

Chapter 14

Consummation, Consecration, and Destruction of the Invisible Hand: Neoclassical Welfare Economics

During the first half century after the publication of the books by Jevons, Menger, and Walras, capitalism underwent rapid change and experienced extraordinary turbulence. The first and most obvious change was the movement toward industrial concentration and giant corporations with worldwide trusts and cartels. The second change was the imperialist frenzy of the major capitalist countries. The third change was merely one of degree: whereas capitalism had always been an unstable economic system, constantly experiencing alternating periods of prosperity and depression, the length and severity of these depressions grew worse and culminated in the worldwide Great Depression of the 1930s. Combined with these changes, as well as with the chaos and social unrest that resulted from the increasing instability of capitalism, was the worldwide social turbulence that was manifested in the massive upheaval of World War I, the Soviet Revolution, and the emergence of fascism in Italy and Germany.

The theorists whose ideas we examined in the preceding two chapters all tried to understand these momentous changes. The increased economic instability, and particularly the Great Depression, also caused John Maynard Keynes (whose ideas we will examine in the next chapter) to reevaluate the neoclassical theories that he had been taught and to reorient his own thinking toward understanding the nature and causes of depressions in a capitalist system.

But if one examines the writings of the economists in the strict utilitarian, neoclassical tradition during this period, one seldom finds any recognition that capitalism was undergoing a period of turbulent change. Say, Senior, and Bastiat had sanitized the theories of Smith and Ricardo and rejected every element of the labor theory perspective in classical economics. Instead, they had focused entirely on the utilitarian perspective—emphasizing market

exchange; calculating, rational, maximizing behavior; the essential similarity of all types of income (and hence the nonexistence of different classes in capitalism); and the universally beneficent harmony created by the "invisible hand" of free market exchange. Bastiat had declared that "political economy is exchange." With the discovery of the marginalist method of analysis by Jevons, Menger, and Walras, Bastiat's slogan became descriptive of nearly all orthodox neoclassical theory. Increasingly, neoclassical theory resembled medieval scholasticism, with innumerable scholars working endlessly to refine, develop, elaborate, and embellish the utilitarian vision of a society consisting of numerous, small, relatively powerless, rational utility maximizers, ceaselessly repeating the same harmonious social process.

Perhaps the three most obscurantist aspects of the theory were its conceptions of the entrepreneur, the nature of production, and the process by which competitive equilibrium prices were determined. We have already discussed the entrepreneur in Chapter 11: the entrepreneur was the person who perpetually hired factors of production, transformed them into finished commodities, and sold these commodities; the entrepreneur was motivated entirely by the desire to maximize profits, although in the neoclassical scheme there were never any profits when the economy was at competitive equilibrium. The entrepreneur never learned this sad fact, however, and endlessly bought factors and sold commodities in search of these nonexistent profits. At the end of each production period (if equilibrium prevailed), the entrepreneur found that paying each factor owner the value of what that factor created in the production process exactly exhausted the total value of what had been produced. The entrepreneur's only remuneration was the normal return received for his or her own factors that were used in the production process. He or she got no profit and therefore would have been just as well off if he or she had passively hired out their factor to another entrepreneur and not bothered to be concerned with profits at all.

As obscurantist as the neoclassical conception of the entrepreneur was, the conception of the production process was equally so. When neoclassical economists wrote about production, they never mentioned bosses and workers, strikes, lockouts, struggles over safety conditions or the length of the working period, speedups of workers, factory discipline, assembly lines, work stoppages, Taylorism, or any of the many other negative features of the production process under capitalism. Production, in neoclassical theory, was a kind of alchemy. The entrepreneur had a complex mathematical recipe, called a "production function," which explained how various combinations of quantities of the factors of production could be transformed into different quantities of outputs of finished commodities. The entrepreneur looked at the prices of the factors (which were provided by the market or by Walras's "crier") and the prices of the finished commodities (provided from the same source), and selected the factors to hire and the commodities to sell accordingly. He or she always made this selection, within the above-described constraints, so as to

maximize profits. Once such a choice was made, the problem of production was over. The alchemy of the production function simply transformed the inputs into outputs so that the cycle of exchanges could be completed. When competitive equilibrium prevailed, the profit-maximizing combination of inputs and outputs happened to yield no profit. Any other combination would result in a loss.

Such was the nature of the entrepreneur and the nature of the production process in neoclassical theory. They were useful fictions permitting the process of universally beneficial and harmonious market exchanges to perpetually repeat itself. For this reason we have said that, despite theorizing about production and production functions, neoclassical economic theory was the contemporary version of Bastiat's utilitarian vision. It was a theory of exchange, and, as such, it was an elaborate and esoteric version of Adam Smith's invisible-hand argument, in which there was very little concern with real production processes.

The third principal obfuscation of neoclassical theory was its conception of the process by which competitive equilibrium prices were determined. In this theory, each consumer, each owner of a factor of production, and each entrepreneur were passive "price takers." All prices were determined by the competitive market completely independently of the actions taken by any individual or business firm. Despite the considerable amount of attention that this problem received after the publication of Walras's *Elements*, the neoclassical theorists did not substantially improve on Walras's attempts to solve it. They could assert that these equilibrium prices were arrived at through a process of "groping," but they were never able to give any convincing empirical or theoretical argument to show that such groping would not take the economy farther away from equilibrium rather than closer to it. They could rely on Walras's useful fiction of the crier, but such an obvious resort to a useful fiction as a *deus ex machina* designed simply to hold the theory together reduced the effectiveness of the theory's ideological defense of free market capitalism.

In the more esoteric literature of professional journals, the neoclassicists demonstrated that the existence of such a set of equilibrium prices was not logically impossible, given their initial assumptions. This demonstration was taken as a reasonable justification for the textbook practice of simply assuming that this set of equilibrium prices existed and was known to all individuals and business firms.

This was a particularly critical assumption because the three pillars of the neoclassical ideological defense of free market capitalism were the marginal productivity theory of distribution (which will be discussed further in Chapter 16), the invisible-hand argument, and the belief, *held purely on faith*, that the free market forces of supply and demand automatically and efficaciously take the economy to a full-employment equilibrium (although, as we will see, one branch of neoclassical economic theory, in response to the ideas of Keynes, at least partially abandoned this third point). None of these three ideological

props for capitalism could be defended if the market did not automatically create equilibrium prices. Therefore, the third useful fiction of the crier was as important as the first two.

Before we proceed with a summary of neoclassical welfare economics—which is the final and most elaborate apotheosis of Adam Smith's invisible-hand argument—three comments must be made about the difference in style between this chapter and the preceding chapters, as well as the place of neoclassical welfare economics within the context of the entire neoclassical school. First, in this chapter we will rarely refer to the writings of any significant economic theorist. This is because neoclassical welfare economics is essentially an elaboration, with relatively minor modifications, of the analysis of Walras, and no particular theorist added so significantly to Walras's version of the theory as to merit individual treatment. If we were to make an exception to this statement, it would be for the refinements added by Walras's disciple, Wilfredo Pareto (1848-1923). Some economists have considered Pareto's contribution so significant that they refer to neoclassical welfare economics as "Paretian" welfare economics. Pareto's main achievement, however, was to recast Walras's ideas in terms of "indifference curves," which had first been developed by the Englishman Francis Y. Edgeworth (1845-1926).

In our explication of neoclassical welfare economics, we will follow Pareto (and most modern textbook presentations) and use indifference curves—and their analogue in neoclassical production theory, "isoquants"—to illustrate the concepts. We agree, however, with the statement made by the eminent historian of economic ideas Joseph A. Schumpeter, who wrote that "as pure theory, Pareto's is Walrasian—in groundwork as well as in most details."¹ Thus, Pareto, as well as all other subsequent theorists who refined Walras's version of the invisible-hand argument, were merely refiners and elaborators and will not be given separate treatment because of limited space. We will therefore simply present a general summary of neoclassical welfare economics without detailing the particular refinements made by different neoclassical economists.

Second, while most of the refinements of the theory had been made by the 1940s (with the exception of the treatment of "externalities," which was further refined in the 1950s and 1960s), we will generally use the present tense because this analysis still constitutes the heart of neoclassical analysis to this day.

Third, over the past century Walrasian welfare economics has become the dominant strain of neoclassical economics (particularly in the United States). Nevertheless, there are two somewhat different versions of neoclassical welfare economics. The one presented here is the dominant version. But there has also been an important minority strain that has persisted to this day and is heavily influenced (particularly on methodological issues) by Menger as well as by Walras. This strain has a somewhat different perspective, and it was known in the first few decades of the twentieth century as the "Austrian School," and then, during the 1950s and thereafter, as the "Chicago School." We will consider their ideas in Chapter 17.

Utility Maximization and Profit Maximization

Neoclassical microeconomic theory serves as the foundation of neoclassical welfare economics and is generally divided into two separate (but analogous and symmetrical) parts—the "theory" of consumer utility maximization and the "theory" of profit maximization by the firm. Both "theories" are simple demonstrations of the logic of constrained maximization.

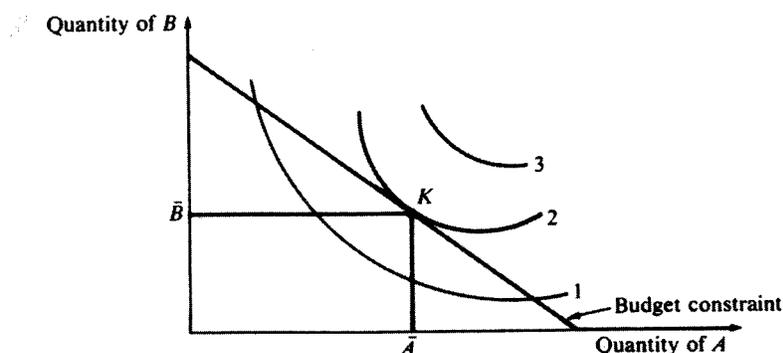
In textbook accounts, the theories yield several conclusions. The theory of consumer utility maximization, for example, shows deductively that a change in the price of a commodity usually (but not always) leads to a change in the opposite direction in the quantity demanded of that commodity. The theory shows how the change in the quantity demanded can be conceptually separated into one part caused by the "substitution effect" and another part caused by the "income effect." Students of economics are usually required to learn a somewhat esoteric mathematical proof of the conceptual identifiability of these two effects, but rarely, if ever, are they told why such a separation has any practical or theoretical importance. It is merely an analytical exercise by which one demonstrates one's competency as a neoclassical theorist. The same is true for most of the other analytical deductions made from the premises of the theories of utility and profit maximization.

There are, however, some conclusions of these microeconomic theories that are important. These are the conclusions that form the foundations of neoclassical welfare economics, and their importance is purely ideological. It is only these aspects of neoclassical theory that we will consider in this chapter.

The use of indifference curves permits the marginal utility analyses of consumer utility maximization to drop the assumption that utility can be cardinally quantified. All that is required is that the consumer be able to list a preference ranking for different commodities. This represents only an ordinal quantification (or ranking) of utility and requires no interpersonal comparisons of utility, which we have already argued are conceptually impossible. The only requirements necessary to get the neoclassical results are that indifference curves have the general configuration illustrated in Figure 14.1 and the consumers act "consistently." Consistency is defined in this manner: If an individual prefers X to Y and prefers Y to Z , then that individual must always prefer X to Z .

Indifference curves permit the neoclassical economist to illustrate graphically how the consumer maximizes his or her utility when there are only two commodities to purchase and consume. The same conclusions can be derived mathematically for many commodities, but the two-commodity case is much simpler and suffices to illustrate the point. In Figure 14.1 the axes of the graph measure quantities of goods A and B . The individual is presumed to be able to rank all possible combinations of A and B that he or she might consume. If the individual gets more of both A and B , his or her utility always increases. If the individual gets more of A and less of B (or vice versa), then it is assumed

Figure 14.1 Consumer Utility Maximization



that he or she can always tell when the added utility from the extra A exactly offsets the utility lost from the decrease in B . The three curves in Figure 14.1 are indifference curves. On each curve are points representing "bundles" of A and B that give the same amount of utility. As we move from one point on a curve to another point on the same curve, the utility gained by getting more of one commodity is exactly offset by the utility lost in getting less of the other commodity. Therefore, the consumer is indifferent between all the bundles of A and B represented by the various points on a single indifference curve.

Any number of indifference curves could be constructed on the graph for one individual. In Figure 14.1 we have three indifference curves. Curve 1 represents the lowest level of utility; curve 2 represents a higher level of utility (insofar as more of both A and B can be gotten by moving from curve 1 to curve 2); and curve 3 represents an even higher level of utility.

The straight line in the figure is the consumer's "budget constraint" line, which shows what combinations of A and B the individual can buy with the income that he receives from the sale of his productive factors. The distance between the budget constraint line and the origin of the graph indicates the size or purchasing power of the individual's income. The slope of the budget constraint line gives the ratio of the prices of A and B (in Figure 14.1, the slope of the budget constraint line is P_a / P_b , or the price of A divided by the price of B).

It is clear that in the situation depicted in Figure 14.1, the consumer maximizes his or her utility by buying and consuming quantities A and B on indifference curve 2. Any higher indifference curve cannot be attained, given the consumer's budget constraint. Any other attainable point within his or her budget constraint lies on an indifference curve below curve 2. Therefore, point K maximizes the individual's utility, and the individual in neoclassical economic theory will always choose point K .

The slope of an indifference curve at any particular point measures the ratio of the marginal utility of A to the marginal utility of B [MU_a / MU_b] at that point. The slope of the budget constraint line measures the ratio P_a / P_b . At

point K , indifference curve 2 is just exactly tangent to the budget constraint line. Therefore, at point K for this individual, it must be true that $(MU_a / MU_b) = (P_a / P_b)$, or what amounts to the same thing, $(MU_a / P_a) = (MU_b / P_b)$. We thus see that point K satisfies the utility-maximizing condition formulated by Jevons and Walras.

Furthermore, because each individual, under a system of perfect competition, faces the identical prices for A and B , it follows that each individual will move to a point on one of his or her indifference curves at which the same maximizing condition is met. Therefore, the equilibrium market prices of A and B , as determined by the competitive market (or by the crier), *perfectly reflect the marginal psychic evaluation of A and B for every single consumer.*

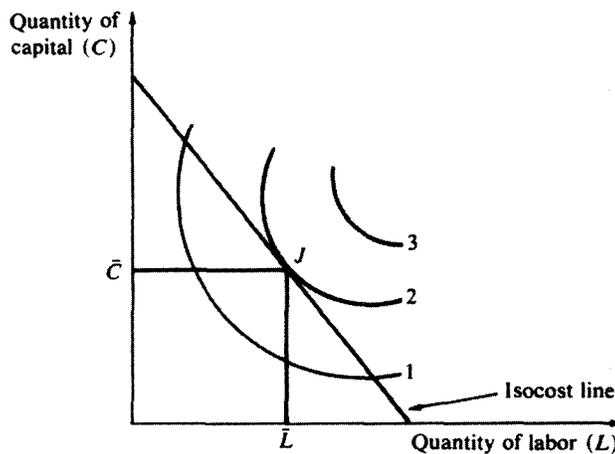
That is, if the equilibrium price of A , for example, is twice the equilibrium price of B , then every single individual psychically considers A to yield twice as much marginal utility as B after he or she has achieved an optimum level of consumption. Therefore, prices perfectly reflect marginal utility for every consumer—and the attainment of this result in a free market is exactly what neoclassical economists mean by the phrase "consumer sovereignty."

The demonstration of a firm's profit maximization is nearly identical to that of an individual's utility maximization. In Figure 14.2, the axes of the graph measure quantities of labor (L) and capital (C) used in a firm's production process. Curves 1, 2, and 3 are now isoquants, which show the various combinations of labor and capital necessary to produce a given level of output (the output could be either commodity A or commodity B). Each curve represents one level of output and is derived from the firm's production function; the closer a curve is to the origin of the graph, the smaller the output represented. The straight line is an "isocost" line, showing various combinations of labor and capital that a firm can purchase with a given outlay of money.

The firm in Figure 14.2 produces on isoquant 2 at point J . It hires quantities C and L of capital and labor. This solution can be interpreted in either of two ways: first, if the firm decides to produce at the output level represented by isoquant 2, then the isocost line shows the lowest cost at which it is possible to produce this amount. Second, if the firm decides to spend only that amount represented by the isocost line, then isoquant 2 represents the maximum possible production for this level of expenditure, and C and L represent the amounts of capital and labor, respectively, that can be purchased for this given outlay and that will maximize the quantity of output that the firm can produce with this outlay.

All firms in a perfectly competitive equilibrium situation will be faced with the same prices for capital and labor (which, again, are determined by the market or by the crier). Hence, all firms will produce at a point such as J on their isoquant curves. The slope of the isocost line is P_L / P_C (or the ratio of wages to interest). The slope of the isoquant is MP_L / MP_C (or the ratio of the marginal product of labor to the marginal product of capital). Therefore, in equilibrium, for each and every firm it is true that $(MP_L / MP_C) = (P_L / P_C)$. It

Figure 14.2 Profit Maximization



is relatively simple to demonstrate further that if perfect competition prevails, it will also hold true that both $VMP_L = P_L$ and $VMP_C = P_C$. That is, the value of the marginal product of each factor is exactly equal to the price of each factor. The marginal productivity theory of distribution holds true. Each factor gets the value equivalent to exactly what it produces at the margin. Production is maximized, and each factor owner receives as income just exactly the value of the marginal contribution of his or her factors.

The Beatific Vision and Eternal Felicity

On the basis of the conditions of utility maximization and profit maximization, neoclassical economists have built an elaborate, symmetrical, esthetically pleasing deductive and mathematical edifice; it "proves" that, given competitive conditions, utility-maximizing exchanging consumers and profit-maximizing exchanging entrepreneurs will automatically act and interact so as to maximize the social welfare. We will not go through either the mathematical or geometrical "proofs" of this conclusion but simply indicate verbally the nature of the steps involved and the intended importance of the analysis. The interested reader may wish to read an analytically elegant journal article in which Francis M. Bator gives a full demonstration of how a competitive, free market, capitalist society will reach a "bliss" point at which total social welfare is maximized.²

The demonstration begins by taking as given the total quantity of capital and labor available at a point in time. Using isoquants derived from the production functions for each of the consumer commodities produced, the profit-maximizing condition described above can be proved to be a necessary and sufficient condition for society to reach what is called a "production-possibility

frontier." A production-possibility frontier is a complex mathematical formula that shows all of the possible combinations of commodities that can be produced when all of society's labor and capital are *efficiently* utilized. Efficiency is attained when, for any combination of commodities produced, increasing the production of any one commodity necessarily entails a reduction in the production of other commodities.

Any point on the production-possibility frontier represents a total output comprised of a particular assortment of quantities of each of the commodities produced. At a given point, one can calculate the "marginal rate of transformation in production" for any two commodities. For example, the marginal rate of transformation of commodities *A* and *B* may be 2 : 1, which means that by giving up two units of *A*, one additional unit of *B* could be produced.

It can be proved that, under competitive conditions, the above-mentioned point on the production-possibility frontier (where the marginal rate of transformation is 2 : 1) will be attained when the equilibrium market price of *B* is twice as high as the corresponding price of *A*. Therefore, under competition, the marginal rate of transformation in production for commodities *A* and *B* will always reflect their prices. Once this particular level and composition of output is produced, consumers will exchange and acquire that bundle of commodities that maximizes their utility. If the 2 : 1 price ratio is an equilibrium price ratio, then all consumers can exchange for any quantity of either commodity that they desire (given their budget constraint) and all markets will clear; that is, supply will be exactly equal to demand in every market.

We have seen that when consumers exchange so as to maximize their utility, the 2 : 1 price ratio for *B* and *A* will exactly reflect the ratios of the marginal utility of *B* to the marginal utility of *A* for every consumer. Therefore, under competition, the marginal rate of transformation of *A* and *B*, as well as the ratio of the marginal utilities of *A* and *B* for each consumer, reflects the price ratio of *A* and *B*. If this were not so, and if the rate of transformation and the ratio of marginal utilities were not equal, then at least one consumer's utility could be increased without decreasing anyone else's utility, either through more exchange or through a change in the composition of output. But because it can be proved that, under perfect competition, all of these ratios will be equal if the economy is in equilibrium, then this is proof that the equilibrium level and composition of production and the resultant exchange of that production have led to a point on society's *utility-possibility frontier*.

Each point on the utility-possibility frontier represents a situation in which no change in production and no additional amount of commodity exchange could possibly make a single individual any better off without worsening the position of some other individual. Given the initial "endowment" of ownership of productive factors (or the initial distribution of wealth), utility has been increased through production and exchange to the maximum possible level consistent with that original distribution of wealth.

This point on the utility-possibility frontier is what neoclassical economists

call a "Pareto optimum." It represents the maximum welfare that society can derive from a particular distribution of wealth. Competitive utility and profit-maximizing behavior have been "demonstrated" to lead automatically to such a point. There is, however, a different Pareto optimum point for each possible initial distribution of wealth. So some individuals may judge other points on the utility-possibility frontier, representing other initial distributions of wealth, to be preferable to the one in question.

But such a judgment, as we saw in our discussion of Thompson's ideas, involves an interpersonal comparison of different individuals' utilities, something that is inherently impossible. It is, in the view of most neoclassical economists, merely a matter of personal bias or prejudice whether a person would like a more equal distribution of wealth or a less equal one. It is not a matter for "scientific economics." Not surprisingly, neoclassical economists have never been able to come up with an "objective" or "scientific" criterion for judging the appropriate distribution of wealth that is, at the same time, logically consistent with the individualistic assumptions of their utilitarian philosophy. To repeat what we have asserted numerous times in our discussions of utilitarian economics: Hedonism or utilitarianism gives one no basis whatsoever for making invidious comparisons among the desires and pleasures of different individuals.

However, if one likes the existing distribution of wealth, then the Pareto optimum point to which individual maximizing behavior automatically takes society is referred to, in neoclassical writings, as the "bliss point" or the "point of constrained bliss." Insofar as most neoclassical economists tend to find very little that is fundamentally wrong with existing capitalist society, it can be fairly said that neoclassical welfare economics represents the contemporary version of Saint Augustine's "beatific vision" of "eternal felicity."

Microeconomic Theory, Neoclassical Economics, and Welfare Economics

The previous section was necessarily terse and somewhat difficult to understand for anyone not already familiar with neoclassical welfare economics. The reason for this is that *contemporary orthodox microeconomic theory, as it is taught in most colleges and universities, is neoclassical economics. Moreover, the very heart of orthodox microeconomic theory, and the principal end toward which it is almost inevitably oriented, is neoclassical welfare economics.* This is a fact of such importance in understanding contemporary economic theory that it cannot be stressed too strongly. To give the careful reader a full and sophisticated understanding of neoclassical welfare economics would require one to write a complete text in intermediate-level contemporary orthodox microeconomic theory. Many such texts already exist that are coherently organized and reasonably well written, which those interested in pursuing this matter further can read.

In the meantime, we will discuss one of these texts. Although it might appear to be dated, it still remains highly typical of the orthodox academic treatment of microeconomic theory (and hence represents an accurate summary of the current state of the core of neoclassical utilitarian economics). The text is the revised edition of *Microeconomic Theory* by C.E. Ferguson, which consists of sixteen chapters. The last chapter is entitled "Theory of Welfare Economics,"⁵ and it is obvious that most of the first fifteen chapters are designed to lay the analytical foundations for the last chapter on neoclassical welfare economics, which is the climax and denouement of the entire book. Early in the final chapter Ferguson has written:

We now wish to show ... that a perfectly competitive, free enterprise system guarantees the attainment of maximum social welfare. The proof rests upon the maximizing behavior of producers and consumers. To recall the dictum of Adam Smith, each individual, in pursuing his own self interest, is led as if by an "invisible hand" to a course of action that promotes the general welfare of all.⁶

There follow nine pages of summary explanation outlining what we have verbally summarized in the preceding section. The most important aspect of these nine pages is this: Ferguson is able to tie together his demonstration of neoclassical welfare economics and the attainment of bliss in a coherent and brief manner, because with each point he makes, he is able to refer his readers to earlier chapters or sections of his book. His standard explanation of orthodox microeconomic theory has developed the ideas and analytical tools *that inevitably lead to the conclusions of neoclassical welfare economics*. Indeed, in examining the previous fifteen chapters, we can see very little else to which they do lead. The nine-page demonstration of welfare economics ties the entire book together and then concludes: "This unique equilibrium . . . is called the point of 'constrained bliss' because it represents the unique organization of production, exchange and distribution that leads to the maximum *attainable* social welfare."⁷

Furthermore, the neoclassical school is the dominant (and probably the numerically largest) school in contemporary economics. For neoclassical economists, microeconomic theory (i.e., welfare economics) underlies every theoretical subfield of specialization and every theoretical, practical, and policy-oriented conclusion at which they arrive. All of their cost-benefit analyses, their demonstrations of the universal gains from foreign trade, their notions of market efficiency that are encountered in every branch of applied economics, as well as their notion of rational prices, *have absolutely no meaning whatsoever* other than that manifested in their faith that a free-enterprise, competitive market system will tend toward a Pareto optimal situation. Without a Pareto optimal situation in effect, these phrases and notions cannot be defended. In fact, in the absence of an optimal situation, these phrases *have no meaning whatsoever*. They are given meaning only when the neoclassical economists first posit the existence of a Pareto optimum; then, *by definition*,

all exchangers are said to gain, resources are said to be "efficiently allocated," prices are said to be "rational" and therefore conducive to making accurate assessments—on utilitarian grounds—of the social costs and social benefits of various government projects. Utilitarian neoclassical welfare economics pervades and dominates nearly all neoclassical analyses on all theoretical and practical matters.

Neoclassical economic theory is the direct descendant of the portion of Smith's and Ricardo's ideas that was dominated by the utility or exchange perspective as developed and elaborated in the writings of Malthus, Say, Senior, Bastiat, Jevons, Menger, Walras, Marshall, and Clark. But neoclassical economics increasingly has taken the form of esoteric mathematical analyses, to the point where an economics student can spend years simply learning the analytical tools and techniques and easily become blinded to the philosophical and social values underlying the analysis. That is one of the reasons it is highly useful and important to examine the above writers' ideas, because the "smokescreen" of esoteric mathematics does not obscure these values. These philosophical, social, and moral values, which are obscured in, but nevertheless absolutely integral to, the writings of contemporary neoclassical economists, remain essentially identical to those unambiguously reflected in the writings of Malthus, Say, Senior, and Bastiat. The writings of Jevons, Menger, Walras, Marshall, and Clark initiated the progressive obscuration of these values, culminating in their being veiled behind an esthetically dazzling monument constructed with elaborate, esoteric mathematical elegance.

For this reason, it is important to construct a critique of contemporary neoclassical welfare economics that extends and refines many of our conclusions here, both explicit and implicit. The remainder of this chapter is devoted to such a critique.

Hedonistic Foundations of Welfare Economics

Neoclassical welfare economics rests squarely on hedonistic preconceptions. It contains both a psychological hedonism and an ethical hedonism. The psychological hedonism was, in the late nineteenth century, a rather crude theory of human behavior. Utility was conceived as a cardinally quantifiable relationship between a person and external consumable objects. This relationship was treated as though it were metaphysically given and fixed, and not a proper subject for further investigation. All human behavior was then reduced to attempts to maximize utility through the use or exchange of the commodities and productive resources with which the individual had been endowed (the source and propriety of the endowment, like the utility relationship, was beyond the purview of analysis).

Psychological hedonism, however, had been thoroughly discredited by the late nineteenth century. The development and refinement of the behavioral assumptions of welfare economics over the past century represent attempts

to obviate the objections against psychological hedonism while continuing to draw conclusions identical to those derivable from the discredited theory. Indifference curves permit the substitution of ordinal quantification of utility for cardinal quantification. Further, the word *utility* is frequently dropped in favor of the word *preference*. Preferences, argues the neoclassical economist, can be empirically observed, provided we assume that individual choices are consistent. The consistency, however, is merely the assumption that choices reflect a preexisting, metaphysically given "preference ordering" (empirical observation, of course, has continuously shown what common sense should have told these economists—that choices do not have this type of consistency). Cardinaly quantifiable utility or ordinally quantifiable preferences have identical psychological and ethical import, and welfare economics remains a hedonistic theory of maximizing economic humankind behaving in a manner totally predetermined, or programmed, by two metaphysically given, and, by implication, immutable entities: the preference ordering and the initial endowment of assets.

The ethical hedonism of welfare economics has been called the "pig principle" by Professor S.S. Alexander. The "pig principle" is simply "that if you like something, more is better."⁸ Thus, the ultimate normative principle of welfare economics can be stated several ways: More pleasure is ethically better than less (Benthamite version); more utility is ethically better than less utility (late nineteenth-century neoclassical version); and a more-preferred position on one's preference ordering is ethically better than a less-preferred position (contemporary neoclassical version). In each case, the isolated, atomistic individual is the sole judge qualified to assess the pleasure, utility, or preferability of an object because these welfare magnitudes are presumed to depend only on the relationship between the individual and the object of consumption. Individual desires, weighted by market purchasing power, are the ultimate criteria of social values. Whenever an individual's utility is not purely a personal, individual matter, that is, whenever the utility of one person is affected by the consumption of other persons (or the production of business firms), such interpersonal effects are labeled as "externalities." Externalities caused by interdependencies of preference orderings (i.e., consumption considered as a social activity) can be handled only by treating them as isolated exceptions (which will be elaborated below). Welfare economics ignores the fact that individual desires are themselves the products of a particular social process and the individual's place within that process. If neoclassical economists did not ignore this, they would have to acknowledge the fact that normative evaluations can be made of totally different social and economic systems and their resultant patterns of individual desires. Welfare economics is the direct descendant of the doctrines that Marx labeled as "vulgar economy," a point of view that "confines itself to systematizing in a pedantic way, and proclaiming for everlasting truths, the trite ideas held by the self-complacent bourgeoisie with regard to their own world, to them the best of all possible worlds."⁹

Essential Nature of the Norm of Pareto Optimality

Upon this foundation of psychological and ethical hedonism is constructed the norm of Pareto optimality—the core concept of welfare economics. We have already seen how neoclassical microeconomic theory inevitably culminates in the norm of Pareto optimality. This theory leads to the conclusion that a free market, competitive capitalist system inevitably allocates resources, distributes income, and apportions consumer goods among consumers so that no reallocation of resources through changes in consumption, exchange, or production could *unambiguously* augment the value of the commodities being produced and exchanged. This is Pareto optimality the fundamental norm of neoclassical economics.

The fundamental rule of Pareto optimality states that the economic situation is optimal when no change can improve the position of one individual (as judged by himself) without harming or worsening the position of another individual (as judged by that other individual). A Pareto improvement is a change that moves society from a nonoptimal position closer to an optimal position: "Any change which harms no one and which makes some people better off (in their own estimation) must be considered to be an improvement."¹⁰

The most significant point to note in the Pareto rule is its conservative consensual character. Defined away are all situations of conflict. In a world of class conflicts, imperialism, exploitation, alienation, racism, sexism, and scores of other human conflicts, where are the changes that might make some better off without making others worse off? *Improve the plight of the oppressed and you worsen the situation of the oppressor* (as perceived by the oppressor, of course)! Any important social, political, and economic situations where improving the lot of one social unit is not opposed by naturally antagonistic social units are indeed rare. The domain of this theory would, indeed, seem to be so restrictive as to hardly warrant serious investigation, were it not for the fact that the theory is considered important not only by the overwhelming majority of neoclassical economists but also by many unwary economists writing in the traditions of Marx and Veblen.¹¹

Social Values Underlying Welfare Economics

We have already stated that the meaning of the neoclassical notions of efficiency and rationality is inevitably tied to Pareto optimality. Acceptance of the efficiency or rationality of the free-market solution to the problem of the allocation of resources demands that one accept the social values as well as the empirical and behavioral assumptions underlying this neoclassical analysis. The above discussion of hedonism alludes to some of these social values. All of these values should be made explicit.

The only values that count in Pareto analysis are the preferences of each isolated individual weighted by his or her purchasing power. The individualism and the distributional assumption will be separately considered.

The axiom of individual preferences is extraordinarily constraining. Because in the neoclassical analysis we have no way of evaluating the relative merits of different persons' preferences, we likewise have no criterion for evaluating changes in a given individual's preferences. To be able to do the latter would imply the ability to do the former. At the level of abstraction on which this theory is constructed, individuals only differ in their preference orderings; there is absolutely no difference between a change in a given individual's preference ordering, on the one hand, and the complete withdrawal from society of one individual and his or her replacement by a new individual, on the other. For this reason the theory can consider neither the historical evolution of social and individual values nor their day-to-day fluctuations. To do so would be to admit the normative incomparability of any two events or situations that are temporally separated, that is, to admit the necessity of excluding nearly all real-life phenomena from the domain to which the theory is applicable. Conversely, to permit such normative comparisons would be to return to the egalitarian conclusions of utilitarian radicals and socialists such as William Thompson and, hence, to weaken seriously neoclassical economics as an intellectual support of the status quo.

It is therefore obvious that this theory is applicable only where individual preferences or tastes do not change over time. It is equally obvious that every person, including fanatics, lunatics, sadists, masochists, mentally incompetent persons, children, and even newborn babies must always be the best judge of their own welfare. (It might also be added that all decisions must be made individually and never simply by heads of families or leaders of other social groupings.) Every person must have perfect knowledge of all available alternatives with no uncertainty about the future. Unless these conditions are realized, people will find that the utility that they expect before an act will have no necessary relation to the utility realized after the act, and individual choices or preferences will have no demonstrable connection to an individual's welfare. This extreme individualism also breaks down when we admit the existence of envy and sympathy, which make one individual's perception of his or her own welfare depend on his or her perception of the welfare of others (this is, of course, a special case of the general problem of externalities, which will be elaborated below).

The fact that any Pareto optimum can be defended only in relation to a specific distribution of wealth and income is perhaps the most decisive normative weakness of the theory. Although neoclassical economists usually admit the extremely restrictive relativity of any Pareto optimum, they tend to ignore this restriction and hurry on to safer topics. By using the normative assumptions of Paretian analysis, it can be shown that unless the existing distributions of wealth and income are socially optimal, a situation that is Pareto optimal may be socially inferior to many situations that are not Pareto optimal but have preferable distributions of wealth and income. Neoclassical economists skirt this issue by inserting one standard sentence: "Assume that the existing

distributions of wealth and income are ideal *or that the government uses a system of taxes and subsidies to make them so.*"

After stating this standard caveat, the neoclassical economist proceeds to his or her policy analysis using cost-benefit techniques that assume the normative and empirical adequacy of standard Paretian analysis. The fact that the government has *never* used its taxing and spending powers to obtain a just distribution of wealth and power is never admitted. The lack of such an admission is not surprising, because it would force orthodox economists to discuss the nature of social, economic, and political power; and an analysis of vested economic interests and their relation to political power has always been taboo for neoclassical economists (and this is, of course, one of the many important differences between their theories and those of Smith, Ricardo, Thompson, Hodgskin, Marx, Veblen, Hobson, Luxemburg, and Lenin). The reason that no serious effort has ever been made to achieve a more just distribution of wealth and income—and the reason seems painfully obvious—is that the ordinary social, legal, and political means of making such a redistribution are themselves integral parts of the initial distribution of wealth. To possess wealth is to possess political power in a capitalist system. For those neoclassical economists who dislike the unequal distribution of wealth, the hope that those now holding political power will redress existing economic inequities is perhaps their most glaring blind spot.¹²

In practice, most neoclassical economists merely accept the existing distribution of wealth without question. Only rarely do they admit that accepting the existing distribution of wealth implies the acceptance of the existing system of legal and moral rules (including the laws of private property), and, more generally, the acceptance of the entire system of social power, all roles of superordination and subordination, as well as the institutions and instruments of coercion through which power is assured and perpetuated. Thus, most of the important issues that concern economists who are oriented toward a class-conflict approach are eliminated from the neoclassical economists' analyses by the initial assumptions of the Pareto approach.

Empirical and Analytical Assumptions of Welfare Economics

In addition to the assumptions of individualism and distributional justice, the neoclassical welfare theory requires many additional empirical and analytical assumptions. These make up the familiar intermediate microeconomic theory textbook recitation of the conditions necessary for equilibrium under pure competition (and no neoclassical economist has ever argued for any other means to achieve Pareto optimality in a capitalist economy). Among these are the assumptions that a capitalist economy includes:

1. a large number of buyers and sellers, none powerful enough to appreciably affect the market;

2. ease of any business firm to enter or exit any industry;
3. homogeneous inputs and outputs, each divisible into units of any desired size;
4. no uncertainty about the future;
5. perfect knowledge of all possible alternatives in production and consumption;
6. production functions having the "appropriate second-order optimality conditions" (i.e., being of smooth curvature, not having increasing returns to scale, and having diminishing marginal rates of substitution along any isoquant curve);
7. similarly appropriate utility functions that are stable over time;
8. productivity that is generally unaffected by the distribution of wealth, income, and power;
9. only those external economies and diseconomies (or "externalities") that can be corrected or nullified with taxes, subsidies, or the creation of new property rights; and
10. markets that are always in equilibrium, with all change represented as instantaneous shifts from one static equilibrium situation to another.

These assumptions do more than limit the domain of applicability of the neoclassical analyses of competitive equilibrium; they overwhelm the whole analysis. Assumptions 1 and 2 are the foundations of the orthodox concept of competition. But in the historical development of capitalism they were the first casualties of competition. Real capitalist competition, unlike the neoclassical textbook variety, is warfare, a deadly struggle to eliminate rivals and achieve monopoly. Competitive neoclassical equilibrium is often called "long-run equilibrium." Real capitalist development, however, moves inexorably in the opposite direction toward the more pervasive existence of monopoly and oligopoly.

Assumption 10 concerning the continuous existence of equilibrium is indicative of the general inability of neoclassical economics to deal with the historical development of economic phenomena. Despite innumerable attempts to formulate theories of economic growth, neoclassical economists have been unable consistently to integrate welfare and growth analyses. Once economic growth is admitted, the neoclassical analysis itself often shows that instability is the inevitable result.¹³ When instability and unemployment are admitted, the Pareto criterion seems unimportant even to most neoclassical economists. Moreover, not only is there nothing in the system to insure smooth, balanced, full-employment economic growth, but the essential question of *what* maximizes welfare in a growing economy is not clear. Is it maximizing the rate of growth, maximizing profit, maximizing total consumption, or maximizing consumption per person? Moreover, none of the proposed answers to these questions helps to resolve the issue of the nature and significance of a method of considering, or giving the appropriate weight to, the welfare of unborn generations, which is being decisively affected by current consumption and

investment decisions. Each possible criterion for judging welfare in a growing economy has no necessary connection to neoclassical welfare economics and no necessary consistency with the assumptions of the static theory.¹⁴ The neoclassical Paretian criterion simply cannot handle such problems. It is, by its very nature, a static theory that cannot be extended to describe a growing or changing economy.

The remaining assumptions (3 through 9) all involve similar difficulties. Assumptions 4 and 5 about certainty and perfect knowledge abstract from two inevitable consequences of free-market capitalism that are of singular significance in understanding the human costs of the system's instability and misallocation of resources. Assumptions 3 on homogeneity of inputs (particularly capital) and 6 about "properly behaved production functions" have both been shown to be untenable by the recent theoretical work of Piero Sraffa (which will be discussed in Chapter 16). Finally, assumption 9 about externalities is perhaps the most indefensible part of the entire analysis. We will examine it in greater detail below.

Neoclassical Welfare Economics as a Guide to Policy Making

Few neoclassical economists would argue that the assumptions underlying the theory of competitive equilibrium are realistic, but nearly all accept the social, moral, and philosophical foundations of the Paretian welfare criterion. This lack of realism, however, does not prevent neoclassical economists from advocating the theoretical model as a basis for policy making by government officials. The analysis should not, they argue, be considered as descriptive of reality but as a normative model that can be used to guide government interventions into the marketplace whenever any of the above assumptions necessary for competitive equilibrium are not met.¹⁵ Two criticisms should be made regarding this view of government interventionism in a capitalist economy.

First, the neoclassical view gives government a shadowy existence. As long as Pareto optimality exists, it is never mentioned. When an imperfection occurs (which is generally regarded as an isolated occurrence in an otherwise perfect world), the government becomes a *deus ex machina* that restores the system to a state of bliss. It is an aloof, impartial arbitrator that descends on the scene and enacts an excise tax or gives a subsidy in order to restore Pareto optimality. If neoclassical economists are asked about vested interests, corruption (which is, after all, simply another aspect of the functioning of the market), economic and political power, or class control of government processes, they reply with disdain that these issues are the concern of sociologists and political scientists (although one searches in vain for such concerns in most conservative, orthodox social science).

The second criticism of Pareto optimality as a norm for government policy is even more damaging. Perusing the several necessary assumptions and contemplating the hundreds of thousands of interdependent markets in the

contemporary capitalist economy, one is impressed by the certainty that at any moment there are innumerable departures from Pareto optimality. The neoclassical economists themselves, in response to the many criticisms about the lack of realism of the assumptions of their theory, modified the theory with the intention of making it more realistic. The modification was dubbed the "theory of the second best" and was still based squarely on the same utilitarian foundations as the original neoclassical version of welfare economics. But the modified version of the theory led to unexpected logical conclusions. According to "the theory of the second best," policies designed to remedy only some and not all of the defects (insofar as simultaneously remedying all would obviously be impossible) will often result in effects diametrically opposed to those intended. In the words of the eminent economic theorist William J. Baumol:

In brief, this theory [of the second best] states, on the basis of a mathematical argument, that in a concrete situation characterized by *any* deviation from "perfect" optimality, partial policy measures which eliminate only some of the departures from the optimal arrangement may well result in a net decrease in social welfare.¹⁶

Where then does this leave the normative theory of Pareto optimality, on which the neoclassical notions of market efficiency and rational prices (not to mention the classical liberal argument for laissez-faire capitalism) are based? The answer is obvious: it is a normative ideal, constructed on the most implausible and unrealistic of foundations, whose adherents cannot show (even in theory) whether any given policy decision will move the economy closer to or farther from the ideal; it is riddled by even more acute contradictions than the economic reality from which it springs and for which it attempts to provide both an obscurantist veil and an ideological defense.

Welfare Economics and Externalities

The Achilles' heel of welfare economics is its treatment of externalities. Of all the unrealistic assumptions underlying neoclassical theory, those upon which this treatment are based are the most implausible. In the usual neoclassical approach, the processes of production and consumption are assumed to have "direct" effects on only one or a few persons who are doing the producing or consuming.¹⁷ Externalities occur when the utility function of one consumer is affected by the consumption of another consumer; or the production function of one firm is affected by the production of another firm; or, most important, the utility of an individual is affected by a production process with which he or she has no direct connection. The traditional neoclassical approach is to assume that, except for a single externality, Pareto optimality exists everywhere. With all prices other than those in the market in question reflecting "perfect market rationality," the welfare economists claim to be able to simulate what would have been the correct, rational market price for the unpriced effect of

the externality through a process of extrapolation or interpolation (commonly referred to as cost-benefit analysis).

The cost-benefit analysis that can be used to correct externalities is itself a mere extension of the Paretian theory of allocative efficiency. As an important contemporary neoclassical theorist has stated:

A person who agrees to apply the principles of allocative efficiency needs no new assumption to extend his agreement to the application of existing cost-benefit analysis. In sum both the principles of economic efficiency and those of cost-benefit analysis derive their inspiration from the . . . Pareto criterion, and a person cannot with consistency accept the one and deny the other.¹⁸

The externality being analyzed is not really imagined to be the only actual deviation from Pareto optimality. Rather, it is asserted that this approach is only a tolerably close approximation to reality. The same neoclassical theorist further asserts that "although it is not expected that the economy at any moment in time, attains an optimum position, in its continuous adjustment to changes in the conditions of demand and supply, it may not be too far from an overall optimal position for any prolonged period."¹⁹

So when we find an externality, the beneficent, impartial government is called upon; this time to tax or subsidize in such quantities as to nullify or neutralize the lone externality. Pareto optimality is restored. But the cost-benefit analysis that forms the foundation of the tax-subsidy approach to externalities is as unrealistic as the simple statement that there are no externalities at all, because it rests on the assumption of Pareto optimum prices in all markets except the one in question.²⁰

An even more devastating criticism results when we realize that externalities are totally pervasive.²¹ When reference is made to externalities, a typical example considered is a factory that emits large quantities of sulfur oxides and particulate matter that can cause respiratory diseases to nearby residents or a strip-mining operation that leaves an irreparable, unesthetic scar on the countryside. The fact is, however, that most of the millions of acts of production and consumption in which we engage daily involve externalities. The lack of realism of welfare economics is but a manifestation of the individualistic hedonism of utilitarianism. As Veblen so convincingly demonstrated, production is a social and cultural process not a process of a single individual or even of an isolated group of individuals (even when the group numbers in the hundreds of thousands, as is the case with large modern corporations). Similarly, all human acts, including consumption, are social. Every individual's well-being is affected in a thousand ways by the social patterns and institutions that determine who consumes what and in what manner. Human beings are predominantly social creatures, not isolated, unrelated atoms.

In a market economy, any action of one individual or enterprise that induces pleasure or pain in any other individual or enterprise and is unpriced by a market constitutes an externality in neoclassical welfare economics. Because the vast

majority of productive and consumptive acts are social, that is, they involve many people to some degree, it follows that such acts will involve externalities. Our table manners in a restaurant; the general appearance of our house, our yard, or our person; our personal hygiene; the route we pick for a joy ride; the time of day we mow our lawn—all affect the pleasures or happiness of others. Furthermore, most of our productive activities have even more widespread and pervasive influences on multitudes of people who are not directly involved. The decision of a business enterprise to relocate a factory may leave an entire community economically destitute. The pollution of the air by a factory may inflict physical discomfort, large cleaning bills, illness, and even death on innumerable people who have no direct connection to the factory. The polluting of water and the practice of strip mining may destroy valuable social resources and disrupt the ecological balance of an entire geographical region in which people must live. But in the "invisible hand" world of the neoclassical utilitarians, each person is concerned only with his or her own actions, and, of course, the general welfare is promoted by all selfish actions.

With the recognition of the pervasiveness of externalities, the tax-subsidy solution is clearly seen as the fantasy that it is. This solution would require literally hundreds of millions of taxes and subsidies (in the United States alone). Moreover, the imposition of any single tax or subsidy would undoubtedly create totally new externalities because it would create new patterns of envy and sympathy. This envy and sympathy would constitute new externalities for which there would have to be new taxes and subsidies. The process would go on forever, with an infinitude of taxes and subsidies never getting us any closer to that most elusive of all individualistic, utilitarian chimeras—Pareto optimality.

But the more reactionary element of orthodox neoclassical theorists, the Austrian and Chicago schools (which we will discuss in Chapter 17), has never accepted the principle of discretionary government intervention into any of the market processes. Therefore, for many years they simply ignored externalities. In the late 1950s and early 1960s, however, they devised new formulations of their doctrines that permitted them to enter the debates on externalities that came into vogue in the late 1960s, when even orthodox theorists could no longer ignore the degradation of the environment by American capitalism. During the decade of the 1960s, the Chicago School theorists formulated a policy recommendation to deal with externalities. This formulation has remained unchanged to the present time.

The policy of the Chicago School neoclassicists was to create new property rights to pollute the environment and then to create new markets in which these rights to pollute could be freely bought and sold.²² Presumably such trade would continue to the point where the marginal utility to the polluter of another dollar's added pollution would just equal the marginal disutility to the sufferers from the pollution. At this point, it would be impossible to effect a Pareto improvement by either increasing or decreasing pollution, and a new,

laissez-faire, competitive Pareto optimum with pollution included would be attained.

One might ask these ultraconservative neoclassicists: to whom would the neutral, impartial government assign these rights to pollute? To the poor residents in the polluted slums? To people chosen randomly? Or to the giant monopolies and oligopolies who do the polluting? The answer to this question might be anticipated from a knowledge of the Austrian and Chicago schools' answer to every policy question of the past one hundred years: *If* we assume perfect competition; and *if* we assume perfect knowledge on the part of all producers and all consumers; and *if* we assume there are no transaction costs (e.g., if victims of a corporate polluter could organize themselves to bargain with the company without cost); then it can be demonstrated that the "initial allocation of property rights has no effect on allocative efficiency." With these assumptions, the inevitable conclusion is that within a laissez-faire capitalist market, the "failure to reach mutual agreement . . . can be regarded as *prima facie* evidence that . . . a net potential Pareto improvement is not possible."²³ This is, however, too obviously apologetic for the more candid neoclassical economists. One of the most important neoclassical theorists (who is not a member of the Chicago School), for example, writes: "Rationalizing the *status quo* in this way brings the economist perilously close to defending it."²⁴ Perilously close indeed! But what this neoclassical theorist fails to mention is that the more moderate neoclassical welfare theorists (such as himself) provide an even more effective rationalization of the status quo—more effective because it is so much less blatant and yet achieves nearly identical results.

The extremely individualistic orientation of the Austrian and Chicago schools is reflected in their view of the nature of externalities. They simply consider externalities, for which they advocate the establishment of property rights and markets, as being somehow metaphysically given and fixed. By ignoring the relational aspects of social life, their theory ignores the fact that individuals can create externalities almost at will. If we assume the maximizing economic man of utilitarian economics, and if we assume that the government establishes property rights and markets for these rights whenever an external diseconomy is discovered, then each person can purposefully impose external diseconomies on other people, knowing that the bargaining within the new market that the government will soon establish will surely make him or her better off. The more significant and unpleasant the social cost imposed on one's neighbor, the greater will be one's reward in the bargaining process. It follows from the orthodox assumption of maximizing economic exchangers that each person will create a maximum of repugnant and pernicious social costs that he or she can impose on others. This general process can quite appropriately be called the "invisible foot" of the laissez-faire capitalist marketplace. The invisible foot ensures us that in a free market, capitalist economy, each person pursuing only his or her own maximum gain will automatically and most efficiently do his or her part to maximize the general public misery.

To see why this principle has some validity, note that a self-seeking, calculating, maximizing individual will maximize the value of participating in these newly organized markets by devising a new production function that creates nonmarket commodities, or external diseconomies, that harm others. Taking this production-possibility set for creating external diseconomies or nonmarket commodities that annoy, harm, damage, or mutilate others, he or she will select only those diseconomies with a higher marginal return than the marginal return that he or she could earn by engaging in market transactions. But by so doing, he or she will maximize the suffering, pain, and misery, or simply the cost, to others, because his or her gain will always be someone else's loss. The recipient of these rationally calculated social atrocities, or external diseconomies, will immediately undertake defensive expenditures or pay bribes until the usual marginal conditions of Pareto efficiency are fulfilled. Thus, the recipient's cost will be minimized, and an efficient pattern of external diseconomies, or mutual social mutilation, will emerge.

But if these external diseconomies, in terms of value to the generator, are maximized in the society, and if they are efficiently contended with by recipients, then we have a completely reversed operation of the rational, maximizing individual and Pareto efficiency. That is, instead of getting those goods produced that have the highest utility and whose costs are minimized, we will have created goods that have a maximum of disutility, pain, and suffering and that are allocated such that they will have the most severe impact that the perpetrator can inflict, with the impact being minimized in terms of recipient cost as well as production costs. The economy, as the accepted principles of neoclassical microeconomic theory will confirm, is efficient, but only in providing misery. To paraphrase a well-known precursor of this theory: *Every individual necessarily labors to render the annual external costs of the society as great as he can. He generally, indeed, neither intends to promote the public misery nor knows how much he is promoting it. He intends only his own gain, and he is in this, as in many other cases, led as if by an invisible foot to promote an end that was no part of his intention. Nor is it any better for society that it was no part of it. By pursuing his own interest he frequently promotes social misery more effectually than when he really intends to promote it.* Such is the principle of the invisible foot of capitalism as it would work if the conservative Austrian and Chicago schools of neoclassical economists were ever to persuade the government to adopt their method of dealing with externalities.²⁵

The utter failure of neoclassical economists to deal adequately with these problems stems from their failure to recognize that in capitalism, while all acts of production and consumption are social (as they are in every other type of economic system), the system of incentives that governs production and consumption is almost entirely individual (as it is not and need not be in other types of economic systems). It is, of course, an utterly impossible task to develop legal property rights to every type of physical, biological, and social interdependence, or to develop a rational taxation system that would eliminate the social aspects

of production and consumption (or external diseconomies). Rather, in order to move toward an economic system that more adequately and more justly satisfies human needs, the incentive system that underlies capitalism itself needs alteration, as does the private-property system. Needless to say, however, this is a task that goes far beyond the purview of orthodox neoclassical economics.

The theory's absolute inability to handle pervasive externalities should more than suffice to convince any reasonable person of its irrelevance, particularly in the light of the conclusion of the theory of the second best, that attempts partially to achieve Pareto optimality may well have diametrically opposed effects. But the theory is much worse than irrelevant. A few of the more candid orthodox economists are themselves admitting this. One of the most eminent has written:

The achievements of economic theory . . . are both impressive and in many ways beautiful. But it cannot be denied that there is something scandalous in the spectacle of so many people refining the analysis of economic states which they give no reason to suppose will ever, or have ever, come about. It probably is also dangerous. Equilibrium economics, because of its well known welfare economics implication, is easily convertible into an apologia for existing economic arrangements and it is frequently so converted. On the other end of the scale, the recent, fairly elaborate analysis of the optimum plans for an economy which is always in equilibrium has, one suspects, misled people to believe that we actually know how an economy is to be controlled. . . . It is an unsatisfactory and . . . dishonest state of affairs.²⁶

The Normative Critique of Pareto Analysis

Some of the more progressive neoclassical economists regret this state of affairs. "Too bad," they say, "that the theory is so irrelevant. It is so elegant and analytically sophisticated, and seems to have such universal normative appeal." This lament, as we have tried to show throughout this book, is misguided. The normative objections to the neoclassical utilitarian theory are more damaging than all of the practical, empirical, and analytical objections raised to this point. Neoclassical welfare economics accepts as the ultimate ethical criteria of social value the *existing* personal desires, generated by the institutions, values, and social processes of *existing* society, and weighted by the *existing* distributions of income, wealth, and power. Thus, the theory becomes incapable of asking questions about the nature of an ethically good society and the ethically good person that would be its product. The plausibility of the normative criteria of the utilitarian theory probably derives from the widely felt moral repugnance toward the notion of an omnipotent central government arbitrarily and capriciously dictating the choices and behavioral patterns of individuals. Moral rejection of this Orwellian specter should not, however, lead to the illusion that existing society reflects that specter's antithesis. Orwell's *1984* was, after all, merely the extension of tendencies that he saw in the capitalist economies of his day, and it remains fairly descriptive of most industrial capitalist countries in the twenty-first century.

Since the existing desires of each person who is socialized under the capitalist system constitute the bases of all moral judgments in utilitarianism, we should begin by discussing these desires. Commenting on a lifetime of psychoanalyzing people afflicted by the system of desires generated by capitalist society, Erich Fromm has written:

Man today is fascinated by the possibility of buying more, better and especially new things. He is consumption-hungry. The act of buying and consuming has become a compulsive, irrational aim, because it is an end in itself, with little relation to the use or pleasure in the things bought and consumed. To buy the latest gadget, the latest model of anything that is on the market, is the dream of everybody in comparison to which the real pleasure in use is quite secondary. Modern man, if he dared to be articulate about his concept of heaven, would describe a vision which would look like the biggest department store in the world, showing new things and gadgets, and himself having plenty of money with which to buy them. He would wander around open-mouthed in his heaven of gadgets and commodities, provided only that there were ever more and newer things to buy, and perhaps that his neighbors were just a little less privileged than he.²⁷

Human nature does not automatically produce the consumption-hungry, maximizing automaton, so necessary for the tranquil, profitable operation of our economic system. Capitalist humankind and most of his or her desires are created through an elaborate system of social control, manipulation, deception, and general verbal pollution.

In this economic and political system based on corruption and deception, each lonely, isolated individual is pitted against all other individuals in merciless competition. Is it any wonder that the result is nearly universal disorientation, apathy, and despair? A pervasive sense of the emptiness and futility of life is the foundation on which corporate advertising executives create the desires of the capitalist person. Such a person watches commercials in which bright, happy, vivacious people buy new cars, houses, and stereos. He or she then strives to overcome particular unhappiness and anxieties by purchasing. Purchase, purchase, purchase becomes his or her Moses and the capitalists' profits. But this gives him or her no relief, so he sets his or her sights on a bigger car, a more expensive house, and so on, and he or she is aboard the Alice-in-Wonderland treadmill of consumerism.

Such are the desires of the isolated, egoistic, alienated, manipulated capitalist person created by the capitalist social system. These desires form the moral foundation on which neoclassical welfare economics is constructed. And the moral weight given to each person's desires, of course, is determined solely by the wealth and income of that person. Many neoclassical economists, when confronted with the arguments of this chapter (as well as many other criticisms that could be made), will admit that welfare economics cannot be defended on normative, empirical, or analytical grounds. Nevertheless, they continue to use concepts that are only defensible when the Pareto analysis is accepted in most lines of applied economics. Pareto efficiency notions underlie (1) the theory

of comparative advantage in international trade theory, (2) most normative conclusions in the neoclassical theory of public finance, (3) most cost-benefit analyses, and (4) nearly every other area in which neoclassical economics affects policy recommendations. Even worse are the rarely defended, sanctimoniously stated clichés and shibboleths about "rational prices" and "market efficiency" in that most ideologically tainted of all neoclassical academic specializations, comparative economic systems, or the analysis of socialist economies. Perhaps the most interesting aspect of the economic reforms in Eastern Europe in the late 1980s and early 1990s was the extent to which this neoclassical argument, despite the numerous weaknesses detailed above, had been naively and uncritically embraced by many of the reformers. It would appear as though the defects of eastern European communism induced many reformers to accept a theory that hides and obscures the defects of capitalism in a desperate hope that capitalism, with all its defects, might be preferable to their economic system. In the 1990s and early twenty-first century, every one of these economies has degenerated to a position of mass poverty, mass unemployment, massive organized crime, mass prostitution, and grotesque inequalities in wealth and income.

We conclude this chapter by repeating our earlier assertion that modern neoclassical welfare economics is the direct descendant of the views of Senior and Bastiat. Like those two nineteenth-century thinkers, neoclassical economists see the capitalist system as a system of natural harmony and universal beneficence. The price of maintaining such a view has always been to ignore or deny all significant social problems and all significant social conflicts. The reward for maintaining this view is, of course, that one can sit back and relax, forget all the unpleasantness of the world, and enjoy one's dreams of the beatific vision and eternal felicity.

Notes to Chapter 14

1. Joseph A. Schumpeter, *History of Economic Analysis* (New York: Oxford University Press, 1954), p. 860.

2. Francis M. Bator, "The Simple Analytics of Welfare Maximization," *American Economic Review* 47 (1957): 22-59.

3. The neoclassical critic may object to this statement. The "bliss point" in neoclassical literature is defined as that point on the utility-possibility frontier that lies at the highest possible point on some "social welfare function." But since neoclassical literature itself has shown that no such "social welfare function" can be formulated that contains a clear and unambiguous principle by which to judge the distribution of wealth, and which simultaneously does not logically contradict the foundational tenets of individualistic utilitarianism, we are justified in asserting that such "social welfare functions" in neoclassical theory reduce to mere statements of one's own biases.

4. The title of this section is taken from the titles of two chapters of the book *The City of God* written by the influential Christian philosopher Saint Augustine in the fifth century A.D. Because Bentham considered his own philosophy to be the "felicific calculus" and because the neoclassical elaboration of Bentham's views is a timeless, "eternal" model, the title seems appropriate.

5. C.E. Ferguson, *Microeconomic Theory*, rev. ed. (Homewood, IL: Irwin, 1969), pp. 442-66.

6. Ibid., pp. 444-45.
7. Ibid., p. 454.
8. S.S. Alexander, "Human Value and Economists' Values," in *Human Values and Economic Polity*, ed. S. Hood (New York: New York University Press, 1967), p. 107.
9. Karl Marx, *Capital*, 3 vols. (Moscow: Foreign Languages Publishing House, 1961), vol. 1, p. 81.
10. W.J. Baumol, *Economic Theory and Operations Analysis*, 2d ed. (Englewood Cliffs, NJ: Prentice-Hall, 1965), p. 376.
11. See E.K. Hunt, "Orthodox and Marxist Economics in a Theory of Socialism," *Monthly Review* 24, no. 8 (1973): 50-56.
12. This point is developed more amply in W.J. Samuels, "Welfare Economics, Power and Property," in *Perspectives on Property*, ed. Gene Wunderlich (Philadelphia: Pennsylvania State University Press, 1972).
13. F.H. Hahn and R.C.O. Matthews, "The Theory of Economic Growth: A Survey," in *Surveys of Economic Theory*, vol. 2, ed. American Economic Assoc. (New York: Macmillan, 1966), pp. 95-99.
14. Ibid., pp. 99-113. See also Richard Goodwin, *Elementary Economics from the Higher Standpoint* (New York: Cambridge University Press, 1972).
15. For a discussion of this view, see E.K. Hunt, "Orthodox Economic Theory and Capitalist Ideology," *Monthly Review* 19 (1968): 50-55.
16. William J. Baumol, "Informed Judgment, Rigorous Theory and Public Policy," *Southern Economic Journal* (October 1965): 138. For the definitive formulation of the theory of the second best, see R.G. Lipsey and Kelvin Lancaster, "The General Theory of the Second Best," *Review of Economic Studies* 24 (1956): 63,64,65.
17. By using the adjective *direct*, I am following E.J. Mishan, "The Postwar Literature on Externalities: An Interpretative Essay," *Journal of Economic Literature* 9, no. 1 (March 1971): 2. Excluded are "indirect effects," which are obtained through changes in relative prices in a Walrasian general equilibrium system.
18. E.J. Mishan, *Economics for Social Decisions: Elements of Cost-Benefit Analysis* (New York: Praeger, 1973), p. 17.
19. Ibid., p. 80.
20. Ibid., pp. 79-83.
21. For an analysis of the implications of pervasive externalities, see R.C. d'Arge and E.K. Hunt, "Environmental Pollution, Externalities, and Conventional Economic Wisdom: A Critique," *Environmental Affairs* 1, no. 2 (June 1971): 266-86.
22. For a clear formulation of this point of view, see Thomas Crocker and A.J. Rogers, III, *Environmental Economics* (New York: Holt, Rinehart and Winston, 1971).
23. Mishan, *Economics for Social Decisions*, p. 17.
24. Ibid.
25. The principle of the invisible foot was first developed in E.K. Hunt and R.C. d'Arge, "On Lemmings and Other Acquisitive Animals: Propositions on Consumption," *Journal of Economic Issues* 7, no. 2 (June 1973): 337-53.
26. F.H. Hahn, "Some Adjustment Problems," *Econometrica* 38, no. 1 (1970): 1-2.
27. Erich Fromm, *The Sane Society* (New York: Fawcett, 1965), p. 123.