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## The End of Welfare Economics As We Know It: A Review Essay

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*The legitimacy crisis of the new international economics has opened a new, atheoretical era in mainstream economics. This new generation of research has strengths and weaknesses: it asks practical questions (appropriate for policy), but it has left a theoretical void (especially concerning social welfare). Neoliberalism has rushed through the open door. One of the great contributions of George DeMartino's Global Economy, Global Justice is to make explicit the normative principles underlying neoliberalism, to explore alternative normative principles, and to pose the question, "what makes for a good economic outcome?"*

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### The Enduring Appeal of Neoliberalism

"Practical men," wrote Keynes in the final paragraph of *The General Theory*, "who believe themselves to be quite exempt from any intellectual influences, are usually slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back" (Keynes 1964, 383). Today's defunct economists are the Pareto-optimizing, general equilibrium theorists of the middle part of the twentieth century. Their work has been eclipsed by at least two new generations of mainstream economists, yet their insights and political perspective on the beneficence of the free market continues to hold sway in most policy circles.<sup>1</sup> Neoliberalism continues to have enormous appeal because of its political conservatism, its intellectual simplicity and power, and the lack of a clear alternative. While the question "what makes for a good economic outcome?" will never go away, "welfare economics" has vaporized in a cloud of multiple equilibria, representative agents, game theory, and increasing-returns-to-scale production functions. Since the recent generations of neoclassical economists have been unable—and, in their moments of regret, unwilling—to dethrone welfarism in policy circles, the important task has been taken up by an antiessenti-

1. Ironically, the same could be said of Keynesianism itself, which, although unseated from its intellectual throne over twenty-five years ago, continues to hold sway in most macroeconomics policy circles.

alist, institutionalist economist in his book *Global Economy, Global Justice: Theoretical Objections and Policy Alternatives to Neoliberalism* (DeMartino 2000).

### The Rise and Fall and Rise of the Global Optimum

The neoclassical theory of international trade has long been interpreted as an application of the competitive, general equilibrium model. Smooth and twice differentiable “social indifference curves” substituted for individual preference mappings. Thus, the same logic that gave the first fundamental theorem of welfare economics—that a perfectly competitive market economy when in equilibrium is Pareto optimal—also underpinned the result of free trade as a global optimum. Mutually beneficial trade resulted from the workings of the principle of comparative advantage.

A curious feature of this longstanding result on free trade, known in its modern form as the Heckscher-Ohlin-Samuelson theorem after its three originators, was that while it was a model of free exchange of goods, it assumed the complete international *immobility* of factors of production. Ricardo, often credited with discovery of the principle of comparative advantage, understood that the theory required the assumption of no international capital mobility. If capital were mobile internationally, then capital would simply move to the country with the higher profit rate. According to Ricardo, the factor immobility assumption was justified for its realism.

Experience, however, shews, that the fancied or real insecurity of capital, when not under the immediate control of its owner, together with the natural disinclination which every man has to quit the country of his birth and connexions, and entrust himself with all his habits fixed, to a strange government and new laws, check the emigration of capital. These feelings, which I should be sorry to see weakened, induce most men of property to be satisfied with a low rate of profits in their own country, rather than see a more advantageous employment for their wealth in foreign nations. (Ricardo 1951, 136–7)

Today, men of property appear to be less satisfied with a low rate of profits at home. If the phenomenon dubbed “globalization” could be reduced to one economic dimension, it would be the extraordinary increase in the international movement of capital. This has posed a challenge to the theory of trade and social welfare.

In fact, the demise of the neoclassical general equilibrium model of trade began over twenty years ago, largely in response to the model’s failure to predict some commonly observed phenomena such as intraindustry trade and successful industrial policy interventions by government, particularly in East Asia. By assuming deviations from the perfect competition, Pareto-optimal general equilibrium model (for example, by assuming the prevalence of imperfect competition, increasing-returns-to-scale technology, or strategic interaction among firms or even among governments), the “new international economics” was able to logically derive the predictions mentioned above about intraindustry trade and the welfare-enhancing

effects of “strategic” trade. This generation of economic models had another important feature. Because of the particular functional forms assumed on preferences and technology, proofs of Pareto optimality became mathematically intractable or structurally impossible. Many theorists abandoned the longstanding treatment of global welfare in terms of social indifference curves, adopting instead the single, “representative” agent’s welfare as the measure of social welfare. Welfare analysis focused increasingly on the capture of rents by national firms or governments, sometimes at the expense of other nations’ firms or governments, representing a distinct break from the Paretian tradition. The rents resulted from the market power created by clever intervention that depended on the particular demand or technological conditions.

Another important feature of the new models was their flexibility: they could be used to “explain” almost anything. This was initially seen as a strength. Phenomena casually observed but inexplicable with the traditional model (Germany’s simultaneous import and export of automobiles, Korea’s export-generating system of subsidies and trade protections, subsidy competition between the U.S. government in its support for Boeing aircraft versus the European consortium subsidy for Airbus) could now be rooted in the “rigorous” rationality of utility- and profit-maximizing microeconomic agents.

The flip side of flexibility was a lack of robustness: because of the stylized mathematical structure of the models, a change in a single assumption often led to a completely different prediction.<sup>2</sup> The result of this lack of robustness was a crisis of legitimacy for the new international economics, and for the hypothetico-deductive methodology that it nominally followed. Robustness, in the sense of mathematical generality, had been the hallmark of the general equilibrium, marginalist tradition. Progress of knowledge came by relaxing an assumption (that is, weakening the axiomatic structure) and generating the same result. In sum, progress of knowledge was synonymous with the increasing robustness of the prediction. In the new international economics, by contrast, the hypothesis was often identified in an ad hoc manner and the model constructed precisely in order to generate the hypothesis. This led to very particular assumptions on behavior, conjectural variations, or even functional forms. For example, the Dixit-Stiglitz utility function dominated the literature because it assumed that utility rose with more product variety, even though it also assumed, absurdly, a uniform elasticity of substitution across all goods.

The legitimacy crisis of the new international economics has opened a new, *atheoretical* era in mainstream economics. International economists now ask simple, intuitively appealing questions and apply sophisticated statistical techniques to get an answer. For example: Does foreign direct investment raise wages in host developing countries (Aitken, Harrison, and Lipsey 1996)? Does international outsourcing by U.S. firms raise U.S. wage inequality (Feenstra and Hanson 1996)? Is

2. In fact, this feature was one reason given by Paul Krugman to oppose the adoption of the policy conclusions of the models. The other reason he gave was that governments were not sufficiently precise to be able to implement the theoretically welfare-improving interventions. See my review in Milberg (1996).

democracy associated with higher rates of economic growth (Rodrik 1999)? Utility and cost functions do not even appear in these works.

The strength of this new generation of research is that it asks practical questions, the answers to which may be immediately useful for policy purposes. In this sense it represents an outward turn of research as opposed to the inward turn of the new international economics which, in providing rational, microeconomic models of commonly observed phenomena, was important mainly to the economists themselves.<sup>3</sup> The weakness of the recent empiricist turn—beyond the well-known Humean limits of inductive knowledge—is that it has left a theoretical void. Explicit discussion of social welfare has disappeared and the focus has turned instead to simple and measurable variables, such as wages, productivity, and economic growth. Into this theoretical void has rushed the old view on the optimality of free markets: neoliberalism unleashed once again!

### Behind the Veil of Neoliberalism

In his *History of Economic Analysis*, Joseph Schumpeter makes a distinction between “vision” and “analysis.” Vision is the set of beliefs and values about society and reality that any theorist holds—that is, it is “pre-analytic.” Analysis always presumes some social vision. As Schumpeter writes, “Analytical work begins with material provided by our vision of things, and this vision is ideological almost by definition. It embodies the definition of things as we see them, and wherever there is any possible motive for wishing to see them in a given rather than another light, the way in which we see things can hardly be distinguished from the way we wish to see them” (1954, 42). The general equilibrium marginalist tradition that underpins neoliberalism is not exempt from visionary underpinnings, and one of the great contributions of *Global Economy, Global Justice* is to make explicit the normative principles that provide these analytically elegant models an underlying vision. Not only is there an implied welfare theory—*pace* Keynes’s defunct economist—but there is an ethical norm.

DeMartino makes the case that neoliberalism’s internationalist welfare principles are flawed: “[O]nce we reject the equal validity and exogeneity of preferences, the concept of social welfare loses its analytical moorings” (2000, 89). Equal validity means that private consumption decisions and public choices can be measured similarly with “willingness to pay” calculations. DeMartino rejects this because the former involves what we want as private citizens, the latter “who we are as a community and society.” Exogeneity means that preferences are assumed to be fully formed prior to and thus independent of market interaction. If they are instead endogenous to this interaction, then we cannot claim markets to have best satisfied *natural* human wants.

At an even more basic level, DeMartino takes issue with the normative principles of the marginalist model’s theory of income distribution. In this model distribution is

3. I should note that much to the horror of the new international economists, noneconomists who supported protectionism and industrial policy embraced the new theories. See the well-known debate over “international competitiveness” in *Foreign Affairs* (July 1995).

taken as a purely technical phenomenon, determined jointly by marginal productivity and the market price of the output produced. It is the market-based version of "to each according to his contribution." DeMartino questions the justice of this and instead supports the principle of "to each according to need." He borrows Amartya Sen's idea of "capabilities equality" as the criterion for social welfare which, on a global scale, becomes the "global harmonization of capabilities." Capabilities require access to, for example, healthcare, education, employment, income, and political freedom. Against the cultural relativists (on the political left or right) who oppose any internationalist normative principle, DeMartino invokes Martha Nussbaum's notion of "internal essentialism," allowing for the possibility of the ex post discovery of shared values and basic capabilities.

The rejection of welfarism leads to a questioning of the process of competition itself. DeMartino identifies three distinct approaches to the process of international competition. The neoliberals are interesting in this regard because of their internationalism and cultural relativism. They are "anti-competitiveness" because their adherence to the principle of comparative advantage leads to the belief that free trade and free markets bring mutually beneficial results, irrespective of the absolute level of productivity or costs of some of the competitors. The second approach, "progressive competitiveness-enhancing," is supported by a prolabor group from the developed countries. They propose policies to boost productivity and lower costs, and support trade protectionism, in an effort to capture market share and more "good" jobs. The third group is that of "competition reducing," which seeks to promote the useful dimensions of exchange and to abandon its negative features.

Progressive competitiveness enhancing turns out not to be so progressive because of its strongly nationalistic bent. And anticompetitiveness, with its deep antipathy toward international standards because of its adherence to the principle of cultural sovereignty, turns out not to practice what it preaches, insisting on market liberalization at all turns, regardless of national "preferences."

That leaves competition reduction, an appealing alternative for the institutionalist because it assumes that the competitive process is not in any way natural, but a social construction. To the extent that aspects of the competitive process fail to serve the normative goal of global equalization of capabilities, then these should be removed from the competitive process.

Building on the capabilities attainment concept, DeMartino proposes a specific policy: the Social Index Tariff Structure. Countries are ranked by their provision of certain basic capabilities and level of gender and income equality (based in part on the United Nations human development index) relative to their per capita income. Tariffs would apply to trade between countries with widely different ranks, with the lower-ranked country paying a tariff.

One can take issue with DeMartino's criterion of global equalization of capabilities and its use in a global tariff scheme. An international standard for equality and capabilities attainment violates the notion of cultural relativism but, given the proposed adjustments based on each country's position, this violation is only in the broadest sense. And the idea is of course impractical and politically unlikely. The strength of the policy proposal is its theoretical underpinning in the normative

principle of equality of capabilities attainment. It is precisely this type of philosophical rigor and honesty that is lacking in most of the *mathematically* rigorous economic analysis done over the past fifty years.

### The Failure of Neoliberalism and the Power of Ideas

Keynes referred to the defunct economist who holds sway over madmen in authority not simply to indicate that policymakers are out of touch with the most recent academic theories, but to emphasize the power of ideas. To quote Keynes, “[T]he ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood . . . [T]he ideas which civil servants and politicians and even agitators apply to current events are not likely to be the newest. But, soon or late, it is ideas, not vested interests, which are dangerous for good or evil” (1964, 383–4).

Dare we, in this age of globalization, cultural relativism, and decentered subjects, speak of “social welfare” or “national welfare”? In *Global Economy, Global Justice*, George DeMartino makes a good case for why, in spite of the potential epistemological and ethical pitfalls, we must continue to ask, “what makes for a good economic outcome?” DeMartino has assigned himself an extremely bold task, but not mainly because of the challenges posed by postmodernism and its deep commitment to cultural autonomy. The main challenge is posed by the ideology of neoliberalism and its intellectual underpinnings in general equilibrium competitive market analysis that dominated economics for most of the latter part of the twentieth century.

The promises of liberalization have not been realized. Liberalized financial markets wreak crisis on emerging markets, globalized production networks perpetuate poverty wages and unhealthy work conditions, and global excess capacity means slow growth and high unemployment throughout the world. While outrage over these inhumanities is appropriate and sometimes effective in promoting change, thinking carefully through the logic of neoliberalism, its moral underpinnings and its alternatives, is also an essential step.

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pen name of J.K. Gibson-Graham, which she shares with her longtime collaborator Katherine Gibson, she co-authored *The End of Capitalism (as we knew it): A Feminist Critique of Political Economy* (Blackwell, 1996) and is currently writing a sequel entitled *Reluctant Subjects: Ethics and Emotions for a Post-capitalist Politics*.

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