BEYOND DISSENT

Essays in Institutional Economics

STUDIES IN INSTITUTIONAL ECONOMICS

PHILIP A. KLEIN

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ESSAYS IN INSTITUTIONAL ECONOMICS
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Routledge
Taylor & Francis Group
LONDON AND NEW YORK

First published 1994 by M.E. Sharpe

Published 2015 by Routledge
2 Park Square, Milton Park, Abingdon, Oxon OX14 4RN
711 Third Avenue, New York, NY 10017, USA

Routledge is an imprint of the Taylor & Francis Group, an informa business

Library of Congress Cataloging-in-Publication Data

Klein, Philip A.
Beyond dissent: essays in institutional economics
by Philip A. Klein
p. cm.—(Studies in institutional economics).
Includes bibliographical references and index
ISBN 1-56324-321-0.—ISBN 1-56324-322-9 (pbk.)
1. Institutional economics.
I. Title.
II. Series.
HB99.5.K58 1993
330—dc20
93-30938
CIP

ISBN 13: 9781563243226 (pbk)
ISBN 13: 9781563243219 (hbk)

For Peggy and Grace
Steve and Barbara
and
to the Memory of Hank Jameson

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Foreword

Professor Philip A. Klein's *Beyond Dissent: Essays in Institutional Economics* appears at a propitious and instructive time. Given the turmoil of structural transformation of much of Eastern Europe, the search for economic community in Western Europe, and the depressed and backward state of the American economy, it now seems obvious that we are in a historically significant watershed period. Major convulsive changes in political economies have occurred and more are already perceived as probable. Yet the query of which direction is forward? remains. What theories will inform the post-Socialist societies? What theories will guide the further integration of European welfare states? What theories will instruct the United States in the search for prudent and progressive structural changes to enhance productive efficiency and equity? Klein's theoretical contributions direct us to positive answers.

In these troubled years, nearly all major political economies, driven by the compelling urgencies of extending and improving the provisioning process and by the clamor for increasing democratic accountability, are forced to reexamine fundamental tenets of what the character and functioning of the political economy will be. The old ism recipes are now everywhere understood to be irrelevant except perhaps for the entry of a few messianic orthodox price theorists as counsels in Eastern Europe. "Marxism is dead; long live Friedmanism?" It will not serve! The convulsive changes must be given more reasoned direction. Relevant and credible theory must be used to inform policy-making and to guide conduct. The scope and character of the productive sectors must be restructured. Distributive mechanisms must be overhauled in pursuit of adequacy and equity. New conceptions of feasible and accountable functions in the public sector are required. The scope, goals, and responsibilities of the private sector must be freshly appraised. Institutional transformation is and must be of high priority on the policy agenda. Yet there is no handbook, no bible, no timeless recipe to which to turn. This volume does not presume to provide one.

But it is possible, as Professor Klein here demonstrates, to write reasonably and relevantly to a number of these concerns. Heterodox institutionalist scholars, including especially the author of this volume, think and write as theoretical realists, pragmatists, and policy-oriented inquirers. What is provided here is a cogent, constructive presentation of a body of theory, with policy implications, that will steer inquiry and effort into timely and constructive channels. As an American institutionalist, Klein joins with other heterodox post-Keynesians, European evolutionary theorists, and Scandinavian "negotiated economy" theorists, among others, in the search for applicable theory and policy to cope with contemporary realities. The papers in this collection, written over the last two decades, show Klein to be a major contributor to, and clarifier of, the theoretical tenets of institutional economics. This volume provides relevant counsel of an exploratory, not a dogmatic, kind. It offers a problem-solving analysis, not ism-imaging apologia for existing control centers, intellectual or political. This collection provides an uncommonly provocative and relevant delineation of major constructs of the institutionalist perspective and a surgically precise and devastating critique of elements of the dominant mainstream neoclassical tradition. The latter is incidental to the former.

Some eighteen essays are arranged and grouped under five major heads: Institutionalism—A Basic Perspective; Institutionalism and Concentrated Power; The Role of the Public Sector; Applied Institutional Economics; and Institutionalism and the Obligation of the Economist.

The first section, constituting perhaps half the volume, sets the context for subsequent discussion. Klein here presents both major theoretical tenets of institutionalism and a running critique of comparable orthodox precepts. In the former, he canvasses the literature and seeks consensus views that reflect both the substance and evolutionary development of the institutionalist mode of inquiry. Among the tenets he develops as central to the institutionalist position are the following: its methodology is processual; its causal inquiry is exploratory; the economy is culturally embedded; social value is a constituent element of inquiry; the economy is a system of power; the quest is for progress, not simply growth; market outcomes are judged against norms of the economy, not the reverse. He demonstrates that institutional economics is not merely or mainly dissent from neoclassicism, but has a robust, evolving, and comprehensive stature with paradigm standing in its own right.

Klein does not dismiss the orthodox tradition with a flippant quip or a cavalier condemnation. He ably confronts neoclassicists at length in their own theoretical backyard, challenging their claims to cogency, rigor, relevance, and substance. Thus, contestable market theorists, public choice theorists, Chicago school market devotees, and Robbins-influenced positivists, among others, are each grasped by the intellectual lapels and faced directly with questions and counter arguments. Contestable markets theory turns out to be apologetics for existing power systems; public choice theory mistakenly redefines the public sector with archaic microtheory assumptions and values; the market devotees speak of an imagined world to be mimicked, not an actual market exchange arena; the normative-positive dichotomy has long since become passé in both philosophy and economics—social value theory inescapably permeates any serious inquiry in political economy, as Klein makes clear. In this extensive dialogue, Klein, for example, explores the reshaping of demand theory where the assumption of "given tastes" is abandoned. He examines the cogency of the "new classical," rational expectations position as it relates to theories of inflation and finds little of merit or insight. The analytic comparisons are cogent and compelling.

But the contribution of this book does not reside mainly with the critiques of neoclassical orthodoxy, striking, original, and devastating though they may be. It resides rather in his impressive positive contributions to institutionalist theory and policy-making. It is of course very helpful to realize the limitations and irrelevancies of orthodoxy. But of greater significance is the fashioning of fresh, pertinent, and productive ways of thinking about the provisioning process at large.

Two papers in the second section are illustrative of this fresh approach to economic analysis. In these, Klein directly confronts the presence and use of power in the economic process. Power is sought; power is held; power is exercised. For Klein, economic power is not a peripheral issue or concern; it is, and since Veblen has always been, a central inquiry focus of institutional economics. Any political economy is a system of power. From Veblen's analysis of the vested interests, to the most recent institutionalist inquiries into corporate hegemony (Dugger) and comprehensive private sector planning (Munkirs), institutionalists have analyzed and assessed the locus and use of economic power to determine and shape the performance of provisioning institutions. Klein contributes importantly to this tradition in defining power as the "disproportionate control over the economic decision-making process," in exploring how the allocation of resources generally is affected by concentrated power, and in explaining how the exercise of power reveals value commitments which themselves must be critically examined. The mainstream deference to status quo reinforcement of acquired property and attained position is itself a value position, a normative posture.

To demonstrate these and related theoretical distinctions, Klein provides a detailed tabular comparison of conceptual positions on a wide range of topics from the perspectives, respectively, of institutionalists, neoclassicists, and political scientists. The first and third are found to have great commonality; both perspectives are addressed in part to power. Klein explains that mainstream economists avoid any serious analysis of the possession and use of economic power. Where treated at all it is a matter of unfortunate monopolistic aberrations; inquiry becomes an exercise in pathology. The free market model is a zero-power ideal; discretion is widely disbursed; individuals and firms are price takers. Klein's canvas of industrial organization theories, public choice theories, and radical economics theories shows that these formulations yield few significant insights on the role of power in the economic process. Institutionalists have more fully developed analyses of the discretionary roles that direct the economy.

The third section is addressed to the role of the public sector. Klein's contributions here are pivotal when we realize that neoclassicists have no *theory* of governmental "intervention" or participation in the economy. (This is one respect in which Keynesian theory departed dramatically from neoclassical theory of the day.) The neoclassical ideological insistence that government "participation" must be "interference" or "intrusion" and disruptive of the private economy's quest for market efficiency, discloses the barrenness and irrelevance of orthodoxy in the arena of *political* economy.

For Klein, the dilemma is inherent in the distinction between macro- and microeconomics. Since Keynes, the public sector's macromanagement responsibility has been largely, if grudgingly, acknowledged. Assuring aggregate demand, so long as it does not significantly threaten private sector centers of power, can be defended. In the microeconomic realm, however, such intervention (except for defense) grossly violates the market allocation ideal. The competitive model is the "benchmark," says Klein, against which one is supposed to judge allocative efficiency in the real world. It is the normative use of the competitive model. Government is presumed to have no goal beyond the creation of an even playing field on which the market game is to be played.

Klein vigorously rejects this torturously reasoned position. Institutionalists, he insists, are not for or against intervention per se. At issue is the character, extent, and purpose of intervention; it is proffered to advance what or whose purposes? They acknowledge that the public sector does shape emergent values of the community. That sector, in Klein's view, has two general functions: one is to monitor and appraise allocative results flowing from private markets; a second is to create resources for allocation and to undertake and direct some part of that allocation. Jointly the implementation of these two functions defines what Klein calls the "collective ought." Contrary to orthodoxy, the sum of individual wants *does not* constitute the "collective ought." To argue such is to indulge the fallacy of composition, as most readers will recall. The "collective ought" is reflected for Klein in "how well . . . the economy reflects the values of its participants—all its participants and all the relevant values—in its operation at any given time." But Klein is not ethically relative about these "values of participants." The "value floor," undergirding the "collective ought," is the life process itself. The public sector's role is corrupted by clogged or distorted information channels, concentrations of economic power, and large inequalities of income and wealth. It is the responsibility, then, of the public sector, continuously to facilitate and support the quest for efficiency, equity, freedom, security, and compassion. The public sector's role is more than that of an umpire; "it is part manager, part coach, and a sometime player."

In the fourth section, Klein makes cogent application of his institutional theory in four major areas of substance and concern: the appropriate size and responsibilities of the public sector; the determination and management of economic development, especially in third world economies; the cyclical instability of market economies, with a special eye on the contributions of Wesley Clair Mitchell; and analysis of the origins and significance of unemployment.

In an assessment of the Reagan revolution, Klein argues that smaller government is not necessarily beautiful when it involves a reduction of regulatory responsibilities, deficit mismanagement, increased tolerance of environmental hazards, and insensitivity to basic welfare needs, and the like. The growth of technology changes the nature of problems; governments must be responsible, and responsive.

With regard to theories of economic development, Klein persuasively argues that, although generally unacknowledged, the institutionalist approach in fact dominates that inquiry field. What is shown is that it is precisely the "givens"—structure, wants, technology—of orthodoxy that development economists have had to abandon in identifying the determinants of growth and progress. In particular Klein joins other institutionalists in the insistence that the savings theory of capital formation simply cannot be sustained.

In addressing cyclical instability of market economies, Klein draws on his own extensive analytical and consultative work in the field. One of his concerns is to demonstrate that Mitchell is properly characterized as an institutionalist, charges of Mitchell's eclecticism notwithstanding. More important, perhaps, is Klein's development of the institutional theoretical underpinnings for the more technical formulation and tracking of business cycle indicators. His exposition here is an analytical tour de force.

Finally, in this section Klein applies his analytical skills to the erosion of the orthodox claims concerning a "natural rate of unemployment." Whatever is "natural" is therewith deemed nondiscretionary and therefore nonproblematic. Klein demonstrates that the traditional analysis is incomplete and flawed. The conventional insistence that our short-term choice is only between unacceptable inflation rates and unacceptable unemployment rates is mistaken. The great "trade-off" is miscast.

The volume concludes with three essays in which Klein holds a conceptual mirror up to the economics profession and asks directly and repeatedly, What is the purposiveness of economic inquiry? Should the discipline, in its mainstream quest for mathematical rigor and deductive inference, be bled dry of its compassionate concern for the well-being of ordinary citizens? He insists that enhancing the provisioning process, and thus the life process, is the raison d'etre of economic inquiry. Klein, reflecting a profound sense of concern for those who fare less well in any economy, defines the role of the economist as a scholar who is *obligated* to develop *relevant* theory and directive policy applications that *do* make a difference in how the allocation of resources is accomplished, and on whose behalf and at whose expense. The institutionalist approach is *driven* by this purposive concern to assist the community in its realization of its "collective ought." The quest is for understanding of causal phenomena generating economic problems of instability, maldistribution, environmental deterioration, stagnant development, unemployment, perpetual poverty, and the like. If the economics discipline fails in this responsibility, some other discipline fulfilling that function must replace it. Problems will continue. Communities will continue to need assistance in understanding their problematic circumstances. The inquiry role of institutionalists in general, and Professor Klein in particular, is therewith identified.

Klein's professional career and his scholarly contributions, as reflected in this volume, exhibit well his scholarly passion to assist economies to generate efficiency and equity in their provisioning processes. The dialogue with orthodoxy encompassed in these essays serves as an insightful example of how to set deliberative inquiry in motion and to sustain it for theory-clarifying and policy-drafting purposes. The dialogue must continue, of course. I strongly commend this volume to the reader as a major analytical resource that will help make that continuing dialogue productive.

—Marc R. Tool

Preface

As the reader will discover, the essays in this book were written over more than twenty years. I have, in fact, been thinking about the matters discussed here ever since I was first exposed to the institutionalist perspective in Clarence Ayres's classroom at the University of Texas in the mid-1940s.

I have never seen any reason to alter my original view that this perspective is a very fruitful one from which to confront the challenges posed by today's economy. I believe that there is a very real disjunction in modern economics. For many academic economists the challenge appears to be to develop a discipline that is rigorous, highly quantitative, capable of simulation and manipulation with modern computers, logical, as abstract as is necessary to make its interrelationships reducible to a set of equations, and satisfying as an intellectual exercise.

I have no objection to any of these provided they are compatible with a discipline focusing on the real world problems which increasingly all recognized modern economies face. The problem, of course, is that the old charge of rigor without relevance has only increased its claim to truth in the past forty or fifty years. Most academic economists today like it that way. They operate within a very complete, comfortable, supportive system: journals have mushroomed to publish their studies; graduate programs, in both their basic theory and increasingly the applied fields as well, are built around the most recent findings of the Young Turks (now often aging) who have led the way back—beginning perhaps in the 1950s—from the wilderness some still call "reality" into which John Maynard Keynes led the discipline in the 1930s. Graduate courses are taught by the newest assistant professors, who teach what they have just learned, thus perpetuating the notion that the most significant perspectives and insights in economic analysis are almost invariably only or chiefly those made in the last few years; courses in both economic thought and methodology are passé except for the thinking and methodology of the various branches of "New Orthodoxy" (which is surprisingly like pre-Keynesian orthodoxy). Research funds are increasingly channeled toward research devoted to accounting for "stylized facts" rather than "real facts."

The result of all this is that the profession that Ayres and his contemporaries found less than satisfactory has, from their institutionalist perspective, become even less congenial. This is anomalous, because as Marc Tool has suggested in his gracious foreword, the necessity of incorporating much of what institutionalists have been saying into our efforts to meet current economic challenges is every day more obvious.

In my own career I have combined writing about institutional economics with work in business cycles. While my colleagues no doubt regard them as completely separate, I find them highly compatible. Wesley Clair Mitchell was both a founding father of American institutionalism and a leading expert in measuring and forecasting business cycles. (I may be the only economist in the United States who tries to wear both of Mitchell's hats!)

As such that part of my work which mainstream economists feel comfortable with has always seemed to me to exemplify how an institutionalist approach can enrich work in any field in economics. Moreover, my work in business cycles has certainly been quantitative. The approach I have taken over the years in many joint projects with my colleague, Geoffrey H. Moore, has not been econometric, but econometrics is compatible with what we have done. Our various studies of business cycle indicators have, along with much other work on indicators, led to their inclusion in many econometric models.

I regard myself as a typical institutionalist, and as such I would assert that institutionalists cannot legitimately be charged with methodological narrowness or exclusivity. We use a number of approaches in our work and appreciate many more. Whether mainstream economists can say the same about their attitude toward institutionalism is moot. I argue that the enormous challenges economists face in the current world, the appalling failures economies are exhibiting, continue to suggest that no economist has a right to claim to have found the methodological single best approach.

The essays in this collection try in various ways to show the flexibility of institutionalism, and to indicate that its emphasis on relating economic activity to the culture in which it occurs is essential to leading to better economic policies.

It is not easy to be optimistic about the years ahead. The problems economies face are huge, and the question whether economists are developing better tools with which to tackle them is at best painfully open. Nonetheless, it is my hope that these essays will illustrate that institutionalism in the last twenty years has made some progress in defining our problems, in refashioning our discipline so as to cope with them more realistically, and in clarifying and keeping current the approach to which Ayres and his generation first exposed me.

If the most recent developments in economics have, as suggested earlier, moved mainstream economics farther away from the institutionalist perspective, there is reason to hope that methodological approaches in social science are themselves cyclical. Having explored, more or less fully, the potential for developing convoluted abstract models, it may well be that pressure to tackle real-world problems will build, echoing a return to the perspective of the Keynesian revolution of the 1930s. There is clearly pressure building both to achieve greater productivity and growth, and to attain stability in market economies, but to have the fruits of this progress distributed by principles societally deemed more equitable.

I have incurred many obligations in the course of writing these essays. My debt to Ayres is obvious. Without his influence I probably would not have gone into economics at all. I am, of course, greatly in Marc Tool's debt for writing a foreword which, among other things, obviates the necessity for me to summarize what I have tried to do here. Far more, he has been my friend and supportive colleague. Without his encouragement and sometimes insistence as editor of the *Journal of Economic Issues* many of the essays in this book simply would not have been written. Similarly I wish to thank Marc's predecessor as editor, Warren Samuels, who was the first editor with whom I worked and who has always been helpful and encouraging. I also am obligated to all the economists in the Association for Evolutionary Economics with whom I have worked over the years and with whom I have had both annual conversations at our meetings and active correspondence. Without that network it would be difficult to sustain the will to persevere. Edythe S. Miller deserves being singled out for special thanks for her many years of wise counsel. I also thank Paul Dale Bush. Monroe Newman and the late Will Mason are my two Penn State friends and colleagues who read many words of mine and always offered valuable advice. Increasingly in recent years, I have benefited greatly from the resurgence of interest in institutionalism in both Eastern and Western Europe, and I acknowledge my gratitude for the encouragement I have gotten from these new colleagues. Among these Owen Nankivell deserves special mention for many hours of valuable discussion. Finally, I thank Dick Bartel at M. E. Sharpe for his help and cooperation. Heterodox economists owe an enormous debt to M. E. Sharpe for the willingness of this publisher to give a voice that can be heard to their work.

Lastly, I thank my family, who has always thought that the opportunity cost of these essays was too high, but has tolerated my contrary view with grace and humor.

—Philip A. Klein
University Park, Pennsylvania
September 16, 1993

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Part I

Institutionalism—A Basic Perspective

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1

Economics: Allocation or Valuation?

Whether or not it continues to be a science of price, economics must be a science of value.

—Clarence E. Ayres
Theory of Economic Progress

Among the social sciences, economics long has suffered from a superiority complex. The economist's view of his field has been of a discipline that was rigorous and precise, with an advanced and pragmatic methodology leading to a highly developed theoretical structure. All this left far behind the imprecise and murky theoretical strivings of political scientists, sociologists, anthropologists, and historians.

The promised land which economic analysis made possible was known as equilibrium.[1] What sociologist or political scientist or anthropologist could offer any piece of analytical apparatus which for sheer beauty, precision, and logic could equal it? True, psychologists kept insisting that the behavioral assumptions of conventional economic theory—maximizing behavior, hedonism, rationality—all the characteristics of "Economic Man" which economics always has relied on for convenience, were fatally oversimplified. But economists mostly have ignored the complaints of psychologists (who after all had problems of their own). Moreover, the psychologists were only too willing to follow the economist down the quantitative primrose path. Both disciplines once worried about their ancient roots in philosophy and could never quite rid themselves of the nagging suspicion that questions of subjective valuation could not be eliminated entirely so as

Reprinted by permission of the publisher from *Journal of Economic Issues*, vol. 8, no. 4 (December), pp. 785–811.

The author wishes to thank Lord Robbins for a very helpful and thought-provoking reading of this article.

to render each a 100 percent pure science. Both embraced mathematics as the true methodological messiah come at last.[2] Together economists and psychologists measured all visibly quantifiable variables, developed models for all problems, and achieved intellectual orgasm through the contemplation of the possibilities of the electronic computer. By enshrining quantification, they believed they had set a standard of scientific excellence sufficiently ahead of their laggardly sister social sciences to enable them to continue virtually indefinitely to play the role of superego to the lowly id of sociology or history.

Without in any way demeaning the very real accomplishments of quantitative procedures in advancing knowledge in critical areas, I should like to suggest that at least in the case of economics, schizophrenia always has been latent in the discipline and has been kept that way only by sweeping under the rug important problems which increasingly have crept out to disturb the neat world of economist and econometrician alike. We can cope with any number of variables in ever more elaborate models, but we cannot cope with underlying questions of direction and meaning, of goals and objectives for the system. The excessive preoccupation with tools with which to cope with problems at best comprising a small corner of economics, and the obsessive need to believe these tools coped with the heart of economics, long has characterized the discipline. Facing up to this obsession involves the fundamental question of whether economics is a science of allocation or a science of valuation. For most of its existence economics has managed to equate the two, and there is a long and bloody literary road devoted to establishing that economics as a "science of price" thereby was coping with all the value problems with which it need legitimately concern itself.

Economics as a Science of Allocation

The central core of economic theory—at least microeconomic theory—was spelled out by Adam Smith and elaborated upon by the well-known nineteenth-century mainstream economists. The culmination was its restatement by Alfred Marshall, who not insignificantly changed the name of the discipline from political economy to economics. The profound changes of the past eighty years have left remarkably untouched much of the field which Marshall defined as "a study of mankind in the ordinary business of life; it examines that part of individual and social action which is most closely connected with the attainment and with the use of the material requisites of wellbeing."[3] Marshall added that economics "concerns itself chiefly with those motives which affect most powerfully and most steadily man's conduct in the business part of his life."[4] The latter is a far narrower perspective and considerably closer to what in fact Marshall's *Principles* dealt with. It was a critical reinforcement to the continued confusion between economics as allocation and economics as valuation.

Marshall's emphasis on materialism subsequently was questioned, for example, by Lionel Robbins, who wondered how a science concerned exclusively with the material could determine the wage rates for opera stars or orchestra conductors whose productivity is not quite so easily viewed as the more concretely material output of ditchdiggers, carpenters, and others among the myriad toilers in the economic vineyards. Robbins concluded that Marshall's materialism was a "pseudo-materialism"[5] and that what was really at the heart of economics was not materialism but allocation. Robbins then defined the field in the way which is customarily utilized to this day: "Economics is the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses."[6] Such a formulation extricated economists from the materialism quagmire; by adding to this the deceptively simple assumption that the allocation process as carried out through the use of prices in the market disposed of all the ends and scarce means that the proper study of economics need embrace, economists thought they were home free.[7] The pricing process was assumed to be the vehicle by which the economic system expressed *all* the allocating priorities of concern to the economist. Thus price became, if it had not always been, the *only* measure of value with which economics had to concern itself.

Robbins himself reached this conclusion unequivocably by saying that the significance of economic science lay in the fact that "when we are faced with a choice between ultimates, it enables us to choose with a full awareness of the implications of what we are choosing." But he was very careful to add that "it is incapable of deciding between the desirability of different ends. It is fundamentally distinct from Ethics."[8] But even if the distinction between economics and ethics were accepted, the discipline must provide (if it is to permit us to choose with the "full awareness of the implications of our choice") mechanisms by which such "full awareness" choice can be made. The market alone cannot fill that bill in a modern industrial economy. Allocation and valuation are indeed different, and a discipline concerned only with the former can never permit "fully aware" choices to be made.

Those who view economics as a science of allocation customarily have argued that all participants in the economic process get their "values" from wherever they get them, that in fact societal values are of no concern to the economist. Thus all the economist need do is pontificate: "If an individual chooses to allocate his income in Direction A he must forgo Direction B." "To achieve certain objectives, here is the most efficient way for society to achieve them, and here is what must be forgone in the process." Consequently, generations of economics students were taught that economics is not concerned with questions of "ought" but only with questions of "is." Economics as a science was not normative but positive.[9] Thus economics was viewed as the administrator of social options, in charge of calculating costs and predicting results, but without any normative participation in the process. The economist qua economist occupied a role in which normative judgments definitionally had no place. Only the economist qua citizen was permitted to be filled with the minimal requisite quantities of passion, prejudice, and "subjective valuation" that reside in the breast of other mere mortals.

This view of economics had some convenient side effects. For one, it enabled economic theory to blind itself to the implicit subjective valuations (previously alluded to) of what it did in the guise of pursuit of the scientific method, rigor, and precision. It therefore enabled economics to emulate the physical sciences and thus led to the coronation of equilibrium as normatively "good" in economics because in physics, from whence it came, it was "natural." If Keynes's notion of underemployment equilibrium represented a severe jolt to this notion, in microeconomics it survived because equilibrium prices led to market clearing, which was definitionally good. Finally, equilibrium could be viewed as an end in itself because the continued assumption that Adam Smith's Invisible Hand (developed for atomistic competition) could be appropriately if only approximately attached to emergent prices in actual markets rationalized away any lurking doubts about how economics disposed of the value problem. Individual selfishness was transmogrified into a process optimizing social welfare, and emergent prices did indeed express the values of society in the only way that need concern the economist.

Economics as a Science of Valuation

The simple world of the classical economist, familiar to all economists, was orderly and attractive, but unrelated to much of the economic reality even of its own time. The history of economics has shown a remarkable tendency to cling to that world, however, and to make emendations only when pushed by a variety of inexorable forces. Even in its own time, classical price theory developed with the Industrial Revolution in England, and so Smith projected his Invisible Hand on a world replete with, among other things, subhuman factory conditions, child labor, widespread poverty, great inequality in the distribution of both wealth and income, vast slums and urban ghettos, and a rigid and uncompromising class system which severely restricted labor mobility and economic opportunity. In short, it was a world with a whole host of problems with which society still copes and from all of which Smith's economics was structured to dissociate itself.

It is interesting to note that this view of economics, based on emulating the physical sciences, has in our own day seen the physical sciences come to question the rigid distinction between the normative and the positive. The dynamism of technology was such that by the 1940s the physicists had begun to realize that merely suggesting what constitutes the most efficient way to destroy the world as we know it might not thoroughly discharge the ultimate responsibility of the physicist qua physicist.[10] So much for the model economics chose to emulate.

To the extent that economics subsequently faced up to its value problem (as opposed to its allocation problem) at all, it did so through the introduction of the familiar notion of the Pareto optimum, which fit extremely well the notion of the Invisible Hand. Pareto optimality (however stated) never has been more than a very carefully hedged statement: With given tastes, technology, and resources, no reallocation of resources could better satisfy any member of the community without someone else being less well satisfied. Such a view, even leaving aside the old controversies about measuring satisfaction, nonetheless fits well into the conventional perspective because it does not ask how the distribution of satisfactions came to be what it is, what the rules of the game are in which satisfaction-seeking is played, and so forth. As was the case with the Invisible Hand, the Pareto optimum was an attempt to define the value problem in economics in sufficiently narrow terms to make it coterminous with resource allocation in the market via prices.

To the extent that conventional theory altered its focus to cope with imperfect as opposed to pure competition, the following conclusions seem germane to our central concern with how economics copes with its value problem. Institutionalism in the past attacked the use of "competition" in conventional theory, but failed to note that *whatever* equilibrium might mean in competitive markets, it means something different in imperfect markets. Institutionalists were thus vulnerable to the charge of beating an ill if not dead horse. However, the charge that conventional economics continues to overemphasize the competitive model because it is elegant, precise, and deterministic while imperfect models have none of these characteristics is probably a fair one. Economists cling to the competitive model, partly at least as a child to a security blanket, and rationalize its continued emphasis in academic curricula by a variety of means. These contain enough truth to avoid broadside attacks on the theory as irrelevant, but enough error to prevent economists from easily addressing the modern world in a realistic, direct, and straightforward fashion.[11]

Economists always have been remarkably unconcerned about the allocational implication of how they spend their time and energy in price theory. Here, put in language the economist is uniquely qualified to understand, the institutionalist may have had a point: Price theory devotes a disproportionate amount of the economist's resources to competitive theory and too little to theories more generally applicable in the real world. To many economists no doubt price theory has the appeal of chess, and (importantly) it does permit the mechanics of the price system to be detailed. But even in the sector of the economy in which market prices still operate it leaves many questions untouched. Despite the failure of men like Clarence Ayres to recognize the development of noncompetitive models, the institutionalists still had a point in criticizing price theory. But this was in any case not the main import of what they were arguing.

The Frontiers of Economics: Valuation in the Market

If, as I believe, economics is and always has been primarily a science of valuation rather than merely allocation, it follows that price is not the only relevant measure of value, even in the areas where the price system still serves as the sole or primary allocative mechanism. There are many questions to which conventional economics should address itself in the areas where prices in fact do the allocating, but which many economists still prefer to ignore. For example, it is by now fairly clear that assuming that consumer wants are "given" assumes away many critical problems bearing on "the meaning of the price system." The normative implications of emergent prices in a system in which large corporate businesses produce whatever they choose to produce and then persuade consumers (through advertising, appeals to snobbery or class, or whatever) that this is also what they want are most assuredly *not* what they would be in a system in which prices reflected the efforts of business firms to adapt to the "sovereign" wishes of consumers. This would, of course, be true no matter where consumer wants came from provided only that they were not created by profit-seeking business firms themselves. This charge always has been leveled at price theory by institutionalists, beginning with Thorstein Veblen and including today J. K. Galbraith. He refers to demand manipulation as "the revised sequence" and comments: "The revised sequence sends to the museum of irrelevant ideas the notion of an equilibrium in consumer outlays which reflect the maximum of consumer satisfaction."[12]

It may be that Galbraith has exaggerated the degree of demand manipulation, as some have charged, but it is unlikely that any would argue that consumers and business firms interact on terms approaching parity. The attention given to Ralph Nader in recent years is due to the fact that consumerism is still so new and immature in our economy. Its rise is recognition that manipulation of consumers by firms unmatched by organized and informed consumer manipulation of firms seriously alters the normative implications of emergent prices. Only in economics as allocation can one argue that "the worth or value of a thing is determined simply by what a person is willing to pay for it."[13] There is no need here to linger over this point except to note that what lies "beyond demand," to use John Gambs's phrase, is an integral part of economics as valuation and always has been.

A second inadequacy of the economist's analysis of how markets operate is closely related to the first and involves again the tremendous concentration of power in the modern business corporation. Economics as allocation has not been unduly concerned with economic power per se, but only with how "market imperfections affected the allocation of resources." Economics as valuation can make no such convenient division. There is by now a vast literature dealing with the rise of the modern corporation, its basis in great wealth, its raison d'être in its unique ability to exploit the fruits of ongoing technological development, and the concentration of power (economic but also political and social) to which these factors led. Certainly relatively little attention has been paid by mainstream economists to the impact of concentrated power on the meaning of the price system in operation. Adolph Berle and Gardiner Means warned in the 1930s of the implications of separating ownership and control.[14] R. A. Brady some years later warned of the implications of concentrated corporate power to the fabric of the sociopolitical as well as the economic system[15] in a view anticipating Dwight Eisenhower's celebrated warning of the dangers to democracy inherent in the military-industrial complex. Despite the effort to develop models of imperfect competition, economics as allocation has never escaped from the dilemma posed by the dynamism of technology which simultaneously destroyed the world of Smithian competition, with its convenient assumptions of the Invisible Hand, and enormously increased the efficiency and productivity (but also the dangers to "sovereignty") of the system in fact operating.

This call to incorporate the realities of corporate economic power into conventional economics thus has a very old if relatively futile history. It may even be a cliché to mention, but like many clichés it represents an obvious necessity since it is still unrealized in economic theory. It is currently being urged most conspicuously by Galbraith.[16] Thus, if institutionalists erred in failing to recognize the impact of imperfect competition theory on the normative implications of "equilibrium," this error was small in the face of the problem they did perceive in the operation of prices to allocate resources in the market. The realities of concentrated power, the implications of an allocative mechanism based on "one dollar, one vote" operating amidst tremendous inequality in the distribution of both wealth and income, the degree to which concentration exercised a pervasive influence on both the flow of information and the "wants" assumed to be given—all these and related aspects of the economy were not so much unknown to economists as simply ignored definitionally by the profession in considering economic theory. The result was that even in its *terra cognita*, the domain of allocation in markets via prices, economists could not really deal with the value problem effectively. But the greatest inadequacies resulted from concentrating the attention of the economists unduly in this corner of their field, thereby ignoring the full implications of economics as valuation.

Institutional Economics and the Valuation Process

The meaning of the price system is only part of the strategy of economic progress, and it is the latter that lies at the heart of economics as valuation. It was this view, of course, that gave institutionalism its characteristic flavor, and Ayres in particular tried to pull the separate threads together to make a complete statement of economics as a science of valuation directed at developing a strategy of progress. From Veblen came his great sensitivity to the impact of institutional forces (economic and noneconomic) in shaping the development of priorities and the resultant futility of presuming wants to be given when in fact they are shaped by the economy. From the disputes in the physical sciences came his conviction that the Newtonian emphasis on equilibrium was far less significant for economics than was the Darwinian emphasis on conflict, process, and change. From

John Dewey came the instrumental theory of value, which succeeded in producing a dynamic from which the valuation process in economics could be analyzed.

What Ayres saw better than anyone else, in my judgment, was that instead of concentrating on how resources are allocated in markets via prices, economists should subsume that problem in the larger and more compelling problem, namely: How does the economy shape as well as channel human choice, both during a given period and through time? What mechanisms does it provide both for the development and for the expression of values? When Kenneth Arrow considered welfare economics, he still viewed the economy as a transmission mechanism for expressing "values" exogenously determined—hence his title *Social Choice and Individual Values*. But a more meaningful title might well have been *Individual Choice and Social Values*. It is the latter which "the economy" represents. And I dare say that the fallacy of composition scarcely could be of greater critical importance than in the placid assumption of economists that the economy is an adequate and effective mechanism for summing individual values into social values. There is clearly a complex interaction between individual and social values, but the way in which the economy directs this interrelationship is far from clear, let alone necessarily satisfactory. (And "satisfactory" here may be interpreted only as certainty that the system accomplishes what each of its participants would prefer it to accomplish if they were "suitably" aggregated.)

The major critical frontier in economics, therefore, cannot be restricted even to market valuation; it lies in a far broader perspective.

The Frontiers of Political Economy: Individual Choice and Valuation in Society

Perhaps even Ayres took too narrow a view, in the sense that the ultimate concern of economics is not merely the meaning of the price system, but the meaning of the entire allocation pattern which emerges.[17] Increasingly it seems clear that economics as valuation cannot avoid concern with nonprice phenomena. The evidence is piling up on all sides that the old view of economics (as primarily concerned with how the market allocates resources via price under rigidly given assumptions) increasingly is being pushed aside by the necessity for facing many critical valuation problems.

This necessity has, however, only exaggerated the schizophrenia in economics. It is suddenly very fashionable in economics courses to include mention of urban blight, air and water pollution, conservation, the energy crisis, the population explosion, racial and sexual discrimination, and even "the quality of life." Our elementary texts exhibit the result brilliantly. They add chapters on these topics as each is pressed upon the professional consciousness in too forceful a manner to continue to be ignored, but these concerns are almost invariably grafted on at the end, in about chapter 37. The central chapters on the operation of the market are untouched, and the inadequacy of the theoretical framework in the field for coping with the valuation problems is glossed over. Price theory, particularly competitive theory, is our rosary. Critical areas of economic valuation are each given a chapter. That is our confession. The religion is intact.[18]

Thus Gunnar Myrdal recently suggested: "Modern establishment economists have retained the welfare theory from the earliest neoclassical authors, but have done their best to conceal and forget its foundation upon a particular and now obsolete moral philosophy."[19]

No better corroboration can be found for the thrust of the argument being advanced than to consider the history of the agricultural sector during the past several decades. Such perusal shows that price is by no means the same thing as value. It should suggest that welfare economics—even of the conventional type—cannot neatly separate allocative from distributive welfare problems, although it customarily tries to do so. It should support the notion that economics as valuation cannot easily isolate utility-based welfare economics, which is conventionally viewed as more manageable, from ethically based welfare economics, considered too ambiguous to be capable of economic analysis, but clearly involved in fact in determining resource allocation and distribution in this sector. It underscores the bases of essential allocative mechanisms in *both* the decision unit of one dollar–one vote and of one man–one vote, and it illustrates the manipulation of both to reveal and shape essential societal values. Finally, in the critical area of interrelationship between the origin and transmission of individual values, on the one hand, and the origin and transmission of societal values, on the other, it reminds us how every beginning student learns to corroborate the fallacy of composition. It is with the recognition that economic analysis shows that the result of individual farmers trying to lower their prices to increase their income may lower the prices and incomes of all. That being true, why is it so difficult to persuade economists who are not beginning students that they cannot blithely assume that individual choice, let alone values, will necessarily be transformed through simple summation into harmonious societal choice, let alone values? Is it not possible that in modern market-oriented economies, so far from atomistic competition, the Invisible Hand could fall victim to the fallacy of composition? Should we not at least attempt to develop a suitable analytical framework, specifically a realistic theory of political economy, in which the question could be pursued?

In fact the necessity for such an attempt is in process of being thrust upon us. Political economy as valuation is being forced to realize by the gap between the central concerns of the conventional analytical apparatus of economics and the central concerns of the economy that they need to be fused. Welfare economics never has been comfortable with notions of Pareto optimality, although it has elaborated them endlessly, because for one thing Pareto optimality never could cope satisfactorily with the Pandora's box Marshall so innocuously called externalities. Nor could it cope with welfare in any except a highly restricted sense involving the allocation of resources by prices with all the determinants of value given. The whole of the public sector, to which attention is shortly directed, is a monument to the limitations of Pareto optimality. Critical resource allocation decisions need to be—and in fact are—made constantly that cannot revolve easily about a market-price-measurable calculus. Pareto's maxim that the improvement in any member of the community improves social welfare if no one in consequence "feels himself worse off" is already inadequate if one must consider (as in all taxation questions, for example) the decrease in welfare of those whose taxes are increased and the increased welfare of those on whom the resultant revenues are spent.

Political economy as valuation then is ultimately as closely related to political science as economics always has been to psychology. Total allocation is made by both dollar votes and man votes.[20] To the conventional concern with how to measure the choices of individuals must be added the problem of how individuals influence each others' choices.[21] Even more crucial is the question of how individual and societal choices are interrelated. We lack a coherent developed theory here for static analysis, let alone for a dynamic theory capable of coping with the notion of economic progress. These problems can best be approached in turn.

The Valuation Process and the Public Sector

From what has been said, it is clear that the meaning of the political economy as the instrument for valuation transcends the confines of economics as allocation. One clear proof is the size of the public sector in all advanced industrialized economies, even the most market-oriented—our own. (More than 20 percent of 1972 U.S. GNP originated in the public sector.[22])

Prices are utilized for the goods and services purchased in the public sector, but we do not permit the price system to do the allocation except in a trivial sense. Indeed, the public sector exists precisely because here we have chosen to express our values through resource allocation by fiat. The quintessential example always has been defense expenditures. Collective consumption of any kind reflects the value process as embedded in the political economy. Our system operates in such a manner that military expenditures far more readily can achieve a high priority justifying taxation for subsequent social expenditures without being termed inflationary or "fiscally irresponsible" than can social welfare expenditures (note the term). The latter run into far stiffer opposition. Elementary macroeconomic theory suggests that a dollar's worth of government expenditure might, as a first approximation, be viewed as being as inflationary as any other dollar's worth of government expenditure. The terminology employed is, therefore, merely obscuring differences in what one defines as "necessary government expenditures." We conclude in effect that we "need" national security "regardless of price"—a subjective value judgment. We opt for stricter controls and limits on our definition of "need" in other directions, also a value judgment and one essentially nonprice determined. This can be illustrated by Charles Schultze's comment that the 1969 Department of Defense appropriation of some $78 billion involved only 50 different appropriations of which one (for procurement and research and development), amounting to $22 billion, was justified by a single-page appropriation. In contrast, the Health, Education, and Welfare budget of a mere $14.5 billion (the non–trust fund part) was covered in approximately 100 different appropriations. HEW's budget is one-fifth the defense budget, but requires twice the appropriations.[23] The same value orientation can be substantiated by dozens of comparable illustrations. The point here is neither to criticize nor to approve any particular attitude toward the resource allocation involved. It is only to underscore that because it concerns resource allocation, it is indubitably economic in nature; it involves political economy as valuation, and we have virtually nothing to contribute to the analysis as political economists.

Resource allocation is being carried out via de facto values, which both shape and are shaped by the economy and are no less integral because economics chooses to take them as given. A mixed economy is definitionally part market and part command, but most of the efforts made to bring the value problem into economics (except for the institutionalists) have centered on value as allocation in the market. This is true (as already noted) of Pareto optimal notions of welfare; and it is true of welfare economics in the Bergson-Arrow tradition.[24] Arrow made this point absolutely unambiguous: "We will assume in the present study that individual values are taken as data and are not capable of being altered by the nature of the decision process itself. This is . . . the standard view in economic theory."[25]

In short, virtually all would agree that modern welfare economics has been deliberately restricted to the interesting but extremely limited problem of defining and measuring social welfare only in cases for which individual values are given data and in which social welfare is restricted to the summation of these individual values. The "welfare" problem is confined to how to express and communicate individual values, how to sum them, and how to interpret the results. Whether individual values even so viewed can include collective consumption is not at all clear. The "social good" is surely deliberately eschewed. This brings us to the current concern with what is called cost-benefit analysis. On the face of it, it appears a potential step forward in coping with the value problem; perhaps it could be. But of crucial importance is the fact that cost-benefit analysis customarily is referred to as an application of welfare economics, and "social betterment" is viewed in terms of "a potential Pareto improvement." In short, social betterment cannot be separated from the summation and transmogrification of given individual values, which brings us back to the fallacy of composition, already commented upon.[26]

E. J. Mishan has suggested that Pareto-improvement notions of welfare are not very adequate until the economist decides whether to ground his welfare economics in utility or ethics.[27] This seems to obscure the issue somewhat, because one certainly could subsume utility under ethics, but what is needed is some more complete calculus than "the market" for expressing the underlying value system in economic decisions. This is more than cost-benefit analysis has ever claimed for itself.

Consideration of the public sector, therefore, suggests the magnitude of the problem. The public sector represents a sizable part of the total allocation of human and nonhuman resources in all market-oriented economies. We have noted that although the resources so allocated have prices attached to them, they are not fundamentally allocated by prices, but by fiat. The fiat comes from the political economy in the form of decisions to tax and to spend which are made by various officials selected in various ways (most through election, although by appointment in many critical areas, such as the Office of Management and Budget), and by consumers and producers organized into political units. What I am suggesting is that the manner and degree to which the economy develops, conveys, reacts to, and acts on societal values is as crucial to understanding and evaluating the political economy as the psychological basis of demand theory is to considering the behavior of individual consumers. Whereas economics may worry at least on occasion about its psychological assumptions, in both demand theory and the theory of the firm (the units involved in conventional economic "value" theory), little concern is expressed for the assumptions or characteristics of the political system through which individual and societal values are intermingled in myriad complex but crucial ways. Here dollar votes often are weighted by power considerations and in any case must be combined with man votes to represent the total allocational machinery—the political economy. Economics traditionally views "the market" as the only such individual-social conduit with which it need concern itself. But while it has concerned itself with its view of the individual, it has been relatively oblivious to the character of the other end of the conduit.

Such analysis is a necessary prerequisite to a meaningful evaluation of the performance of the economy in coping with its value problem. This emphasis is what distinguishes the position taken here from that taken by radicals, liberals, or conservatives, all of whom ultimately would seem to advocate the substitution of their own values for those they perceive in the system. The radical dissent involves, it is true, much that customarily is considered out of the bailiwick of conventional economic theory (the total distribution of power, for example). To the extent that the argument here is that the political economist must focus on the total allocation system, on how the political economy both shapes and responds to emergent societal values if it is to comprehend the meaning of the economy, our view, like that of the radicals, is broader than that customarily taken. To the extent that the radical critique is based on their dislike of the results they *perceive* emerging from the system, judgments with which we may agree or disagree, the argument here is different from the radical dissent.[28]

Liberals such as Galbraith, who is disturbed by "private affluence and public squalor," object to how the public sector is being used. But he, as are radicals and conservatives, ultimately is arguing that he likes his own values better than those he views as emerging from the political economy. His impact, too, depends ultimately on his persuasiveness. But for the science of political economy, adopting the values of any participant is no substitute for developing techniques for ensuring that the economy moves in a way that is consistent with its *own* emerging values, no matter how individual participants may view them. Such a theory of political economy as valuation would suggest, incidentally, appropriate techniques to all groups for influencing it in the marketplace of valuational ideas.[29]

The same judgment is essentially applicable to the conservative critique. Milton Friedman, for example, no doubt would argue that his "positive economics" avoids subjective valuation. He has attempted, in effect, to elevate market allocation per se to a value premise on grounds that the results are, in his view, most efficient, or if not efficient more reliable and ultimately more in accord with his notion of what the economy should be doing than any other allocative mechanism. His argument is that one should "trust the market" because, whatever its flaws, it performs better than nonmarket mechanisms. Friedman has commented, for example, that "the role of the market . . . is that it permits unanimity without conformity; that it is a system of effectively proportional representation."[30] The word *effective* glosses over most of the problems considered earlier (the actual sovereignty of the consumer, the impact of concentration on the use of power in market allocation, and so forth) as well as being fairly irrelevant to collective consumption. The market cannot possibly allocate defense, "proportionally" or otherwise. Friedman, therefore, does find a role for political allocation (man votes). But he suggests that "fundamental differences in basic values can seldom if ever be resolved at the ballot box."[31] It seems inconsistent to place such faith in laissez-faire markets for economic allocation and so little in democratic processes for converting individual values into social policy.

In the end, reliance on the market, even if more consistent than reliance on any one individual, is no substitute for a theory of political economy as valuation. There still will be allocation for necessary collective consumption by political or administrative fiat. Social Security may be "necessary" to Galbraith, but not to Friedman. National defense is "necessary" to them both (but how much and how to decide?). What shall be the criteria for determining "necessary"? The argument here is that these are crucial *economic* problems about which the economist remains mainly mute, that no single individual's values will suffice as acceptable criteria for these allocative decisions, and that the only solution is finally to face the total relevant value problem inherent in shaping and directing the destiny of the economy.

It might be added that Ayres's distinction between institutional and technological values was directed at just this point: that notions of welfare never can be appropriately resolved by the imposition of the "value system" of a single individual or group, nor (he argued) even of a given society. His failure was to suppose that emphasis on *process*, which eliminated the old problem of means and ends, could solve the value problem entirely. He argued that "the general welfare is not a condition; it is a process."[32] While he certainly was correct that values in this sense change, he underrated the practical need to develop an analytical technique by which emergent values in the political economy could be discerned. An adequate theory would constitute a mechanism through which emergent values are recognized, transmitted, and reflected in the ongoing operation of the economy. More important, economists then could judge both the accuracy and the sensitivity with which the political economy expressed society's emerging values and how closely it conformed to any other preconceived "standard." This is why the emphasis here has been on the need to develop a more complete theory of the political economy as valuation.

The institutionalist emphasis on process was convenient in that one could assume that progressive development, as in technology, would constitute economic progress definitionally. It did not entirely serve to distinguish growth from progress, however, unless one assumes that in time society will make the "right" (that is, "technological") choices. (Ayres, of course, did indeed feel technological choices were eventually inevitable. By emphasizing the "continuum" he thought he had disposed of the value problem inherent in the notion of an end in itself ["ultimate values].[33])

If the unsatisfactory way in which political economy currently copes with the value problem is illustrated by what it can offer in evaluating the public sector, its inadequacies for viewing the political economy through time are exemplified by considering the notion of economic progress.

The Frontiers of Dynamic Valuation: Political Economy and the Meaning of Progress

We have proceeded by stages, and we come now to the last step. We have suggested that economics has concentrated its work in welfare theory on that which is measurable within the market through prices and with individual values assumed given. Consideration of the meaning of prices limited to that framework suggests that the institutionalist charge (but only this charge) that conventional equilibrium always meant competitive equilibrium can be partially rebutted. We also have argued that the economy as an overall allocative mechanism should be the proper focus of the economist and that to do so he must once more become a political economist and cope with the meaning of total allocation—that is, the problem of value. It is here that the question of the public sector is most instructive.

If, finally, the element of time is added, as it must be if questions such as pollution, conservation, and development are considered, even a simple Pareto optimality would become quite complex. Should we try to "dynamize Pareto optimality" by saying that "a dynamic Pareto optimality implies that a change