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School of Economics

LEADERSHIP AND ECONOMIC THEORY

by

JOE WALLIS, BRIAN DOLLERY AND HO CHONG MUN

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LEADERSHIP AND ECONOMIC THEORY

Joe Wallis, Brian Dollery and Ho Chong Mun**

Abstract

Although the phenomenon of leadership has attracted considerable attention in the humanities and social sciences, it has been severely neglected by economists. Hermalin (1998) has recently demonstrated that leadership can be accommodated within the rational behavior paradigm of mainstream economics through “leading by example”. However, the Hermalin model accords no role to the inspirational dimension of leadership. This paper seeks to extend the basic Hermalin model to enable it to allow followers to be responsive to “moral rhetoric” by leaders. We examine the influence of emotions, especially hope and disappointment, on decision making aimed at the realization of shared group goals.

** Dr Joe Wallis, Senior Lecturer, Department of Economics, Otago University, Dunedin, New Zealand.

Brian Dollery is Professor of Economics at the University of New England, Australia and Visiting Foreign Scholar, Yokohama National University, Japan.

Ho Chong Mun is Lecturer in the School of Science and Technology at Universiti Malaysia Sabah.

Contact information: School of Economics, University of New England, Armidale, NSW 2351, Australia. Email: bdollery@metz.une.edu.au.

Leadership and Economic Theory

I. INTRODUCTION

The phenomenon of leadership has been the subject of a considerable body of literature in certain branches of the humanities and the social sciences. Traditions of inquiry into leadership have been particularly prominent in philosophy, politics, anthropology, psychology, sociology and history. Moreover, insights from all these traditions have been integrated into studies of management and organizational behavior that have been of both an academic and popular nature¹. Most of these studies attempt some definition and typology of leadership. This has given rise to a wide range of definitions which seem to be converging toward the concept that leadership is a social influence process through which the members of a group are steered toward a goal (Bryman, 1986).

The considerable interest other disciplines have shown in leadership makes the relative neglect by economists of this phenomenon all the more striking. The traditional reluctance of economists to examine leadership may have been based on the perception that, in seeking to influence followers, leaders are trying to change their preferences. The study of leadership would therefore seem to be out of bounds to the majority of economists who subscribe to the convention that economic analysis should either (i) take the preferences of individuals as given and not look inside the "black box" within which they are formed and transformed; or (ii) assume that they are stable and explain apparent preference change in terms of adjustments in the shadow prices of inputs in household production functions (Stigler and Becker, 1977).

A recent paper by Hermalin (1998) may, however, have shown mainstream economists how they can account for leadership without breaching this convention.

¹ A particularly comprehensive survey of these studies is provided by Bass (1990).

Hermalin demonstrates how it is rational for individual members of a team to follow the exemplary levels of effort expended by a leader where this person has superior information about the value of effort devoted to their common activity. "Leading by example" is thus a mechanism by which leaders convince followers that they are not misleading them. In the absence of this signal, followers will be "predisposed to disregard (the leader's) calls to action" (Hermalin, 1998, p.1189).

Hermalin attempts to make leadership amenable to economic analysis by addressing the two major concerns that are repeatedly raised in the broader literature about the distinctiveness and significance of this phenomenon. His model does, however, limit followers to being influenced by the actions and not the words of their leaders. It thus neglects the significant inspirational dimension to many instances of leadership. This neglect is evident in Hermalin's comment that "historical instances of leading by example include Dr. Martin Luther King, Jr. marching at the head of civil rights marches" (p. 1189). But surely King's rhetoric mattered to at least some of his followers. They would have been influenced both by his exemplary actions and the inspirational effect of verbal messages such as the famous "I have a dream" speech had on their emotions and behavior.

The main purpose of this paper is to suggest ways in which economists may extend the basic model formulated by Hermalin to account for the inspirational dimension of leadership. Section II will outline how this model establishes a distinctive and significant role for leadership by example in the context of team activities and will elaborate on some of the implicit assumptions in this model that seem to exclude an inspirational dimension to leadership. Section III will then consider how the assumption that followers are insensitive to the leader's rhetoric has been dispensed with in an earlier model developed by Casson (1991) that shows how leaders can use "moral rhetoric" to manipulate the shame and guilt followers experience from shirking and free-riding in the pursuit of collective goals. For a leader's rhetoric to be inspirational it must, however, influence the hopes rather than the emotions of shame and guilt experienced by followers. Section IV applies some

of the main propositions in Elster's (1998) survey article on the nature of emotions and how they influence decisionmaking to an analysis of the role hope plays in inducing the members of a group to strive toward the realization of their shared goals. The ways in which an inspirational leader can strengthen the hopes and counter the disappointments of followers are considered in section V. The paper concludes by discussing the relevance of the economics of leadership to other developing areas of economic thought in section VI.

II. HERMALIN'S MODEL OF LEADERSHIP BY EXAMPLE

Two issues are repeatedly raised in the leadership literature. They concern the distinctiveness and significance of leadership. These issues are, of course, inter-related. For leadership to be seen as being distinct from, say, management or administration, an account must be given of how it can influence the discretionary effort exercised by members of a group. Its significance can then be posited in terms of the impact this influence has on the overall performance of the group in realizing its own (or some broader social) goals². It would seem then that any leadership theorist worth her salt needs to address the fundamental counterfactual question: "Would the improvements in performance attributed to leaders have occurred without their distinctive influence?"³

² A substantial literature has developed which has been directed towards authenticating claims about the distinctiveness and significance of leadership. As Bass (1990) reports "countless surveys can be cited to support the contention that leaders make a difference to their subordinates' satisfaction and performance...(and)...in whether their organizations succeed or fail" (p. 6). Although most of these studies have focussed on business organizations, a number have advanced evidence for the quality of leadership being the "x-factor" accounting for variations in indicators of the performance of schools (Sylvia and Hutchison, 1985), churches (Smith, Carson and Alexander, 1984) and military units (Gal and Manning, 1984).

³ The major sceptical response to claims made about the distinctiveness and significance of leadership has been associated with various "attributional" theorists. From their perspective, followers attribute

Hermalin addresses this counterfactual by comparing the aggregate welfare a team engaged in a common endeavor would generate under conditions of asymmetric information, where followers look to the leader's actions for signals about the return to their efforts, with that under symmetric information where no person can be a leader by virtue of having superior information. Formally, he follows Holmstrom (1982) in proposing that in a team in which N identical workers (indexed by n) supply effort e_n the value to the team of its member's efforts will be $V = \theta \sum_{n=1}^N e_n$, where $\theta \in [0,1]$ is a stochastic productivity factor realized after efforts have been supplied. Each worker's utility is assumed to be $w - d(e)$, where w is the worker's wage and the disutility of effort, $d(e)$, is an increasing, convex and thrice differentiable function. The explicit assumptions made in this model are that although contracts can be written contingent on V and *ex ante* announcements about $\hat{\theta}$ they cannot be contingent on θ directly, or on the team members' efforts.

It is then shown that if workers have symmetric information about θ , a set of optimal affine-shares contracts will divide the effort equally among workers to minimize the aggregate disutility of effort. These contracts will, nevertheless, still be second-best efficient, since they do not solve the underlying "teams problem". This arises since each team member gets only a fraction of the overall return to the effort they expend and will expend less than the first-best level of effort on the common endeavour; thereby failing to internalize the positive externalities their effort has for the team.

Hermalin then shows that within this framework a distinctive leadership role can emerge for that person who receives a private signal concerning θ , before the expenditure of effort but after contracts have been fixed. A "hidden information" assumption is introduced into the model in terms of which workers realize that the

effects due to historical, economic and social factors to leaders, as in romantic fiction (Meindl and Ehrlich, 1987). Improvements in the performance of individuals, organizations and nations are thus determined by other factors, but leaders are credited with what happened after the fact (Pfeffer, 1977).

leader has an incentive to lie by announcing the maximum possible value for θ . They will therefore rationally disregard such announcements. Hermalin suggests that leaders make their signals about θ credible either by "sacrificing"⁴ or by "setting an example". Leading by sacrifice has no direct impact on welfare since the signal is a transfer. With leading by example, however, the followers make inferences about θ based on the leader's effort. In a two state model (where $\theta = \hat{\theta}$ in the bad state and $\theta > \hat{\theta}$ in the good state), workers will only believe that the state is good if the leader's effort signal is greater than her symmetric, second-best level. This means that "the harder the leader works, the harder the followers work" (p. 1196). Aggregate welfare is therefore greater than under symmetric information: "Because the free-riding endemic to teams means too little effort to begin with, inducing harder work is welfare improving" (p.1196).

In Hermalin's view, an asymmetric information model of leadership can make a significant contribution to interdisciplinary studies of this phenomenon since its "analysis is both consistent with the analyses in other literatures and offers explanations for many of them" (p. 1201). In particular, he points out that the traits and behaviors that have been found (by other social sciences) to be critical for establishing the legitimacy of informal leadership "such as education and task-specific knowledge, would seem correlated with knowing θ and so in keeping with our analysis" (p.1201). Moreover, he suggests that this framework can be extended to address a wider set of questions dealing with leadership such as:

" . . . `Which traits make a good leader? To what extent is leadership defined or limited by its cultural context? How are leaders chosen? And why do people want to be leaders?" (p.1200)

⁴ According to Hermalin: "Leader sacrifice corresponds to real-world phenomena in which the leader promises a big party or more vacation time at the end of a big project. Alternatively, a team leader could provide pizza and coffee to team members who work evenings on a big project. In short, we have leader sacrifice whenever a leader promises a group a big reward to convince her team that effort pays big benefits" (p.1195).

A model of leadership which precludes followers being affected by the rhetoric of leaders does, however, seem to be somewhat limited, particularly in those cases where leaders have established the credibility of their words by also leading by example. Perhaps the economics of leadership is an area where, as Hirschman (1985) puts it "parsimony in theory construction can be overdone and something is sometimes to be gained by making things more complicated" (p.8).

One complication that Hirschman proposes is that economists should recognize that there are "two kinds of activities" which human agents can engage in. The first kind has historically tended to monopolize the attention of economists. It is the type of instrumental activity that "carries with it a neat distinction between process and outcome, inputs and outputs, or costs and revenue"(1985, p.11). The motivation to engage in such activities is essentially extrinsic since "from the point of view of the individual participant in the process, a seemingly similar distinction can be drawn between work or pay or between effort and reward" (p.11). This distinction is explicitly built into Hermalin's model with each team member comparing the disutility of effort with their contract share of the value, V , of team output.

This model therefore ignores the possibility that teams may engage, at least to some degree, in a second kind of activity identified by Hirschman (1985). This is the expressive, non-instrumental type of activity engaged in by individuals in "the pursuit of truth, beauty, justice, liberty, community, friendship, love, salvation, and so on" (p.12). Such activities do not remain entirely outside the domain of economic inquiry since as Hirschman observes "the neglect of the non-instrumental mode of action was responsible for the inability of the economic approach to understand why people bother to vote and why they engage from time to time in collective action" while "lately the conviction has gained ground that fluctuations in this component must be drawn upon to account for variations in labor productivity and for shifts in industrial leadership" (pp. 14-15).

In a non-instrumental type of expressive activity, a "fusion of striving and attaining" may occur as individuals "savor in advance" the realization of what they are

striving for. This not only compensates them for "the uncertainty about the outcome, and for the strenuousness or dangerousness of the activity" but can act as a disincentive to free-riding in team situations. As Hirschman pointed out in his earlier book:

" . . . Since the output and objective of collective action are . . . a public good available to all, the only way an individual can raise the benefit accruing to him from the collective action is by stepping up his own input, his effort on behalf of the public policy he espouses. Far from shirking and attempting to get a free-ride, a truly maximizing individual will attempt to be as activist as he can manage" (1982, p.86).

To the degree that team activities have a non-instrumental component, there must be scope for a credible leader's rhetoric to strengthen and sustain the emotional reserves of hope that enable followers to derive these "in-process" benefits. Under these circumstances the team can be conceived as striving together to advance a common quest, where the process of striving yields distinct intrinsic or solidary benefits that compensate team members for the disutility of effort. This intuition will be developed when the nature of inspirational leadership is considered in sections IV and V.

Another complication suggested by Hirschman is that economic discourse should recognize that there are "two kinds of preference change" (Hirschman, 1985). They would therefore recognize that individual preferences do not only change due to "wanton", unreflective and unpredictable shifts in tastes but also due to reflectively monitored commitments to realize "second order values". While Hirschman accepts that the first type of preference change is "inscrutable, capricious (and) of little analytical interest", he contends that changes in values should not "be downgraded to the wanton kind by assimilating them to changes in tastes" since they "do occur from time to time in the lives of individuals, within generations, and from one generation to another, and that those changes and their effects on behavior are worth exploring- that, in brief, *de valoribus est disputandum*" (pp.10-11).

In directing attention to the "distinctively human capacity" to reflexively form "second order" "metapreferences" about the way we want our preferences to be shaped

by our values, Hirschman drew from the seminal analyses of this issue by Frankfurt (1971) and Sen (1977). In an earlier book (1982) he argued that second order metapreferences would only be relevant in those situations of dissonance where individuals were wrestling with decisions about whether or not to keep or break commitments in respect of which they had experienced an accumulation of disappointments. This situation is clearly relevant to studies of leadership since an important function of leaders would be to supply followers with "reasons" that reinforce their second order metapreferences to sustain their commitments to strive toward the realization of team goals.

The role which a leader's rhetoric can play in shaping the type of team norms that express a second order metapreference against shirking has been modelled by Casson (1991). This model must now be examined since it suggests how the relationship between rhetoric, emotions and behavior may be incorporated into a more comprehensive economic theory of leadership

III. CASSON'S THEORY OF MORAL LEADERSHIP

In his book *The Economics of Business Culture* (1991), Mark Casson not only makes a particularly strong claim about the significance of the quality of leadership as a factor that can affect the performance of economic institutions but relates this significance to the distinctive way in which leadership can counteract agency failure. His project is similar to Hermalin's in that he posits the informal authority leaders exercise over followers as an alternative to more formal contractualist methods of inducing individuals to internalize the positive externalities of their effort decisions. The central insight of Casson's theory seems to be that if principal-agent relationships can be transformed into leader-follower ones in which followers can be motivated to strive to advance the leader's quest, then there may be significant scope for reducing the types of agency cost identified by Jensen and Meckling (1976).

These agency costs include both the negotiating, monitoring and bonding costs involved in establishing a principal-agent agreement and the residual losses that arise from the potential agency failure which remains uncorrected by the agreement. Significant savings in these costs may occur if principals forego a contractual approach to governing their relationships with agents and, instead, choose to exercise leadership by developing a distinctive culture that transforms them into followers with an emotional incentive to carry out the tasks and functions delegated to them. The significance of this cultural dimension to agent behaviour is only alluded to in the "new institutional economics" (Coase, 1937; Hodgson, 1988; and Williamson, 1975) and agency theory. It has however been transported to center stage in the "economics of business culture" formulated by Casson (1991).

According to Casson, leaders can reduce the agency failure associated with forms of opportunism such as shirking through either (i) more intensive monitoring of the individual efforts of group members or (ii) more intensive "moral manipulation". The latter involves the use of "moral rhetoric", addressed to the group as a whole. It aims to establish a group norm for moral commitment that indicates the extent to which members can expect to place their trust in one another⁵.

Casson suggests that the utility functions of followers will include emotional components, the parameters of which are susceptible to moral manipulation by the leader. Specifically, the guilt a follower associates with failing to comply with the group norm for moral commitment will be affected by a combination of his or her innate moral sensitivity and the "intensity of manipulation" applied by the leader. It follows that even if the disutility of effort supplies a team member with an incentive

⁵ Casson justifies his treatment of these options as mutually exclusive along similar lines to Frey (1994). The basic argument is that if principals seek to strengthen the extrinsic motivation of agents by making their rewards or sanctions more contingent on their individual performance their intrinsic motivation will be "crowded out" since (i) agents may have a reduced degree of discretion to exercise moral responsibility and behave in a trustworthy way and (ii) the strengthening of monitoring mechanisms often involves an implicit withdrawal of trust.

to break the team norm against shirking, this person will still comply with it if the disutility of guilt exceeds disutility of effort.

Casson proposes that there will exist a threshold intensity of manipulation, below which even the most morally sensitive follower does not experience sufficient guilt to make keeping the commitment worthwhile. He suggests, though, that once this threshold is passed, the benefits of raising the intensity of manipulation will be subject to diminishing marginal returns since its impact will be felt more and more by people who have already decided to comply with the group norm and less and less by the remainder of relatively insensitive "hard cases" for whom non-compliance is still an option.

There will be fixed and variable costs to raising the intensity of manipulation. These will depend on the charisma of the leader, the cost of media services and the level of trust in the culture in which the group is imbedded. While these costs will vary between groups it is assumed that each leader will know the marginal cost function that applies to the particular group concerned. Since the leader will also know the shape and position of the declining marginal benefit function this person will be able to set the optimal intensity of manipulation where marginal benefit equals marginal cost. This optimum will be associated with a particular level of agency failure, whose cost to the leader can be added to the total costs of achieving an optimal intensity of manipulation to ascertain whether manipulation is less costly than monitoring.

Casson derives a number of interesting and testable hypotheses from his model. For example, he hypothesizes that monitoring is likely to be favored where leaders lack charisma or face high media costs or where followers are subjected to hazardous or strenuous work in warm climate. Manipulation may, however, become more appropriate where the performance of followers is difficult to measure. In intellectual work or in the "craft" and "coping" activities performed in the public sector where work tends to be "unobservable" (Wilson, 1989) the type of morally manipulative leadership described by Casson would seem to be an attractive option.

The central insights of the models formulated by Casson and Hermalin can be combined to account for those situations where a leader has established some moral authority by leading by example. In these situations, followers will not only focus on the leader's actions, as Hermalin suggests; they will also attend to this person's words. Their sensitivity to the leader's rhetoric will give this person some leverage to strengthen and reinforce team norms against shirking.

It could be argued that a combination of example and moral rhetoric may overdetermine the efforts of team members. However, overdetermination does seem to be a feature of the normative dimension of human behavior (Etzioni, 1988). This may be because the battle to impose a metapreference for striving to advance a team's quest is fought out within the self and "is marked by all kinds of advances and reverses as well as by ruses and strategic devices" (Hirschman, 1985, p.9). It involves the type of "intimate contest for self-command" described by Schelling (1984) in which the leader, as the source of both rhetoric and example, can empower team members to become the "kind of followers they want to be".

Further criticisms of the approach Casson recommends to modelling the influence of leadership on follower emotions may be derived from a general survey of "emotions and economic theory" by Elster (1998). In this article Elster points out that emotions can function as "tiebreakers", enabling agents to make decisions where rational choice theory is indeterminate. He refers to Damasio's (1994) research in neurobiology that finds that patients who have experienced damage to their frontal lobes lose their capacity to make decisions. This is because they cannot perform the basic agenda-setting function of screening issues according to their urgency and significance, since it is the emotions that enable "normal" people to spontaneously react to, and focus their attention on, issues that are urgent and significant.

This perspective on the way the emotions shape decisions leads Elster to reject the notion that emotions can be incorporated as psychic costs and benefits in individual utility functions (along the lines proposed by Casson) in favor of an approach which he sums up as follows:

" . . . The role of emotions cannot be reduced to that of shaping the reward parameters for rational choice. It seems very likely that they also affect the ability to make rational choices within those parameters. This dual role of the emotions - shaping choices as well as rewards - has analogues in pain, addictive cravings, and other visceral factors. As in these other cases, the claim is not that the emotions fully determine choice, or that there is no tradeoff between emotional rewards and other rewards. Rather, it is that the tradeoff itself is modified by one of the rewards that is being traded off against the others" (p.73).

From Elster's perspective, Casson's theory of leadership is also flawed since the intention by leaders to induce shame and guilt through manipulative rhetoric is incoherent. He generalizes this concept in the following way:

" . . . By an incoherent intention I mean the intention to induce emotion X by behavior that would induce X if it was spontaneous but that induces emotion Y if believed to be motivated by the intention to induce X" (p.58).

Thus, for example, if followers come to believe that their leaders are trying to manipulate their emotions of shame and guilt they may become aggrieved by these leaders and experience a build-up of resentment toward them that would undermine their willingness to look to them for leadership. Moreover, as Elster points out, "although a person with an incoherent intention may try to get around this problem by hiding his motivation, this requires an effort that should itself be counted as a cost and may in a given case be hard to achieve successfully" (1998, p.58).

If, however, the inspirational leadership is conceived as involving the influence, by leaders, of the emotions of hope possessed by the members of a particular group, then these problems of incoherence will not arise. Followers are unlikely to be angry with a leader when they realize that the rhetoric used by this person is directed toward strengthening their hopes. Moreover, to the extent that inspirational leaders succeed in doing this they will enable followers to counter the disappointments they experience during the course of their engagement on a particular quest. To account for the inspirational dimension of leadership, it may be helpful,

then, to draw from the general conceptual framework formulated by Elster to analyze the nature of hope and the way in which it can be influenced by the rhetoric of inspirational leaders.

IV. THE NATURE OF HOPE

Hope would seem to unambiguously qualify as an emotion. Elster brackets it, along with fear, as an emotion that is "generated by the thought of what may happen" (p.48). To hope is to "savor in advance" (Hirschman, 1985) the realization of some worthwhile future state. In this regard hope can be distinguished from (i) various social emotions like "anger, hatred, guilt, shame, pride, pridefulness, admiration, and liking"; (ii) the "counterfactual emotions" of "regret, rejoicing, disappointment, (and) elation"; (iii) emotions generated by "things that have happened" such as joy and grief; (iv) "emotions triggered by the thought of the possessions of others" like envy, malice, indignation and jealousy; (v) emotions that "do not fall neatly into any category" such as contempt, disgust and romantic love; and (vi) "borderline or controversial cases" which "include surprise, boredom, interest, sexual desire, enjoyment, worry and frustration" (p.48).

Along with these other emotions, hope can be distinguished from non-emotional mental states by six features "cognitive antecedents, intentional objects, physiological arousal, physiological expressions, valence, and action tendencies" (Elster, 1998, p.49). This scheme may be reduced to the proposition that hope is a particular type of action tendency engendered by antecedent beliefs and the investment of emotional energy⁶. These features of hope need to be analyzed in more detail.

⁶ This is consistent with the treatment of emotions in psychology since, as Elster (1998) has pointed out:

The action tendency produced by hope is a readiness to keep striving to advance a particular quest or strengthen a particular relationship in the face of the discomfort or disappointment experienced over the course of the quest or relationship. Snyder (1994) defined hope as "the sum of the willpower and waypower that you have for your goals" (p.5). He proposes that, in the course of striving to achieve the goals they place their hopes in, people need to exercise (i) "willpower" as they draw on their reserves of emotional energy or "determination and commitment", and (ii) "waypower" as they generate one or more effective paths to their realization. They will particularly need to exercise willpower and waypower in the face of opposition or resistance or when the path they are pursuing toward a goal comes to be blocked. From this perspective, hope primarily generates an action tendency toward perseverance. It can thus be seen as an important source of the in-process benefits that reward people for their participation in the type of non-instrumental activity described by Hirschman.

The action tendencies of hope will be triggered by two core beliefs. The first is the belief that the advancement of a quest or the maintenance and strengthening of a relationship is "neither impossible nor inevitable" (Sutherland, 1989, p.195). This belief does not have to be based on probabilistic calculation. A commitment to a particular quest or relationship is often made under conditions of "bounded uncertainty" such that its consequences cannot be probabilistically calculated - they can only be imagined (Shackle, 1973, p.62). In the case of team members striving to advance a particular quest, it would seem to be sufficient that they believe that they have the "waypower" (Snyder, 1994) to effectively react to the obstacles and resistance by devising and pursuing alternative ways to advance their quest.

" . . . By and large, psychological studies of the emotions have not focussed on how emotions generate behavior. Instead, they have tried to identify the proximate or ultimate causes of the emotions. To the extent that psychologists are concerned with behavior, it is usually with *action tendencies* rather than with observable actions" (p.47).

The second belief is that the advancement of a quest or "reproduction" of a relationship is "worthwhile" or "important" in the sense that it is "worthy of pursuit in a special way incommensurable with other goals we might have" (Taylor, 1985, p.135). The process of placing our hope in certain goals seems to involve an investment or commitment of self to the realization of these goals. Or, to use Hirschman's terminology, once again, it requires us to form a second order metapreference that committing ourselves to realize these goals expresses the "kind of life I want to live" or the "kind of person I want to become".

Hope, however, involves more than a set of beliefs. These beliefs must be expressed with a degree of emotional energy or passion that is reflected in the characteristics of physiological arousal, physiological expression and valence described by Elster (1998). Perhaps the most immediate indicator of passion is a person's level of emotional energy.

Collins (1993) has formulated a theory in which emotional energy is "the common denominator in rational social action". According to this writer, people invest varying levels of emotional energy in their social interactions. High levels of emotional energy will be reflected in feelings such as enthusiasm and confidence while low levels are manifested, for example, by apathy and depression. However, in most interactions the emotional energy of individuals is at a "medium level" which will be unnoticed by both themselves and those with whom they are interacting. Only people with very high or very low levels of emotional energy will pass the attention threshold at which their degree of emotional intensity becomes "empirically visible, both in behaviour (especially nonverbal expressions and postures) and in physiology" (p.211). It is suggested that "passion" consists in the high and observable level of emotional energy that can either draw people toward, or repel them away from, interactions in which it is generated by participants.

How then are economists to model the effect of hope on behavior and so establish the foundation for a satisfactory account of inspirational leadership? Wallis (1996) suggested some reasons why hope can be treated as the human capital input

used to produce in-process benefits from participating in a team quest in a standard Beckerian model in which individuals use inputs of purchased goods, time and human capital to "produce" satisfaction from "commodities" which constitute the actual arguments in their utility functions. Firstly, it is possible to distinguish between general and specific forms of hope in the same way that it is possible to distinguish between general and specific forms of human capital. The general capacity for hope enables people to place their hope in specific projects or relationships without necessarily attaching an "ultimacy" to these projects or relationships. Like general human capital this capacity will to some degree be innate but can also to a significant degree be developed⁷. The specific hope which individuals have in particular projects or relationships is like the specific form of human capital that is formed "on-the-job" through practice. This is the type of hope which individuals place or invest when they commit themselves to particular leaders, teams and quests.

In common with any form of capital, the specific hope that is invested in this way can be subject to processes of accumulation and depreciation. The distinctive role of leadership is to reinforce and strengthen it in the face of disappointments that can accumulate in a way that undermines it. These disappointments can arise from a number of sources. Firstly, the members of a leader-follower network will be exposed to disappointments associated with their quest. Due to their "poverty of imagination" (Hirschman, 1982) they may not imagine all the obstacles to its advancement so that surprising failures and setbacks may be interpreted as

⁷ Religion can play an important part in the development of this capacity. The essential function of religion would seem to be to explain the meaning of life in ultimate terms, so that any who believe in, the explanation given can be enabled to "make sense" of life, especially of their own lives and particularly of those aspects of their lives which have been a source of disappointment (Kelley, 1972). By providing a transcendent focus for a person's general hope, a religion such as Christianity can protect this sense of hope from erosion by the disappointments, the "trials and tribulations" experienced during life. The nature of "religious human capital" and its effect on religious practice has been examined from a Beckerian perspective by Iannacone (1990).

disappointments. Secondly, they may experience disappointments associated with belonging to a particular group. These disappointments typically arise when group pressures to conform its norms lead to "preference falsification" (Kuran, 1990) among its members as they over - or - under commit themselves in relation to the degree that they seek to express their hope in the quest. Thirdly, to the extent that individuals internalize group norms and form "second order" "metapreferences" to keep them, they will experience disappointment with themselves when they fail to keep the commitments that are the subject of these norms. These different sources of disappointment can clearly combine and interact with one another in a cumulative process.

In terms of a Beckerian model changes in the stock of human capital will change the "shadow prices" of the inputs that are used to produce satisfaction from a commodity. Where the accumulation of disappointment weakens the hope placed in a leadership network and its quest, these shadow prices will rise and induce the type of substitution effects that are very familiar to economists. This suggests that there will occur smooth and continuous adjustments of the inputs supplied to produce satisfaction from participation in the leadership network in relation to those supplied to produce other commodities (including those derived from participating in other networks).

This ignores the punctuated equilibrium pattern that has been observed with regard to many types of commitment. This is reflected in the way individuals sustain their commitments until their disappointments have accumulated above the threshold at which they break these commitments and commit themselves to alternative quests and relationships (Hirschman, 1982). This type of behavior does, however, become readily explicable when disappointment is treated as a source of dissonance and leadership as a dissonance reduction mechanism.

V. INSPIRATIONAL LEADERSHIP AS A DISSONANCE-REDUCTION MECHANISM

Elster (1998) rejects a cost-benefit model of the emotions that treats them "as psychic costs and benefits that enter into the utility function on a par with satisfactions derived from material rewards" (p.64) in favor of an approach that views them both as sources of dissonance and as mechanisms of dissonance reduction. The concept of "cognitive dissonance" was first popularized by Leon Festinger (1957). It refers to the unpleasant feeling of tension individuals experience when they have to choose between alternative, mutually exclusive courses of action. Once they have committed themselves to a particular course, they will look for cognitions that support it and reduce their feelings of tension or dissonance. A classic example of this is provided by automobile buyers who, after having decided to buy a particular model, mainly read literature that serves to confirm the wisdom of this decision.

According to Elster, dissonance theory is more realistic than the cost-benefit model in that it views individuals as making hard choices "on the basis of *reasons* rather than on the basis of introspections about how they feel" (p.66). It can help explain the "sticky", "punctuated equilibrium", "path dependent" nature of many commitments in respect of which individuals seek for reasons to sustain their commitments until a threshold is reached "when the arguments on the other side become too strong and the rationalization breaks down" so that "a switch in behavior occurs" (p.66). Although Elster points out that "psychologists have not considered emotions as sources of cognitive dissonance and dissonance reduction", he suggests that "there seems to be no reason why emotions could not be sources of dissonance" (p.66). Elster proposes that if emotions can be incorporated into dissonance theory then this could lead to their incorporation into economic theory since a number of economists (such as Akerlof and Dickens 1982; and Rabin 1994) "are now incorporating dissonance theory into their framework" (p.66).

The networks that link leaders with followers provide the context within which their shared hopes can be strengthened through interaction so that the dissonance associated with accumulated disappointments can be reduced. There are

two ways in which network interaction can strengthen hope and reduce disappointment. Firstly, such interaction is likely to involve a mutual sharing of reasons for hope. Each member is likely to have his or her own reasons for participating in the leadership network but these will always, to a degree, be implicit, inchoate and partly articulated. They will therefore look to other members to provide a clearer, more explicit articulation and to buttress their beliefs in the worth and possibility of committing themselves to the advancement of their quest. This will not only strengthen the cohesion of the network and facilitate the convergence of their hopes on a shared vision. It may also serve an "evangelistic" function, persuading outsiders of the worth and possibility of committing themselves to a particular leader-follower network and its quest.

While every member of a team striving to advance a quest may make some contribution to this process, leader-follower relationships will emerge in those groups who look to one person to act as a "final respondent", to have the "final word" in articulating its shared vision. To be able to inspire followers with their rhetoric leaders must occupy the central position in what Charles Taylor (1985) called the "public space" of a group that engages in "a common act of focusing" on the worth and possibility of advancing its quest. They have the capacity to command the attention of every member of this group so that these members do not just focus on these questions but also on the leader's response to them.

The key rhetorical role of an inspirational leader does not essentially arise from from the social division of knowledge produced by asymmetric information as Hermalin (1998) suggests. Inspirational leaders do not necessarily have to have superior knowledge to their followers. Their relationships with them may thus be distinguished from those which are clearly based on asymmetric information such as teacher-pupil, adviser-client or doctor-patient relationships. These leaders may be in a position to gain access to and process more information than their followers but, in exercising inspirational leadership, they are not simply attempting to change their behavior by supplying them with information they do not have. Inspirational

leadership more essentially involves influencing followers through a process of what (Kelman, 1958) calls "internalization" - the amplification and clarification of values and beliefs that are shared by both leaders and followers. As Bennis and Nanus (1985, p.96) have found in their studies of leadership, inspirational leaders were "rarely . . . the one who conceived the vision". They tended, more often, to have been "the one who chose the image from those available at the moment, articulated it, gave it form and legitimacy, and focussed attention on it".

A second way in which network interaction can strengthen hopes and counter disappointments is by enhancing the emotional energy or passion of its members. Collins (1993) has proposed that this type of passion can be both a product of, and a resource that can be invested in, what he calls "interaction rituals" (IRs). This "emotional energy" will reach its peak at the climax of a "successful" IR in which the participating group's focus of attention and common emotional mood go through a short-term cycle of increase and mutual stimulation until a point of emotional satiation is reached. The interaction will leave each participant with an "energetic afterglow" that "gradually decreases over time" so that individuals have an incentive to reinvest their emotional energy in subsequent interactions. It may therefore accumulate across IRs so that "an individual may build up a long-term fund of confidence and enthusiasm by repeated participation in successful IRs" (p.212). It is this fund, this reserve of "willpower and waypower", that can be drawn on by the members of a team to counter the emotional component of the dissonance they experienced as a result of disappointments and to sustain their "action tendencies" to persist in striving to advance their quest.

To develop this type of culture in a leader-follower network, leaders will have to structure group interactions so that they pass the thresholds of "physical density" and "boundedness" that are necessary for their success. The threshold of physical density is passed when at least two persons are close enough for a sufficient period of time to ensure that they can be moved by one another's passion. The threshold of boundedness may be passed when there is an expressive dimension to group

interaction so that participants are expected to identify themselves as followers by expressing a passion for advancing the leader's quest.

A person who does not have this passion will find it more difficult to interact as a member of the leadership network than Kuran's (1990) theory of preference falsification seems to suggest. It will be hard to "keep up an act", continuously "fooling" other members about their lack of passionate intensity and even if they succeed in this falsifying strategy, they will derive no satisfaction from a sense of belonging to this group. A culture of passion can therefore function as a selection mechanism screening out those participants who do not believe the quest to be worthy of their passion and drawing into the network those people who are willing to commit themselves passionately to it in the hope that it will prove worthy of this commitment. The boundedness of the group may be enhanced over time by the selective effect of this culture.

Leaders may ensure that these thresholds of density and boundedness are passed by structuring group interaction into a number of levels descending in status from the "inner circle" of followers who the leader chooses to interact directly with. Access to this level of interaction will be limited to those followers in whom the leader has placed the highest level of trust. This trust will be based not just on the skills and resources which these followers can deploy in performing the tasks allocated to them, but also on the passion which they express in seeking ways to advance the leader's quest⁸.

Leaders can thus shape the development of their follower culture by setting the terms according to which followers compete for access to their inner circle. Moreover they can influence the passion that is generated in this circle and which

⁸ It should be pointed out that the members of a leader's inner circle will often typically be "autonomous" rather than "habituated" followers (Howell 1988). The passion that is expected of them will not be a blind zeal but a persistent focus on seeking the best means available to advance a particular quest.

filters down the different levels of followership by enhancing the commonality of focus and emotional mood that is stimulated by IRs. Bennis and Nanus's (1985) conception of leaders as "managers of meaning" would seem to be pertinent in this regard. Leaders direct followers' attention to the point and significance of their actions and interactions and they narrow their evaluation of this point and significance to a simple consideration of whether these activities are moving the quest in the direction intended by the leader. Leaders may be able to create a common focus among their followers through the intensity of their own passion to advance the quest. As Bennis and Nanus have observed, "these intense personalities do not have to coerce people to pay attention. They are so intent on what they are doing that like a child, completely absorbed with creating a sandbox, they draw others in" (p. 28). A large proportion of effective leader's signals to his or her followers must comprise signals of their attention to the advancement of their quest since, as Peters and Austins found, "it's a matter of the quantity of attention paid to the matter at hand rather than the quality, odd as that statement may sound" (1985, p. 270).

Attention is not, however, just signalled by the expenditure of effort before followers. It is also signalled through language. As Berger (1989) has pointed out, attention is a scarce resource and language plays a key role in its deployment. He follows Taylor (1985) in highlighting the inextricable link between language and the evocation of "subject-referring" emotions. These clearly include hope and disappointment since, along with "our sense of shame, of dignity, of guilt, or pride, our feelings of admiration and contempt or moral obligation, of remorse, of unworthiness and self-hatred (and less frequently) of self-acceptance" (Taylor, 1985, p.59), they can only be experienced if a certain "import" or significance is ascribed to the situations that give rise to them. This constitutes more than a subjective reaction to an objective situation since as Taylor puts it, "to ascribe an import is to make a judgment about the way things are which cannot be reduced to the way we feel about them" (p.54). Taylor stresses that subject-referring emotions have to incorporate a degree of articulation in order to open a person to the imports involved. To recognize

that these emotions are bound up with a process of articulation is to accept that, at any time, they will be, at least partly, constituted by their latest articulation and that further articulation may change the valence of the emotions being experienced.

It would seem then that the inspirational dimension of leadership cannot be explained without taking into account the impact of the leader's rhetoric on emotions of hope and disappointment. It should nevertheless also be borne in mind that the expressive power of the leader's words, their capacity to express and evoke these subject-referring emotions will depend, at least partly, on the extent to which they are validated by exemplary action. As Kelley (1972) has pointed out:

" . . . There is as realistic an economy in the realm of meanings as in commodities, but the currency is different. In both cases, it obtains its value from the guarantees that undergird it: what has been invested in it, what backs it up. In the realm of meaning that backing, that guarantee or validation, is a personal and social earnestness shown in the investment by real people of time, money, effort, reputation and self in the meaning and movements which bears it" (pp.52-53).

To satisfactorily address the central question of how leaders induce the members of a team to voluntarily follow them, economists would seemingly have to combine Hermalin's insights into leading by example with an explanation of the inspirational effect of leader rhetoric along the lines suggested in this section. While these two types of influence would be empirically difficult to separate, their analytical distinction would characterize that which the broader literature on leadership has long made between the "charismatic" and "inspirational" dimensions of this phenomenon (Downton, 1973; Howell, 1988). The relevance of the issues raised in this paper to other areas of economic thought and some directions for further development in the economics of leadership must now be considered by way of conclusion to this paper.

VI. CONCLUSION

The economics of organizations, the theory of collective action and the political economy of policy reform constitute three rapidly developing areas of contemporary economic thought in which an economic theory that addresses the issues raised by leadership theorists would appear to have a striking relevance. Both Hermalin and Casson have been impressed with the contribution an economic theory of leadership could make to economic analyses of organizations since the transformation of principal-agent into leader-follower relationships could do much to limit agent opportunism and avoid the transactions costs associated with contractual solutions to agency problems.

The significance of leadership has also been recognized in economic theories of collective action. In his seminal work in this area, Olson (1965) suggested that leaders exist to provide selective incentives that solve collective action problems. This approach was elaborated upon by Frohlich, Oppenheimer and Young (1971) who proposed that social leaders can found and expand organizations and seek collective benefits for interest groups in exchange for organizational and financial resources from organization members. The members of the group, who enjoy the collective and private benefits that leaders provide, have an incentive, then, to accept and contribute to the beneficial position of the leaders, giving them their support or votes. More recently, Colomer (1995) has found that his analysis "supports the conclusion that leadership can explain the creation of organizations for collective action and that leadership effects reinforce the differences in the relative strength of different kinds of groups" (p.225). While these theories of collective action highlight the significance of leadership they do not follow the broader tradition of inquiry into leadership in delineating its distinctiveness. This is because they tend to treat the interactions between leaders and followers as strategic and extrinsically motivated. It would seem, then, that they could be usefully complemented by a theory which explains how leaders can positively influence their followers' intrinsic motivation to strive to advance collective goals through a combination of exemplary action and inspirational rhetoric.

The significance of leadership to the political economy of policy reform (recently surveyed by Rodrik, 1996) was highlighted in a 1993 colloquium sponsored by the Washington-based Institute for International Economics. This brought together a group of high-ranking officials who had been key players in designing and pushing through reform programs in their particular countries to discuss the factors that contributed to their successful implementation and consolidation. Interestingly, among the factors cited most often were the need for "visionary leadership and for a coherent economic team" (Williamson 1994, p.589). A similar conclusion was reached by Krueger (1993) who writes that:

" . . . The adoption of the same economic policies in response to the same economic circumstances will ... have different consequences under a politically strong leadership of a government with a well-functioning bureaucracy capable of carrying out the wishes of the leadership than it will when... a weak leadership of a coalition attempts to do the same things in circumstances where bureaucrats believe that they can generate support for opposition to those policies" (p.9).

An impressive volume of case study material has accumulated in this area which suggests that the policy leadership required to drive radical reforms through the agenda-setting, formulation, decisionmaking, implementation and evaluation phases of the policy cycle is rarely supplied by one person⁹. It is much more likely to be collectively supplied by a reformist network of "technopols", "technocrats" and "change agents" who share a commitment to both advance the same policy quest and advance one another into positions from which they can exert leverage over the policy process (Wallis, 1999). The hopes that underlie and are expressed through these commitments are likely to be strengthened through social interaction in these

⁹ As Bryson and Crosby (1992) have pointed out:

" . . . In a world where shared power is more effective than individual power, the tasks of leadership must be widely shared. No one person can embody all the needed qualities or perform all the tasks. People will pass into and out of leadership roles; a person may be a leader on one issue and a follower on others. This year's leader on a particular issue may even be next year's follower on the same issue" (p.32).

horizontal leader-leader networks in a way similar to that described in the previous section with the exception that no one person would play a focal role as they tend to do in vertical leader-follower relationships.

While the theories of team leadership discussed in this paper could make a useful contribution to the policy reform literature, this literature does, in turn, intimate at least one area of future development for the economics of leadership. According to Rodrik (1996), the issue of how participatory reformist policy leadership should be is "a fundamental fault line that divides the contributors to this literature" (p.32). This is also a major concern in the broader tradition of inquiry into leadership in which distinctions are repeatedly made between styles of leadership that are "democratic", "participative", "group developing", "relations-centered", "supportive" and "considerate" on the one hand, and those that are "authoritative", "dominating", "directive", "autocratic", "task-oriented" and "persuasive", on the other hand. Bass suggests that "it is possible to encapsulate many of these typologies into the autocratic versus democratic dichotomy" (1990, p.33).

Scope would seem to exist, then, to extend the economics of leadership to address the question of effective leadership style. Rotemberg and Saloner (1993) have already made some progress in this regard by showing that shareholders gain from appointing participatory leaders when firms have the opportunity to exploit numerous innovative ideas and more autocratic leaders when the environment is relatively poor in new ideas.

This type of analysis does, however, need to be extended to consider criteria, other than effectiveness, according to which leadership styles can be evaluated. Social capital theory does seem to provide a broader perspective for evaluating different styles and instances of leadership. The key measurable components of social capital identified by various writers on this subject (Putnam, 1993; Fukuyama, 1995; and Knack and Keefer, 1997) are "networks of civic engagement", "norms of generalized reciprocity" and relations of social trust. While the theories of team leadership discussed in this paper would seem to explain how social capital can be

developed within bounded groups, social capital theorists are often more concerned with factors allowing a broader social rather than a narrow group cohesion. They have found that the link between social capital and economic performance is strongest where it promotes social cohesion, a goal that is realized in a society in which people work toward common goals and in which diversity is recognized but does not lapse into conflict (Knack and Keefer, 1997, p.1283). The view that leadership should be evaluated according its impact on social cohesion has been forcefully made by Burns (1978) who asserts that it is a characteristic of "good leaders" that while they may initially be locked into relationships that are "closely influenced by particular local, parochial, regional, and cultural forces" they should be able to "find a broadening and deepening base from which they could reach out to widening social collectivities"(p.429). This suggests that the economics of leadership might eventually have to move beyond a narrow focus on the leader-follower relationship to a broader consideration of the impact of different styles of leadership on social cohesion.

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