norms*.

I have argued at length elsewhere (Basu, 1984) that at least a part of the smooth functioning of an economy depends on the existence of contract-adherence norms. Self-interest and policing cannot always explain why individuals do not run away without

paying after a haircut, why the bank clerk does not take your check, put the cash in his pocket, and ask you not to be silly.<sup>5</sup>

Contract-adherence norms vary across societies and also may exist for some kinds of exchanges and not for others: In Bombay taxi-drivers normally take passengers to their destination by the shortest route as is implicitly required of them. Take a taxi in Delhi and the chances are you will get to see a fair amount of the city. A visiting professor travelling from Palam Airport to Delhi University saw the Red Fort twice!

Where contract-adherence norms are weak markets function poorly and may not even exist. There is little evidence of this only because the *non*-existence of a market is not a terribly observable phenomenon. There is however a lot of evidence of ill-functioning markets. I consider here the example of rural credit markets.

The problem of contract violation is acute in rural credit markets. However, the consequence of this for the rural economy is not always properly understood. A popular theory—the lender's risk hypothesis—tries to explain the high rural interest rates observed in India and the other less-developed countries in terms of default risk. According to this hypothesis (Bottomley, 1975), default is high in backward agriculture. Hence when a moneylender gives credit, he takes a risk of losing the entire principle; and the high interest rate is merely a compensation for this risk. Once the cost of risk is deducted, the *effective* interest turns out to be quite reasonable and comparable to organised sector interest rates.

The lender's risk hypothesis has been criticised for theoretical and empirical reasons (Bhaduri, 1977; Raj, 1979; Basu, 1984a). Raj has pointed to evidence that in India the incidence of credit default is extremely small. From this it is easy to jump to the conclusion that default or contract-adherence has no effect on rural credit markets. This will be fallacious. Even though there is almost no default, the *potential risk* of default plays a fundamental role in shaping markets. The reason for the low default is not that contract-adherence norms are well-developed, but that lenders lend only to those over whom they have some control and can ensure repayment. Thus merchants lend money to regular customers at their shops and landlords generally lend money to those who work on their land. Hence when lenders actually give credit there is very little risk of default, but this is only because they lend to those over whom they have control.

This immediately means that the credit market is severely fragmented and within each fragment it may be fairly monopolistic (for empirical evidence on this see Chandavarkar, 1965). Hence, interest rates could be usurious and could vary widely within the same region as has been empirically obser-

ved (Griffin, 1974). In short, proper credit markets are virtually non-existent. There may be a severe credit shortage in one village but there would be no flow of credit from the adjacent village which has adequate liquidity.

The core of the problem lies in the absence of contract-adherence norms in the credit market. This does not mean that there is plenty of default in the rural loan market, but the effect is much more indirect. It means that one does not lend to a person over whom one has no control. This implies that competition is restricted in the credit market, which is severely fragmented and functions inefficiently.<sup>6</sup>

Individual adherence to certain kinds of socially desirable behaviour is possible, as we have seen, through policing or social norms. There is also a third method, *via* a network of social sanctions. But I shall first develop this idea in the context of power structures and customs, before commenting on norms.

#### POWER

Social customs, it is believed by many, emerge when there is a need for them. I see no compelling reason for accepting this. But whatever be the germinating cause of various customs, what is true is that customs may *persist* even though everybody would be better off without these customs. This has been demonstrated by Akerlof (1976) and this is precisely what Sen (1985, p 1) is referring to, when he writes, "The value to an individual of a particular institution when society has been organised around that institution must be distinguished from how the society—and even that person—might have fared had society been organised differently."<sup>7</sup>

Such an argument is predicated upon the existence of "triadic" relations in society—the importance of which sociologists had noted a long time ago, the classic work being that of Georg Simmel (see Simmel, 1950). Informally speaking, relations are 'triadic' when  $i$ 's relation with  $j$  depends on each of their relations with uninvolved third parties. Once we allow for triadic relations in economic interactions, a variety of real life experiences come within our ambit of analysis (Akerlof, 1984; Basu, 1986; Platteau and Abraham, 1985). With this we can show how Pareto suboptimal equilibria can get sustained even though each individual pursues his own selfish ends.

While most of traditional economics is "dyadic" (i.e., based on pair-wise interactions between human beings) there is considerable evidence of triadic interactions in reality, and as I have shown in Basu (1986), this can explain the sustenance of certain power structures and institutions. Let me illustrate this with a simple example. Suppose a country is ruled by a king whom no one likes. The king has decreed that everybody

must give him a portion of his output, which is then used by the king for his own merriment and squandering. If a citizen fails to give the king a part of his output, he is labelled 'disloyal'. A citizen may get labelled disloyal also if he maintains relations with someone who has already been labelled disloyal.<sup>8</sup> Now suppose that everybody believes that everybody else wants to be loyal to the king. Then, if being ostracised by society is sufficiently painful, everybody will give the king a portion of his output, even though there may be no direct punishment meted out by the king for failing to give. This is because each person calculates that if he does not give the king one unit, then he will be regarded as disloyal. And once that happens others will ostracise him because otherwise they themselves would get labelled disloyal and would, in turn, be ostracised. Given such beliefs everybody will religiously give the king a part of his output and they will all appear loyal thereby fulfilling (or rather not contradicting) the initial belief that everybody wants to be loyal.

Of course, there need not exist any king in the above example. There can simply be a ritual whereby you are expected to discard or burn a part of your output. Anthropologists have given many examples of such practices. The above logic can be used to explain the sustenance of such a ritual. Akerlof (1976) has used essentially this kind of argument to explain certain behaviours of caste societies, such as in India.

The above example illustrates how a group of people can be caught in a low-level equilibrium trap because of certain interpersonal conjectures. We do not notice such occurrences not because they are rare but because we live amidst them. In caste relations (Akerlof, 1976), credit relations (Platteau and Abraham, 1985) and political institutions one can find conjectures and triadic relations playing a crucial role. The Czechoslovakian dissident playwright Vaclav Havel (1985) has described how there may be dictatorships in which no one or no group plays the role of dictator. Each citizen, from fear of being labelled disloyal and being harassed, conforms to the rules of the system. Even those who harass do so because they are worried that if they do not harass the disloyal, they themselves may be labelled disloyal. So each individual through his own little rational acts helps sustain a regime which he might not actually want. Similarly people around a leader often mimic loyalty to the leader for fear that he will be ostracised by the other members of the caucus should he behave otherwise. The other members would ostracise a disloyal person for fear that otherwise they themselves will be labelled disloyal and get ostracised.

While we have considered cases where *everybody* who conforms to a custom or a political system does not like it, reality is seldom this pure. But the above argument

should be taken to demonstrate how *some* people may mimic loyalty, though they may be mingling with other individuals who actually get *direct* benefits from a custom or a political regime. In weaning people away from a social custom or certain regime, very different kinds of motivation are needed for these two types of people who are behaviourally indistinguishable. Similar observations can be made concerning international relations. Two countries which belong to the same power block and behave indistinguishably could have very different innate motivations. One may be having a direct affinity for the block to which it belongs, whereas the other may choose to belong to this group for strategic reasons, i.e., for the indirect benefits that such an association confers.

As a digression it may be pointed out that triadic relations play a very important role in international trade and economic exchanges in general; and this is what explains the intertwining of economics and politics in the international domain. To consider a simple illustration, in 1974 during the Bangladesh famine the US threatened to cut-off its grain supply to Bangladesh if it did not stop exporting jute to Cuba. For those who wish to know the end of the story, Bangladesh complied and the US continued its grain supply. Similar examples abound though the triadic nature of interactions may be implicit. In this case, fortunately for the social scientist, Bangladesh was exporting jute to Cuba and then ceased to do so. If however, anticipating such a threat, it never did export to Cuba, the triadic interaction would not be visible to us because Cuba would not enter the picture at all.

Similar problems crop up in rural relations. Triadic interactions could be sufficiently implicit to be unobservable to the occasional surveyor. The threats being well known, need never be reiterated. Nevertheless, they may play a very important role.<sup>9</sup>

So far I have discussed conjectures which are harmful, but we could equally think of self-sustaining conjectures which are beneficial for society. The most striking example of an institution sustained by a conducive conjecture is money. We accept money because we conjecture others will accept it. Others do because of similar conjectures and the conjectures become self-fulfilling. Without this conducive conjecture we would have had no medium of exchange and modern society would not have been possible. In a pure barter society people cannot imagine what they have missed out on by not having the institution of money. The realisation of this should make us appreciate that there may be other useful potential institutions which we do not have (and are unaware that we do not have) because of the absence of supporting conjectures. We do not have evidence of these for the same reason that a society of blinds would not have evidence of a world of

vision. Hence, it is possible that along with the visible sub-optimality of our society, we may have fundamental sub-optimality which are so deep that we do not realise them.

Turning to social norms, it is now easy to see that a partial policing of these can take place through interpersonal conjectures and sanctions as discussed above. Let us consider a society where individuals do not automatically adhere to certain desirable social norms but would do so if it was in their self-interest. What I am arguing is that adherence can be made to be in their self-interest in two ways by having a police force which penalises non-adherence or having others 'look down' or castigate those who do not adhere.

The method of policing can be very expensive compared to the method of sanctions. Also policing raises the everpresent question: who polices the policeman? In short, ultimately one may have to fall back on sanctions and that may be the more efficient method. Different growth propensities of countries may have something to do with the existence of suitable social norms and sanctions. For example, if hard work is admired in a society then everybody may work hard not because they like the work but because they like being admired. In fact such societies may be working to the point of having less leisure than what, as a group, they would find desirable.

The trouble with using the method of interpersonal sanctions to bolster norms which are congenial to growth is that we do not have a well-founded theory of how particular social norms come about. It is important to appreciate that in this paper I have tried to show how certain customs, institutions, political regimes or social norms *persist*. There is no explanation of why that particular custom, or that particular social norm is in existence in the first place. In other words, what has been constructed above is a theory of *persistence* of institutions and not one of the *origin* or *source*. The latter is an important question but a very difficult one, which would require an understanding of not only the social sciences but also history.

In the language of economic theory, what I have constructed is a model of multiple equilibrium, that is, a model which can explain a collection of institutions but cannot predict which one will actually occur. It gives a method of weeding out certain outcomes as not possible but cannot predict the one that actually does materialise. More importantly, it suggests a way of looking at institutions. It says that to explain a particular institution, e.g., dowry or widowhood in India, one must not simply search for who benefits by it and then claim that it is these beneficiaries who cause the institution to prevail. We cannot as yet generally explain the causes of institutions but can explain individual adherence to it.

In a subject bent on proving uniqueness properties, a solution concept which suggests multiple possibilities may seem, to be unacceptable. But I would like to argue that our search for uniqueness is overdone. To illustrate with an example, consider the Prisoner's Dilemma game played repeatedly a finite number of times. Almost all well known solution concepts, e.g. subgame perfection or rationalisability, and all standard arguments like the backward-induction one, suggest that both players will choose not to co-operate in each game. However, we know from empirical studies and introspection that players would co-operate for some time, at least in the early games.<sup>10</sup> Also, how exactly the games are played would vary depending on who the players are. This being so, it seems to me, that we should search for a solution concept which is *not* unique and allows for a certain range of outcomes. Otherwise, as the evidence suggests, we are bound to be wrong; and it is difficult to feel enthusiastic about the fact that we are 'uniquely' so. Given the sparse information structure of games and even economic theory in general it is not surprising that we are unable to predict exactly what will happen. It would indeed be surprising if we did.

#### CONCLUSION

Social and political institutions impinge on our economic relations in important ways. Perceptive economists have always been aware of this but contributions in this area have been negligible. The reason for this is that the way in which institutions enmesh with economics is extremely complex. To analyse this requires a theoretical sophistication which economics is only now beginning to acquire. This paper offers comments in the spirit of an overview for this large agenda.

The traditional model of an economy is institution-free in the sense that customs and norms play a passive role, if any.<sup>11</sup> This has been criticised by several economists and other social scientists, who have argued that institutions *can* influence the outcomes of economic models. In this paper I tried to go a step further and argued that all economic models make use of institutional assumptions. These may be explicit as in Akerlof (1976) but even when these are not explicit, as in the standard general equilibrium model, they are present (e.g. contract-adherence norms are used implicitly). The recognition of this is important, because then we could choose our institutional assumptions consciously and in conformity with reality, instead of trying to build institution-free models and ending up with ones in which the institutions are implicit and arbitrary. Bringing customs and norms within the ambit of our models would also open up newer modes of explaining economic outcomes and the varied performance of different economies.

#### Notes

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- 1 For a critical assessment of the institution of the free market from the point of view of moral philosophy, see Sen (1985) and Gibbard (1985).
- 2 See Arrow (1982) and Sen (1983).
- 3 Suppose  $U$  is the set containing everything. Define a set  $X$  as follows:  

$$X = \{x \in U \mid x \notin x\}$$
 Since  $U$  contains everything,  $x \in U$ . Now either  $x \in X$  or  $x \notin X$ . Suppose  $x \in X$ . Then from the definition of  $X$  it follows that  $x \notin X$ . If  $x \notin X$ , it follows again from the definition of  $X$  that  $x \in X$ . This contradiction establishes that  $U$  is not a set.
- 4 Thus, if it is true as *popular* neoclassical theory often claims that individuals maximise utility not only in choosing from their budget sets but even in other matters (let us assume this is a well-defined set), then we can no longer be sure of Pareto optimality because our formal theorems say nothing about this.
- 5 In game theory there have been attempts to explain co-operation in terms of self-interest by considering repeated plays of non-co-operative games. Unfortunately, though, most of the convincing cases of co-operation occur in infinitely-repeated games. The backward-induction argument seems to destroy the possibility of co-operation in a large class of finitely-repeated games, which are relevant in real life and especially in public decision-making (Basu, 1980; Schick, 1984). Some recent advances have explained co-operation in a class of finitely-repeated games but the number of repetitions needed for co-operation to occur is endogenously given and may be extremely long and also there must exist more than one Nash equilibrium in the game.
- 6 An interesting analogous problem arises in the context of North's (1984) argument that associated with different contractual arrangements are different transactions costs. He rightly asserts that these costs are likely to be very large in reality. Nevertheless, he neglects a very important indirect cost associated with transactions. This stems from the fact that if contract enforcement is too costly then the contract might not occur at all. In such a case there is no cost of enforcement. But there is, of course, a huge cost—that of the transaction not taking place.
- 7 Sen's concern in this paper is with a particular institution, the market.
- 8 For a more precise and rigorous definition of disloyalty, see Basu (1986, footnote 7).
- 9 I have discussed the role of triadic rela-

tions in rural societies in section III of Basu (1986).

- 10 For a discussion of the philosophical issues involved in the repeated Prisoner's Dilemma, see Schick (1984).
- 11 Their only possible role is to influence individual preferences. But since these are taken as given and unchanging, customs and norms end up playing a passive and uninteresting role.

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