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Welfare economics and the economics of socialism

Towards a commonsense critique

WELFARE ECONOMICS AND THE ECONOMICS OF SOCIALISM

TOWARDS A COMMONSENSE CRITIQUE

by MAURICE DOBB

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PREFACE

Although some of the chapters which follow originated in lectures, as may well be apparent, there is little attempt in this work either to fashion novel analytical techniques or to expound precepts for handling particular problems of planning policy (for which the writer would have been insufficiently equipped). For this reason some may regard it as falling between stools and as failing to cater for what is professionally esteemed as being of intellectual interest and of moment. The writer's concern has been with the general framework of thought in which the economic problems of a socialist economy are approached; but with an eye to the economic content of the theorems that economists have propounded rather than to the enunciation of new ones. In this he has been influenced, no doubt, by the extent to which the somewhat tortuous history of Welfare Economics has witnessed formal sophistication serving as a cloak for deficient logic and plain confusion (this being nowhere more evident than in theorems about the welfare-yielding attributes of perfect competition). The humbler task of clarifying meaning and relevance and putting problems in perspective seemed more likely to be 'fruit-bearing', at any rate so far as the building of a political economy of socialism was concerned, with a view to realistic comparison of the modes of operation of different economic systems or to improving the methodology and the practice of planning. Discussion of the latter as well as accumulated experience in the socialist countries of eastern Europe now suffice to allow at least some provisional generalisation to be made where this was scarcely possible thirty or so years ago; although attempt at generalisation has here been limited advisedly to what falls within the bounds of so-called 'optimising' problems. It is, perhaps, hardly necessary to add that the reference to 'commonsense' in the sub-title is intended strictly within the context we have mentioned and must not be taken as having wider philosophical implications.

While the author, not unnaturally, has had the student of economics and the professional economist in mind in writing this, he has tried not to burden the treatment with technicalities more than the subject itself obliges, and has sought to make the main issues at least accessible to the layman who is enquiring enough not to be deterred by a few diagrams and some specialised terminology from finding what the discussion is about in plain words. He even ventures to hope that the result may be to reveal the subject as less tricky and devious than economists have recently tended to make it.

Acknowledgement and thanks are due for advice on special points to Professor K. A. Naqvi, Professor A. K. Sen and Dr L. Pasinetti, and for the benefit of discussion, comment or detailed suggestions also to Professor Leif Johansen, Professor J. Mirrlees, Mr D. M. Nuti and Mr Brian Pollitt. But this must not be held to associate them with the views expressed or with any of the reasoning employed in the following chapters.

M. H. D.

Cambridge, June 1968

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PART I

WELFARE ECONOMICS

CHAPTER I

INTRODUCTORY

Modern discussion of what has come to be called Welfare Economics, while it has not been at all lacking in formal refinements, has often been defective in economic content and in relevance, especially in its application to the comparison of different economic systems. The present attempt to re-survey the field makes no claim to add anything new to the former; but it does venture to hope to make some contribution on the side of commonsense and of practical meaning.

It is true that some professional economists today regard the analytical study of welfare as a boring irrelevance. This is largely because discussion of the difficulties posed by the so-called 'denial of interpersonal comparisons of utility' (of which we shall have more to say below) has become over the past two or three decades increasingly restricted in scope and appears now to have reached a dead end. It has become fashionable among economists to assume that no answers about welfare are possible without resort to so-called value-judgements and that everything involving these must fall outside the boundaries of economics treated as 'a positive science'. Economists are advised to stick to the analysis of various types of market equilibrium. Yet questions involving welfare obtrude themselves into almost every discussion of economic policy (including the policy of non-intervention and of 'leaving it to the market'); and if he persists in closing his eyes to such questions, then it would seem that the economist, *qua* adviser, "had better be suppressed completely" (as Sir Roy Harrod once warned his colleagues would be the logical outcome of current tendencies in their thinking).*

At the same time the inclination of socialists, at least those of Marxist persuasion, had been to dismiss the whole subject as part of the delusive heritage of the 'marginal utility' approach inherited from Jevons and the Austrian School, with their

* R. F. Harrod, 'Scope and Method of Economics', in *The Economic Journal* (Sept. 1938), p. 397. (For the fuller context of this remark, see below, page 81.)

obsession with justifying free competition and the free market in terms of the maximising of utility. Such a dismissal is understandable in view of the apologetic uses to which the notion of utility has commonly been put. None the less, the classical heritage, with its Smithian dichotomy between 'value in use' and 'value in exchange', should have reminded them that propositions referring to the former are not identical with those referring to the latter, and that maximising a sum of use values (if that can be given a meaning) is to be distinguished from maximising either profits or a sum of commercial values. Had this been remembered, less surprise might have been shown at certain recent tendencies in economic discussion in the socialist countries of the contemporary world, where attention is being increasingly turned towards maximum satisfaction of consumers' needs and towards means of ensuring that optimal as well as self-consistent plans are chosen. Experience seems to indicate that a planned economy cannot entirely dispense with discussion about welfare criteria in some shape or form;* and whether it can or cannot has nothing to do with the validity of the 'classical' approach *versus* the 'neo-classical', of the Marxian theory of value and surplus value as against the theory of value and distribution of Jevons or Pareto.

* In this connection an article by Y. V. Sukhotin, 'On Criteria of Optimality in an Economic Plan' in *Ekonomika i Matematicheskie Metodi*, Moscow, 1966, no. 2, pp. 283–94, is significant in emphasising that "comparison of useful effects of different means of consumption" (Marx) is essential to any notion of optimality in the sense of the attainment of a "maximum level of welfare". "The composition of an optimal economic plan," he writes, "must necessarily include in itself a search for the best structure of final production, and not start from an already formulated (in some fashion not known) assortment" (p. 286). He then goes on to define an optimum assortment as one which expresses "a full correspondence between the share of each product in total expenditures of social labour and its significance in the balance of social consumption" (p. 290); quoting the remark of Engels in *Anti-Dühring* (to which Oskar Lange long ago drew attention in his *On the Economic Theory of Socialism*, Minnesota, 1938, p. 133): "The plan will be determined in the last analysis by a weighing and comparison of the useful effects of various means of consumption one with another and with the quantities of labour necessary for their production." *Cf.* also A. N. Efimov (ed.), *Ekonomicheskoe Planirovanie v S.S.S.R.* (Moscow, 1967), p. 28: "Marxian economic theory has always attached great significance to the category of social utility. It has criticised and criticises the bourgeois conception of so-called marginal utility, not for operating with the category of utility itself nor for using the method of analysis of marginal magnitudes, necessary in every science, including economics. . . . But Marxism acknowledges the important role in economic processes of the category of social utility, consumers' [use] value of goods and social use-value."

It happens (as we shall see) that much of the modern discussion of economic welfare developed out of a debate about economic rationality in a socialist economy, even if the notion of maximising utility (connected with what Marshall called "the Doctrine of Maximum Satisfaction") was first introduced in the context of perfect competition. It is accordingly interesting to find today the Director of the Institute for Mathematical Economics of the Soviet Academy of Sciences (founded in 1963) declaring that "realisation of the principle of economic optimality is characteristic only of a socialist type of economy and presupposes first and foremost the presence of social ownership of the instruments and means of production, planned development of the national economy and socialist forms of distribution".*

There is a particular respect, it is quite true, in which the approach to problems of economic welfare has been biased by those theories which, since Jevons, have analysed exchange-value in terms of the subjective attitudes or the behaviour-reactions of individual consumers. This bias is implicit in the essentially individualist presuppositions of that approach. The individual is treated as the primary atom, and his wants or preferences as the ultimate data of the problem; individuals being regarded as independent units with respect to the influences affecting demand.† It is scarcely surprising that what has been called consumers' sovereignty should be an implicit corollary of this approach—a sovereignty that a free market (under perfect competition) is held to enshrine. *Per contra* it has been held that in so far as planning interferes with, or supplants, the automatic mechanism of a free market, the rule of consumers' preferences over production is replaced by the 'arbitrary' rule of something called 'planners' preferences', or more pejoratively

* N. P. Fedorenko in *Ekonomika i Matematicheskie Metodi* (1965), no. 3, p. 313.

† *Cf.* Paul Streeten: "Les interêts des hommes ne sont pas des données ultimes mais sont eux-mêmes le resultat du cadre économique et social qu'elles contribuent elles-mêmes à former; l'utilité, la satisfaction, le bien-être, le bonheur, etc., ne sont pas des entités isolées, autonomes . . . Les intérêts sont largement influencés par les activités et les interêts des autres membres de la société et par des valeurs que crée l'activité économique. Cette dépendance des desirs vis-à-vis de l'activité sociale va plus loin que l'influence de la publicité, qu'on cite souvent, ou la volonté que se manifeste dans la demande des diamants" (*Économie Appliquée*, Tome v, no. 4, Oct.–Dec. 1952, p. 449).

by 'dictatorship"* Some might say that this sort of corollary may be a habit of thought engendered by myopic concentration on indifference-curves or behaviour-lines, but is not a logical inference from this type of approach. None the less, the latter holds a bias, from the very manner in which the problem is framed, towards ignoring the *inter*dependence between individual desires, through the play of social convention, emulation and other Veblenesque factors, as well as their dependence on producers' initiative (notably with regard to new products), producers' propaganda and presentation. Of the social formation, more generally, of individual tastes and of preferences over time Dr Graaff has said: "Little room is left for doubt about the extent to which tastes (and, naturally, especially those of the young) are moulded by social forces."† Such neglect can beget, indeed has begotten, fallacious interpretation. Professor Alvin Hansen has even gone so far as to declare of the present advertising age that "nowadays consumers no longer act on their own free will. The demand-curve is no longer the product of spontaneous wants. It is manufactured . . . The consumer is 'brain-washed' . . . [and] the process of consumer brain-washing has become a branch of psychoanalysis. Consumer wants are no longer a matter of individual choice. They are mass-produced."‡

To say that individuals and their desires cannot be treated as absolutes in considering the ends of economic activity, and that analysis cannot start from them, is not to say that individuals do not matter at all: this would be to accept the unreal antithesis between 'consumers' sovereignty' and 'dictatorship' that individualist theory itself has formulated. The fact remains that purely individualist conclusions are implied in any approach that ignores the complex social influences which serve to mould the wants and market-behaviour of individuals and which make the demand-pattern of a market so largely a reflex

* *Cf.* Branko Horvat, *Towards a Theory of Planned Economy* (Beograd, 1964), p. 32: "It would seem necessary to call attention to a dangerously misleading practice, common to many economists, of treating all non-individualist choices as *arbitrary*."

† J. de V. Graaff, *Theoretical Welfare Economics* (Cambridge, 1957), p. 44. Of so-called 'external effects', Dr Graaff adds: "In the main there has been a tendency for professional economists—with notable exceptions—to ignore them" (p. 43).

‡ 'The Economics of the Soviet Challenge', in *Economic Record* (March 1960), p. 10.

of the socio-economic relations of a given society (*e.g.* through the distribution of income and the class conventions and standards associated therewith).

Clearly, there is still a good deal in the modern debate which remains to be clarified; and some of the issues in the discussion among English-speaking economists of thirty years ago have reappeared in recent discussion in socialist countries, if in a more realistic context and within a setting of given institutional constraints. There would seem to be some point, at least, in reviewing the subject again, if only to sort out wheat from chaff and to purge our thinking of confusing formulations and unreal questions. Such positive conclusions as emerge may appear to some unworthy of the machinery by which they are produced and as adding little to what unaided commonsense could discern. Whatever their proper assessment may be, however, the sceptical reader can be assured that no bold claims are made for these conclusions in the sequel, and that as much attention is paid to what can *not* be said as to what can usefully be said and should be observed in the course of formulating policy.

One conclusion of the present study will be that there can be garnered from a discussion of theoretical welfare economics (as this has been conducted in the past) a limited number of conditions, or criteria, for attaining an *optimum*—as necessary conditions for maximising economic welfare; but that such conditions are far from being *sufficient* conditions, and cannot be made to yield a unique maximum without introducing some *deus ex machina* that only *seems* to afford an answer on a purely formal plane without really doing so. It follows that, while we can derive some useful and quite important rules for avoiding certain kinds of *non*-optimality—certain kinds of irrationality or inefficiency in the use and deployment of economic resources—there is no such thing as a unique set of 'rational prices', as many (if not most) economists have apparently supposed, and no such thing as a uniquely efficient production-pattern and allocation of productive resources.* That this is

* One should, perhaps, explain forthwith that this must not be taken to imply that, in face of a *given output-plan* (or alternatively a system of weighting the various competing ends of activity) there is not an optimum use and disposal of productive resources to achieve this (with a set of 'shadow prices' relative thereto). Also, as we shall suggest later, with a given rate of growth there is an optimising system of pricing material inputs and products.

the case has no doubt been appreciated by a number of economists taking part in the debate. Yet they seem too often to have remained captive, nonetheless, of accepted habits of thought when formulating conclusions; and the illusion of a unique optimum has at any rate persisted to breed quite a tribe of fallacy. Here as in other fields one could well say, with Lord Keynes,* that "the difficulty lies, not in the new ideas, but in escaping from the old ones, which ramify, for those brought up as most of us have been, into every corner of our minds".

Although such a degree of scepticism as this will no doubt make more difficult the task of those seeking to demonstrate that optimality (in its static interpretation) is "characteristic only of a socialist type of economy", at the same time it draws the sting from the many charges levelled at a socialist planned economy of patent irrationality *sui generis* by comparison with a 'free market system'. In doing so it may enable us to view the actual problems of a socialist economy (to which we shall come in Part II) in fresh perspective and with less clouded eyes.

* In the Preface to *The General Theory of Employment Interest and Money* (London 1936), p. viii.

CHAPTER 2

UTILITY AND PERFECT COMPETITION: WALRAS AND PARETO

The justification in a rigorous form of free trading and free competition on the ground that the resulting situation represented a maximum of utility to the parties concerned was afforded by Léon Walras in 1874, and was afterwards developed by his successor (in the Chair of Political Economy at Lausanne), Vilfredo Pareto. This was something that had been lacking in the case for free trade as presented by the classical economists, which had linked the argument with particular objectives such as promoting the accumulation of capital or "greatest improvement in the productive powers of labour" and "progress of opulence".* Walras, after setting out the general equilibrium-conditions of exchange, first enunciates the proposition that "given two commodities in a market, each holder attains maximum satisfaction of wants, or maximum effective utility, when the ratio of the intensities of the last wants satisfied [by each of these goods], or the ratio of their *raretés*, is equal to the price". Then, after setting out the equilibrium conditions for production in a set of production equations, he concludes that, when "production in a market ruled by competition" takes place, "the consequences of free competition . . . may be summed up as the attainment, within certain limits, of maximum utility. Hence free competition becomes a principle or a rule of practical significance, so that it only remains to extend the detailed application of this rule to agriculture, industry and trade."†

* It is true that the germ of the later idea was implicit in Adam Smith, who said that "consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to, only so far as it may be necessary for promoting that of the consumer" (*An Inquiry into the Nature and Causes of the Wealth of Nations*, 4th edition, London, 1826, p. 620); while Bentham used utility as the touchstone of economic policy. But explicit statement of maximising conditions, or the stipulation of an 'objective function' to be maximised, was absent (*cf.* Hla Myint, *Theories of Welfare Economics*, London, 1948, pp. 53–5).

† L. Walras, *Elements of Pure Economics*, trans. William Jaffé (London, 1954), pp. 125, 255 (*Leçons* 8, 22).

This proposition, while emphasising it as a rule of practical policy ("the conclusions of pure science bring us to the very threshold of applied science"), he was quick to qualify two pages later, firstly with the remark that "this principle of free competition, which is applicable to the production of things for private demand, is not applicable to the production of things where public interest is involved", and secondly by pointing out that "the question of the [original] distribution of services remains open, however"—as he added, "an observation of fundamental importance".* If we substitute here the word "wealth" for "services", which better conveys to our ears the meaning he was intending, we shall see that he was not unaware of a consideration that will recur repeatedly in our subsequent analysis. But the qualification, important as he himself apparently considered it to be, was not emphasised at the time and was more often than not forgotten by those who quoted and made use of his proposition.

This idea that free exchange resulted in a maximum of satisfaction to those concerned in the exchange was developed by Pareto with the aid of Edgeworth's indifference-curves and the notion of tangency of indifference-curves as the condition of equilibrium in exchange. It is in this form that the principle is familiar to students of economics today. He defined a position of maximum (maximum *ophelimité* as he preferred to call it) as one where no further exchange could bring further benefit to *both* parties (or if to one only, then without loss of benefit to the other). As he says in the *Manuel:* "We are therefore led to define as a position of maximum *ophelimité* one where it is impossible to make a small change of any sort such that the *ophelimités* of all the individuals, except those that remain constant, are either all increased or all diminished".† Until such a point was reached in exchange, there would be further possible exchanges of potential mutual benefit; and if the trading process stopped short of this point (owing to inertia or ignorance, for example, or to some artificial barrier such as rigid

* *Ibid.* p. 257 (*Leçon* 22). It would appear that Walras had only in mind here distribution as a question of "justice" between the parties, and not as something that affected and qualified the nature and significance of the 'maximum' reached —the aspect which will be developed below.

† *Manuel d'économie politique* (Paris, 1909; being the French version of the *Manuale di economia politica* of three years earlier), pp. 617–18, also *cf.* p. 354.

prices inconsistent with reaching the maximum position) there would be a loss of (potential) utility to both parties. Until it is reached, some gain of utility is possible to one party at least without involving any loss to the other. This limit beyond which no further mutually beneficial exchange is possible was formally defined by the familiar condition that the ratios of the marginal utilities of the goods in question were equal to the rates of interchange of these goods, or to the ratios of their prices; this condition holding for *both* (or all) parties to the exchange. In the language of indifference-curves it is where the price-line, or exchange-line, is tangential to indifference-curves of the two parties (which are accordingly tangential to one another). Such a point is customarily referred to as a Pareto-optimum, or utility-maximum.

It should be intuitively obvious that, attractive as this notion is at first sight, the maximum that it defines is a conditional one and does not define a unique position. To speak of the best one can do, or the furthest one can go, within the limits of *mutual* benefit, leaves open the area of possible positions where, although further mutual gain is excluded, it is quite possible for one person to gain more than another loses.* No criterion of choice is afforded within *this* area. The Pareto-criterion stops short, as it were, of providing an answer precisely within a region of decision where possibly the most crucial (and in practice the most difficult) decisions may lie. Another way of putting it is to say that it merely expresses how the utility of any one individual can be improved on the assumption that the utilities of all other individuals in the community are held constant at some arbitrary levels.† Indeed, the Pareto-corollary to the effect that free trading results in a maximum as defined might seem to be a quite trivial result, and something pretty close to a tautology. If free trading is conceived of as a process of unhampered exchange between freely acting individuals, each conscious of and motivated by his own benefit, it is obvious that exchange between them will proceed so long as both (or all) parties see a benefit to themselves in proceeding and will stop

* *Cf.*: "the subjective optimum defined in the Paretian way has nothing to do with the maximum sum of satisfaction of both individuals" (H. Myint, *op. cit.* p. 103).

† *Cf.* Oskar Lange, 'The Foundations of Welfare Economics', in *Econometrica*, vol. 10, nos. 3–4 (July–Oct. 1942), p. 218.