

# WELFARE ECONOMICS AND HAPPINESS ECONOMICS

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## **Abstract**

*One of the most important and discussed issues of social welfare has many theories substantiating its validity. One of the most basic theories in social welfare, Pareto Optimality, has been explained and then critiqued. Backtracking social welfare to individual welfare and that to the basic constituent of individual welfare, the paper explores the possibility of happiness (subsequent well-being) having an important role in the development of self and the achievement of individual objectives.*

## **Welfare Economics**

Efficiency in economics would mean whether any state or situation regarding resource allocation maximizes social welfare or not. In welfare economics, attempt is made to establish criteria or norms with which to judge or evaluate alternative economic states and policies from the viewpoint of efficiency or social welfare. These criteria or norms serve as a basis for recommending economic policies which will increase social welfare. Thus, according to Prof Lange, "The norms of behavior established by welfare economics are supposed to guarantee the optimal allocation of economic resources of the society."<sup>1</sup> More specifically Prof Baumol writes, "Welfare economics has concerned itself mostly with policy issues which arise out of the allocation of resources, with the distribution of commodities among various consumers."<sup>2</sup>

The three concepts of social welfare<sup>3</sup> are-

- The first concept of social welfare is the paternalistic one which describes the views of a paternalistic authority or state and not of the individuals in a society. According to this concept, the preferences of the individual members of the society may be ignored and the state or a paternalistic authority uses its own ideas about social welfare.
- The second concept has been used by Pareto. According to the Paretian concept, social welfare is simply the function of the welfares of various individuals in a society. If some people in a society are made better off and none worse off, social welfare increases, and if some are made worse off and none better off, it decreases. But if some are made better off and some worse off, we cannot know what has happened to the welfare of the society.
- The third concept involves interpersonal comparisons of utility<sup>4</sup>, which is to be made by introducing explicit value judgements.<sup>5</sup> They believe that changes in the social welfare cannot be assessed without making interpersonal comparisons of utility. It is because this concept of social welfare is able to judge the welfare implications of even those changes in economic organization and policies that make some people better off and others worse off.

In all of the above concepts, we should remember, that the efficient resource allocation should be given paramount importance. The next question would be to objectively measure the social utility<sup>7</sup>, which will thus avoid interpersonal comparisons whose scientific nature can be challenged<sup>8</sup>. Thus Jeffrey M. Herbener, chose to establish the purpose of welfare economics so as to develop scientific analysis of social wellbeing as a justification of government policy.<sup>9</sup>

Throughout history, various attempts have been made to quantify and take into account utility without the distortion of value judgements. The following are few of the major theories made with respect to the same. **Misesian Welfare Economics**- “seeing the causal relationship between the means and the ends. In a value free manner... Socialism would destroy material prosperity, thus market economy is the mean that would suit everyone”<sup>10</sup> The value judgment here is the assumption that is made in the beginning that everyone shares the end if there is more material progress. This ethical coin may not be the case.

**Classical Welfare Economics** - “The way to create social welfare is to maximize physical output i.e. better material and consumer goods along with free trade. Not only this, there is special emphasis on monetary value of assets.” Adam Smith<sup>11,12</sup> argued that, the way to increase production is to extend the division of labour and capital accumulation. Part of the problem, he didn’t base it on subjective value and on physical production of goods.<sup>13</sup> Technological advance and capital accumulation would go against the underlying private property system, by invoking govt. policies like credit expansion, monetary inflation, under this theory, such policies would also be justified.<sup>14</sup>

**Old Welfare Economics** – Edgeworth and Pigou saw “social utility as cardinal expressions<sup>15</sup> and cumulative of individual utility...the classic public policy would be that of income redistribution<sup>16,17</sup>The problem is that it would destroy the whole market structure due to the capitalisation of the rich and subsidization of the poor leading to collapse of productivity of the society. What overthrew this view was demonstration by Pareto and Robbins that, in scientific theorizing, we cannot make interpersonal utility comparisons.<sup>18</sup>

**New Welfare Economics**<sup>19</sup> – Adopted the Pareto rule which included the literature of Pareto Optimality. Pareto rule says, if a social interaction makes a person worse off, then any judgment regarding the interaction requires an ethical rule involving interpersonal comparisons. It has to make at least one person better off and no one worse off.<sup>20</sup> The theory<sup>21</sup> includes that entrepreneur maximizes profit given prices of inputs with perfectly competitive market assumption and promotes free markets.<sup>22</sup> (Herbner, 1997)

Kaldor denied the relevance of interpersonal comparisons of utility to the problem by attributing to the classical economists a more ‘objective’ test of economic efficiency- a new arrangement is an improvement if the *losers* could be compensated by the *gainers*. Whether compensation should be paid was a political question and the economist had no special authority to pronounce it. This test or principle of hypothetical compensation was hailed by John Hicks,<sup>23</sup>(1939) a more suitable foundation for welfare economics than the utility foundation provided by Marshall.<sup>24</sup>

Mainstream welfare economics does not claim that compensation will achieve equitable outcomes, but argues that there will be enough gains for winners to compensate losers. Should the society want this?<sup>25</sup> Thus a cost – benefit analysis would consist of an enumeration and evaluation of the consequences for individuals or groups of a particular policy or investment. Lewis Froman’s classification could be used to help identify these groups (areal, segmental approach)<sup>26</sup>. Significantly, however, the outcome is expressed in terms of a

single net compensation principle whereby if the aggregate benefits exceed the aggregate costs- so gainers could compensate losers - then the policy or investment would yield a net increase in social welfare and is acceptable irrespective of the actual consequences or outcome for the individuals identified in the evaluation. Both the winners and the losers will usually be expected to pay taxes or other user charges for benefits equally and other windfall benefits are rarely recouped. (Dasgupta, 2014)

### **Pareto Optimality**

Velfredo Pareto was the first to part with the traditional approach to social welfare. He rejected the notion of cardinal utility and its additive nature and detached welfare economics from interpersonal comparisons of utilities. Pareto's concept of maximum social welfare is free of value judgment and based on ordinal utility. Pareto optimum is a position from which it is impossible to make anyone better off without making someone worse off by any re-allocation of resources and outputs (Ahuja, 2008).

The three aspects of the optimality would include:

1. Exchange efficiency
2. Production efficiency
3. Product-mix efficiency

#### **● Exchange Efficiency:**

Exchange efficiency means the distribution of a given output of goods between individuals in a society should be such that it should not be possible to make someone better off without making anyone worse off. It can thus also be referred to as 'The optimum distribution of products among the customers'. For explanation of this model, the following assumptions have been made:

- a. Each individual has his own ordinal utility function and possesses a definite amount of product and factor
- b. Production function of every firm and the state of technology is constant
- c. Goods are perfectly divisible
- d. A producer tries to produce a given output with the least-cost combination of factors
- e. Every individual wants to maximize his satisfaction
- f. Every individual purchases some quantity of all goods
- g. All factors of production are perfectly mobile.

#### **● Production efficiency**

Production is Pareto Efficient when it is not possible to reallocate resources to produce more of some goods without producing less of some other goods. First aspect of production efficiency relates to the allocation of resources within each firm while the second aspect deals with the allocation of resources among firms producing the same or different products. Allocation is efficient when all firms producing a product have the same marginal cost. Production efficiency requires that the economy must operate on the production possibility curve.<sup>29</sup> (Annexure 2)

The condition could also be reframed as –the marginal rate of substitution<sup>27</sup> between the two goods must be the same for every individual who consumes them both. It can be better explained with an Edgeworth Box Diagram. (Annexure-1) Where  $U_a^1, U_a^2, U_a^3$  are the indifference curves representing the preferences of A and  $U_b^1, U_b^2, U_b^3$  are the indifference curves representing choice bundles of B. Both consume Good X and Good Y shown in x and y axes respectively. The Contract Curve (AB) passes through the points where the indifference curves of A and B are tangential to each other. Any point outside the contract curve does not represent the equality of MRS<sup>28</sup> between the two goods for A and B. Thus every point on AB denotes maximum social welfare in the Paretian sense but we cannot say anything about the best of them.

#### ● Product –Mix Efficiency :

The product mix efficiency means that allocation of resources among the production of various goods and services is in accordance with the preference of the people. This is basically the combination of the above two efficiencies and gives the final denotation of the optimality condition. The Pareto optimality cannot be achieved in isolation in production or exchange efficiency.

To explain the optimality condition, we juxtapose the Edgeworth Box in the production possibility curve  $TT'$  between the commodities X and Y.  $TT'$  could also be called as the society production-transformation curve. Given  $O_x$  and  $O_y$  produced of Good X and Y respectively, the indifference curves are also drawn. S is the consumption efficient point where the curves are tangent to each other, slope of the tangent indicates the marginal rate of substitution of the two consumers between the two goods. Also, drawing a tangent  $gg'$  to the  $TT'$ , indicates the marginal rate of transformation between Goods X and Y<sup>30</sup>. The two consumers will attain equilibrium at S on the contract curve, if the slope of 'k' i.e. their marginal rate of substitution equals the marginal rate of transformation curve between the two goods. The higher the point of the PPC curve, the higher is the satisfaction derived. (Annexure -3)

#### Critique of the Pareto Criterion and Pareto Optimality

1. It is not completely free from value judgments. "Pareto criterion fails seriously when it comes to comparing alternatives. Whenever there is a conflict of preferences of two individuals with respect to two alternatives, the criterion fails to rank those two alternatives no matter what the preferences of the rest of individuals in the society might be." (Patnaik, 1974)
2. It leaves a considerable amount of indeterminacy in the welfare analysis since every point on the contract curve is Pareto optimal. Therefore, to choose between them, and to compare the various alternatives lying on the contract curve, interpersonal comparisons and value judgments regarding proper distribution of income needs to be made. There are infinite numbers of points which are Pareto optimal. (Quandt)
3. Quoting Amartya Sen, "A social state is described as Pareto optimal if and only if no one's utility can be raised without reducing the utility of someone else... A state can be Pareto optimal with some people in extreme misery and others rolling in luxury, so long as the miserable cannot be made better off without cutting into the luxury of the rich" (Sen, 1990) . It identifies well-being with utility and captures efficiency aspects only on utility based accounting.
4. In a developing country like India, where the disparities between the richest and the poorest are huge, such sort of optimal conditionality cannot be possibly used to measure the welfare aspect of individuals.

### **An Alternative Approach- Economics of Happiness**

While studying welfare economics, we actually study economics of social welfare. Social welfare is the sum total of individual satisfaction in a society. Thus, it is the individual that would comprise of a unit of welfare. The emotional quotient and the subsequent well-being<sup>31</sup> of an individual is thus of an extreme importance. In the present time market society, there is a little doubt that humans are treated more as a factor of production than as humans itself<sup>32</sup>. The mechanized approach to work and producing results is much like the Taylor approach to management. With the offset of the industrial revolution and the Marxist approach to a stateless society, I believe, that it is extremely important that before it is too late, we derive and understand the subtext in these theories.

Emotions play a major role in every aspect of the human nature. It is this human being, the basic micro economic unit in an economy, who is the subsequent target for all the economic and social policies. We, therefore, cannot afford to put aside the extremely delicate yet a powerful linkage that makes up this fundamental micro economics unit. It is that of the thoughts and emotions. Firstly, it is essential to clarify what constitutes thoughts and emotions. Thoughts can be thought of as the mental cognition of our ideas, beliefs of the world around us. Emotions are the flow and an experience of feelings.<sup>33</sup> A general trend is that thoughts trigger feelings which in turn form emotions.

“All we are is the result of what we have thought. The mind is everything. What we think, we become”-  
Gautam Buddha

Since there has been given an extraordinary importance to the thoughts in the mind of a person<sup>34</sup>, economics needs to exploit this fertile ‘market’ to the maximum benefit. Imagine the situation where, in an economy, all the citizens are achieving their potential. The capabilities approach, as marvelously described by Amartya Sen, I believe, could be supplemented by ‘happiness approach’.

Since, economics cannot function in isolation like any science in this world, one cannot undermine the influence of philosophy and psychology in economics. (This has, in the late times, been emphasized on by the neo-classical economists.) Even if the capabilities have been laid down in a bullet- listed chart as to-dos for an individual, the way to accomplish those objectives is what I want to focus on in this paper. Thoughts and the state of mind that would enhance the productivity and achievement of the potential of a human being are as important as the end result itself. Since, means are as important as the end, the ‘skill set’ of achievement is important to be supplemented by the subtle but nevertheless extremely important emotion behind it. The entire point is that there needs to be an inculcation of ways and means to help the most important economic unit blossom to its fullest extent.

### **Economics and Happiness**

Optimality in production and economics would be achieved when there is true welfare of the human. “The capability of a person reflects the alternative combination of a functioning of a person, and from which, he or she can choose one collection.”<sup>35</sup> Identification of set objectives plays a very important role here. As a byproduct of the objectives penned under this approach, the know-how of the technical knowledge can be added on with the supporting thought process. It would facilitate the achievements of such objectives and in a much more comprehensive way<sup>36</sup>.

Among the positive emotions, happiness is the focus in this paper. The role of happiness<sup>37</sup> is understated in traditional economics. As stated earlier, human beings are products of their emotions.

The upbringing of positivity has been proven to create a very strong energy in human body. With scientific research<sup>38</sup> showing that 70 percent of our system would be affected by our thought processes, it is of extreme importance that the world taps into this magical power that all humans possess. (Emoto) Emotions thus are a large stakeholder in our actions in the outside world. In the present time, we are looking into maximizing output and growth at a micro and a macro level. Since a macro is inclusive of micro units, it is desirable that we focus on maximizing the productivity of the latter.<sup>39</sup>

What is being proposed here is to the creation of mentalities that would enhance the growth of the happiness. An assumption that is held here that well being is one of the conditions that create happy thoughts and hence happiness. In the research that was done in— various implications emerge that proved the positive causal force between emotional well-being and productivity and productivity (Oswald P. S., 2014).

It is now known that happiness<sup>40</sup> does have a substance influence over the capacities of choice and innovative content. In their experiments<sup>41</sup>, they observed that increase in well being in individuals led to an increase in productivity of about 12%. Lower happiness was linked with lower productivity. This thus, strengthened the existence of a causal link between happiness and performance of the humans. Therefore, such happiness raises the possibility, at the microeconomic level and perhaps even at the macro level, of self-sustaining spirals between increased productivity of human beings and their own well being.

In another experiments conducted by Isen and Reeve (Alice M. Isen, 2006) it was demonstrated that positive effect fosters 'intrinsic motivation' and is reflected by the choice of activity, it also promotes enjoyment of a novel and challenges task along with provision of a more responsible work behaviour.

### **Health and Happiness**

A university of Texas Health Science report said that "A growing body of research shows that gratitude is truly amazing in its physical and psychological benefits". (Robbins, 2011) Experience of gratitude might be associated in a causal fashion with happiness. There has been speculation by researchers, writers, and practitioners, that gratitude possesses 'happiness-bestowing' properties. (Robert A. Emmons, 2003)

And it is common sense that a healthy body will be able to focus and produce more than a sick and unhealthy one. Thus, not only will the individual expenses on health care reduce significantly, it goes hand in hand with the significant rise in the level of outcomes by whatever measure we choose.

### **Happiness as a Common Good?**

Layard<sup>42</sup> believes in taking away from the goal of public policy of wealth and shifting it to 'well-being' and 'quality of life'. He rejects the idea of John Stuart Mill which distinguished the types of happiness in terms of higher and lower happiness. Higher would be associated with virtuous conduct and philosophical pleasures and lower can be in direct correlation with superficial pleasures. According to Layard, happiness is different from all other goals like health, autonomy, accomplishment and freedom, because it is self-evidently good and not just instrumental in achieving alternative goals. (Ott, 2006). Since people care about their reputation and social approval by others, they have a sense of fairness and want to make commitments and thus as a

consequence, they would need a common good or goal as a single overarching principle, to solve problems between existing rules, to review rules and to provide help in situations where rules provide little guidance.<sup>43</sup>

### **Happiness in a Function**

A general function could be derived at: reported wellbeing and happiness= (age, gender, income, education, marital status, diet, personal characteristics, region characteristics, country characteristics).<sup>44</sup>

Can economic incentives make people happy even to further provide a forward linkage towards a growth in productivity?

The potentially weak incentive effects of monetary rewards has been observed and highlighted in economics. (Amegashie, 2006). Monetary compensation as the sole motivator is both costly and ineffective. They remain a blunt instrument. If an organisation needs to function well, it cannot rely solely on monetary incentive schemes (George A. Akerlof, 2005). Thus, this is a cycle that needs to be injected with the positive push towards the greater efficiency. This might even be related to a micro economic 'Big- Push theory' where in the big push in a section of the micro economic units will result to have a macro economic effect on the economy as a whole.

### **A Suggestion**

Among other injections that needs to be made in the different cycles in the economy, the most important and 'needs to be stressed upon' is the education injection. Since education brings up the next generation of individuals who will lead the economy further and to higher ranks, it is of extreme importance that the mind set of these 'fertile seeds' is nourished and polished in the right fashion. Along with the basic syllabus under the various education schemes such as the Right to Education implemented by the Government of India, there ought to be a separate subject on how to think 'right'. i.e. how to think most productively. Counting your blessings might be one of the first steps that would invoke gratitude and subsequently happiness. Many other ways to conduct your thoughts and mind activities would have an impeccable effect. Such big would be the impact, that it is my prediction that within two generations, our economy will be renowned for the most sustainable and developed economy. Such a virtuos injection would be a sure shot way of a holistic development of the present and future generations.

### **Conclusion**

Thus, in the paper at first the importance of social welfare and the concepts regarding it was talked about. Welfare economics was then arrived at as a suitable weapon to target the welfare quotient in the society. The model of Pareto-Optimality was looked at and explained. The reason why it will not work in the present times was illuminated. Lastly, an alternative to the welfare economic approach was proposed which was based on the theory of happiness. It could also be expected to have a mass appeal as another 'invisible hand' in today's market driven society. The resultant development would be an 'in and out' development.

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**End notes :**

<sup>1</sup> O.P. Lange (Lange), Political Economy, Vol 1 ,p.317

<sup>2</sup> (J.Baumol)

<sup>3</sup> J.De Graff, Theoretical Welfare Economics, Cambridge University Press. 1957

<sup>4</sup> Utility is the satisfaction that a consumer derives from consumption of a good or service.

<sup>5</sup> This has been bought forward by Bergson and Samuelson.

<sup>6</sup> Value Judgements or values is meant the conceptions or ethical beliefs of the people about what is good or bad.

<sup>7</sup> Utility and welfare has been used interchangeably in this case.

<sup>8</sup> Lord Robbins, in his researched has established this challenge, bringing the issue to the forefront.

<sup>9</sup> Video lecture form, the MISES university, Alabama <https://www.youtube.com/watch?v=dzfDDOuRg8>

<sup>10</sup> Ibid.

<sup>11</sup> The father of classical economics, Adam Smith was also the propounder of free market which can be as an extension of indirect relation with the two points he had suggested in order to increase productivity.

<sup>12</sup> Others prominent economists who supported this theory was John Stuart Mill, Ricardo , and Malthus.

<sup>13</sup> A gunpoint policy would also be onerous, the classical economists will be in favour of patents and copyrights. And it would be okay for the government to subsidise certain lines of technological improvement

<sup>15</sup> Or monetary proxies for utility which were addable or summable would serve the purpose.

<sup>16</sup> Transfer money or money assets from the rich to the poor

<sup>17</sup> The bases of such policies were diminishing marginal utility (DMU) for money. It was explained that since the DMU for a rich person was much lesser than the DMU of a poor person, the aggregate sum of utilities would rise if we take income from the rich person to the poor person.

<sup>18</sup> According to them, even if every one has diminishing marginal utility of money, it basically tells us what is going on in the minds of a person, which is extremely subjective.

<sup>19</sup> The so-called new welfare economics is dated, somewhat arbitrarily, from the appearance of a short note by Nicholas Kaldor in Welfare propositions of economics (1939) in response to a paper by Roy Harrod (1938).

<sup>20</sup> Such an arrangement is Pareto efficient or Pareto optimal when no further Pareto improvements can be made.

<sup>21</sup> First condition: Marginal Rate of substitution of the consumers would have to be equal to maximize utility.  $MRS_{xy} = P_x/P_y$  where P are the prices of Good X and Y. And the marginal rate of technical substitution between good X and Y should be equal. Second condition: Marginal Rate of transformation = marginal rate of technical substitution (Production to be efficient and in demand by the consumers)

<sup>22</sup> Interventionism consists of mixture of voluntary and involuntary acts of acquisition and interactions. Each such act would be Pareto inferior. Thus interventionism fails to achieve a degree of all individual utility as great as the free market. See The Pareto Rule and Welfare Economics – Jeffrey Herbner, Review of Austrian Economics 10, No.1 (1997)

<sup>23</sup> Called the Kaldor –Hicks efficiency , Short history of Welfare economics (<http://www.socrethics.com/Folder2/Economics.htm>)

<sup>24</sup> This was associated with the Cambridge school of thought in particular with the welfare economist Pigou.

<sup>5</sup> Balakrishnan et al , 2009,10

<sup>26</sup> (Greenberg)

<sup>27</sup> Could be explained as the rate at which a consumer is ready to give up Good X for Good Y assuming that he is consuming both. Or the amount of good X compensated for consumption of another unit of Good Y to retain the same level of satisfaction.

<sup>28</sup> Indifference curves represent the MRS of individuals. Where the curves are tangential, the MRS would be equal to each other which would be the Pareto optimality condition.

<sup>29</sup> This guarantees the maximization of resource utilization and not a single resource going waste.

<sup>30</sup> Since the production possibility curve denotes the marginal rate of transformation of resources used to produce two commodities in a society.

<sup>31</sup> Gough et al (2007) defined well being as ‘What people are notionally able to do and to be, and what they have actually been able to do and to be’. We could consider it as presence of positive attributes (happiness, gratitude) and absence of negative ones (jealousy, boredom). Happiness is the focus in this paper.

<sup>32</sup> (Sraffa) 'Production of commodities by Means of Commodities' lays emphasis on the fact that labour or the human factor isn't any different from the other factors of production. Marx, in his work about commodity fetishism throws on the similar concept edging more on the alienability and the alienation of human aspect of production.

<sup>33</sup> <http://www.takingcharge.csh.umn.edu/enhance-your-wellbeing/health/thoughts-emotions/what-are-thoughts-emotions>

<sup>34</sup> One of the most common examples is the 'silver lining' concept that prompts us to think positive about a situation.

<sup>35</sup> (Sen, Capabilities and Functionings)

<sup>36</sup> Even though there is no substitute to hard work, being happy while working hard makes the entire process much more faster and merrier. Happiness would give that additional push.

<sup>37</sup> There has been as many definitions of happiness as there has been people studying it. Webster simply defines it as – a: state of well-being characterized by emotions ranging from contentment to intense joy; b: a pleasurable or satisfying experience. '...people can focus on more than survival, the non-economic aspects of life become increasingly important influences on how long, and how well, people live. This societal-level shift is linked with individual-level value changes, or a transition from giving top priority to economic and physical security to self expression values that emphasize participation, freedom of expression, and quality of life' (THE PSYCHOLOGY OF HAPPINESS)

<sup>38</sup> Masaru Emoto had conducted an experiment and discovered that if thoughts and words are directed at water, the water crystals undergo changes depending on whether the thoughts are positive or negative. When directed at with emotions of happiness and joy, they formed beautiful crystals as opposed to distorted shapes when attacked with hatred.

<sup>39</sup> This could be referred to as a trickle up effect? Where in the flow is non monetary but developmental in nature.

<sup>40</sup> Or a positive well-being

<sup>41</sup> (Oswald P. S., 2014)

<sup>42</sup> Richard Layard, An economist specializing in unemployment and inequality. He worked for the British Govt. as an economic advisor and in 2000 joined the House of Lords.

<sup>43</sup> As micro economic units would then merge together to form a macro unit, it is then hoped that such a common goal would have a macro impact as well. (Ott, 2006)

<sup>44</sup> (David G. Blanchflower, International Happiness, 2011)