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The Economics and Politics of Consumer Sovereignty

By ABBA P. LERNER*

The basic idea of consumer sovereignty is really very simple: arrange for everybody to have what he prefers whenever this does not involve any extra sacrifice for anybody else. It might seem that the only issue could be about the possibilities of achieving this most desirable objective. But there are other objections. One of the deepest scars of my early youth was etched when my teacher told me, "You do not want that," after I had told her that I did. I would not have been so upset if she had said that I could not have it, whatever it was, or that it was very wicked of me to want it. What rankled was the denial of my personality—a kind of rape of my integrity. I confess I still find a similar rising of my hackles when I hear people's preferences dismissed as not genuine, because influenced or even created by advertising, and somebody else telling them what they "really want."

In a rich society like ours, only a very tiny part of what people want is determined by their physical and chemical makeup. Almost all needs and desires are built on observation and imitation. As a social critic, I may try to change some desires to others of which I approve more, but as an economist I must be concerned with the mechanisms for getting people what *they* want, no matter how these wants were acquired.

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This view I find very close to the idea of democracy or freedom—the idea of normally letting each member of society decide what is good for himself, rather than have someone else play a paternal role. It is also very closely related to the idea of efficiency—efficiency in the use of resources for the greatest possible satisfaction of the needs and desires of people. It is understandable why the full achievement of consumer sovereignty has been called "ideal output."

One imaginary achievement of a golden age of consumer sovereignty has been described in Belloc and Chesterton's distributist society. Every family had its own house and garden where it produced everything it needed. It alone decided what to grow or to make and how to divide its time between work and play. No other family was concerned with how it made its choices, and it was not concerned with how other families made their choices. Each family could mind its own business, both in the sense of not meddling with the business of others, and in the sense of not having any others meddling in its business. Independence was complete.

An approximation to the ideals of the distributist state in combination with modern technology is achieved by the approximation to *one of the results* of perfect competition, namely, the equality of price to marginal cost. Other devices can also bring about this approximation, but a widespread belief that only the capitalist system can do this has made some enthusiasts for consumer sovereignty root for capitalism and made some haters of capitalism run down or deny the importance of consumer sovereignty.

Simplified accounts of how the market mechanism works, of which I have just provided an extreme example, seem to have led to the notion that a free market is a natural state of affairs. Indeed, the expression *laissez-faire*, which was intended as an admonition against deliberate restrictions on production and trade, has given rise to the idea that a working market mechanism will automatically arise like weeds in the garden or the fish in the sea, if only there is no human, and particularly no governmental, intervention.

There can be no greater misunderstanding of the origin of market economies. Thousands of habits of behavior and of enforced laws had to be developed over millennia to establish the nature and the minutiae of property rights before we could have buying and selling, instead of each man just taking what he wanted if only he was strong enough. Basically, what needed to be done was to disentangle sets of rights from the buzzing chaos of the universe and designate each such set of rights as a commodity that an individual (or a group) could exchange for another set of rights. We have got so used to such groups of rights that we tend to think of them as simple "things," but every "thing" is a set of rights. There are acts one has the right to perform with the "thing" and acts which one does not have the right to perform. When I buy a bottle of Coke I have the right to drink it or to pour it down the sink, but not the right to pour it over my neighbor or to throw it through his window. Soon, I hope, I will not have the right to put it in my garbage can. Every day devices are invented that require new sets of rights. Recently an electronic invention made it technically possible to buy for twenty-five cents the right to see a particular television program. The laws that will make this right practically operable have not yet been agreed on.

The development of such sets of rights enables us to deal with the "things" whose marginal costs and prices are to be brought into equality. Each set of rights begins as a conflict about what somebody is doing or wants to do which affects others. Some of the others are pleased and some object. With or without a fight, there is a settlement or compromise in which the rights are defined. Those who benefit from the activity gain the approval of those who object by giving them something to get them to agree. What I want particularly to stress is that the solution is essentially the transformation of the *conflict* from a political *problem* to an economic *transaction*. An economic transaction is a solved political problem. Economics has gained the title of queen of the social sciences by choosing *solved* political problems as its domain.

Consumer sovereignty is, of course, far from completely achieved even where appropriate institutions have been fully developed. Where the approximation to consumer sovereignty is left to perfect competition, we do not reach it if the competition is not perfect.

Consumer sovereignty is not served where knowledge of better or cheaper ways of production is suppressed or where there is insufficient investment in the production of such knowledge. It suffers on account of ignorance and is damaged by fraud. These and other faults and corruptions call for efforts to change the laws or the manner of enforcement of the laws. As time goes on we may hope that improved understanding will lead to corrections. The hope lies in the nature of the case. There is always enough to be gained from a movement toward ideal output to give full compensation to all who would be harmed by the correction, even if it is felt that they do not deserve it, and still leave some gain to be shared by all. Perhaps the greatest handicap here is a very powerful reluctance to pay compensation.

Closer approximation to consumer sovereignty may be expected from further development of devices, like the scrambling technique for pay television, which would make it possible to apply the market mechanism to parts of the economy where it was not possible before. The expanding application of the principle of equating price and marginal cost appears in the socialist countries' increasing the use of market prices for improving efficiency of production and distribution and in the current interest in imposing charges per unit of pollution emitted. This hopeful outlook goes against a current pessimistic trend. The importance, the significance, the prospects, and even the meaningfulness of consumer sovereignty, are all caught in a bear market which to me seems quite unjustified.

The most legitimate reason for playing down the importance of consumer sovereignty is to be found in the actual deviations of prices from marginal costs where, for political, sentimental, or bureaucratic reasons, the market mechanism is not being applied, or where appropriate technology or legal arrangements have not been worked out. Here the motto must be to try and try again to correct the distortions and to develop the technical and legal mechanisms required.

A second element in the current denigration of consumer sovereignty is an unreasonable exaggeration of the actual troubles. Some studies of the degree of damage done by monopolistic restrictions estimate it at less than one percent of the national income. These may well be underestimates, but vociferous critics of our society speak almost as if monopoly was wasting the greater part of our potential output. Similar exaggerations of the degree to which the wants of consumers are being manipulated by advertising charge that instead of industry producing what the consumers want to buy, consumers are being duped, manipulated, and brainwashed into buying what industry wants to sell.

A third element in the pooh-poohing of consumer sovereignty consists of denials that it really works. This has two roots. The first is a sentimental antagonism to money and prices and all its works as of the devil: materialistic, encouraging selfishness and greed, and destructive of mankind's natural or original virtue. Although this view should logically be against marginalism more strongly the better it works, the passions involved seem to cause its protagonists to seize with glee any arguments that claim that the hated machine does not even work right.

The second root is nourished by taking simplified *illustrations of the benefits* from price equal to marginal cost as *descriptions of the mechanism* for getting the equality. Each producer is seen as directly adjusting the output of his factory or workshop so as to equate his marginal cost to a price which he accepts as beyond his control.

The critics are right in saying that this is true only in a small part of the economy. Most prices are determined by bargaining between representatives of groups, as in the setting of wage rates, or by the deliberate setting of a price by a manufacturer at the level which he considers best—generally that which will yield the greatest probable profit.

But this does not invalidate the underlying tendency for the price to approximate marginal cost (with the deviations considered above). Unless there is restriction of entry into the industry, the price will be pushed into equality with average cost; and unless there is "fair trade" price maintenance, or an extreme product differentiation establishing local monopolies, the rate of markup and the resulting price will be lowered, in pursuit of profitable expansion of sales, until the price is near the marginal cost. Subject, of course, to the uncertainties involved, price will tend to a reasonable approximation to equality with the marginal cost of the factors employed by the firm plus the marginal cost of the capital at the current rate of return.

A fourth element in the current downgrading of consumer sovereignty comes from a refusal to separate this issue from the problem of inequality of income. Joan Robinson, for example, scolds economists for concerning themselves with "why a cup of tea costs more than an egg" instead of concerning themselves with the division of the national income between profits and wages, loosely identified with the division between rich and poor. The claim that the market guides production to what is preferred by consumers is ridiculed on the ground that relatively unimportant desires by the rich have priority over much more urgent needs of the poor. But the separation of problems increases the probability of the human brain being able to understand them.

The rejection of marginal analysis on this count implies that marginalism is somehow responsible for the extreme inequalities of income. There have been one or two economists who claimed the payment of factors in accordance with marginal productivity was "just" in that it gave them "what they produced." It is now almost universally agreed that there is no content to such an argument since "what they produce" is *defined* as the marginal product. The proposition is an empty one from which no moral or any other conclusion can be drawn. The argument for paying (the owners of) the factors the

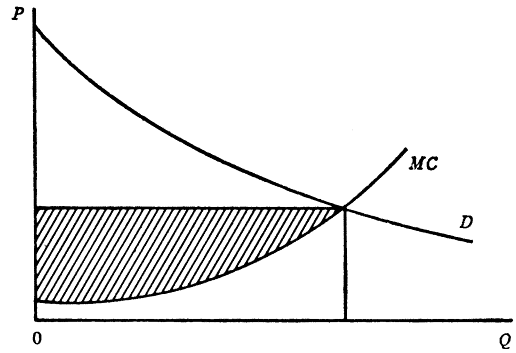

FIGURE 1

value of the marginal product is based, not on "justice," but on concern for consumer sovereignty. Against this must be considered whether it results in more inequality of income than is justified by the benefit.

Figure 1 shows how the division of income is affected by paying the owners of a factor its marginal product. The rectangle is drawn with its upper right-hand corner at the intersection of the demand curve for the factor (for use in the production of a particular product) and the factor-owner's supply curve. At this point, the price of the factor is equal to the value of its marginal product. This is what is required for consumer sovereignty. The height of the rectangle represents the price per unit of factor; its length, the quantity of the factor supplied; and its area (price times quantity), the total amount paid to the owner.

The area of that part of the rectangle which lies below the supply curve measures the "necessary" payment—what has to be paid (to the owner) to keep the factor from going elsewhere. The (shaded) area above the curve represents "unnecessary" payment, the excess of what is actually paid over the "necessary" payment.

It is possible to avoid making these "unnecessary" payments because ideal output requires not that the price of *all* the units of the product be equal to the marginal

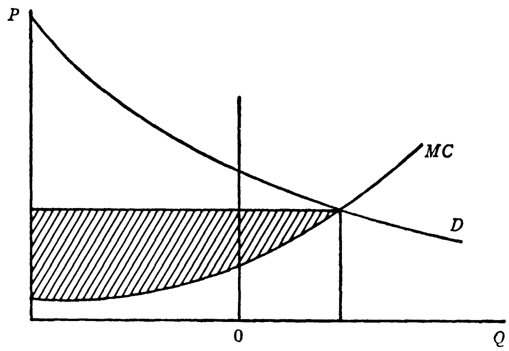

FIGURE 2

cost, but only the *marginal price*, the price paid for the marginal unit; and similarly, not that the pay for all the units of a factor be equal to (the value of) the marginal product, but only the *marginal pay*, the pay for the marginal unit.

Paying for *all* the units of the factor at the same marginal product rate may seem necessary because it is natural to start counting from zero. But this is quite arbitrary. A count could begin at any other point established by convention. If the owner of the factor is providing eight hours of labor, it would be possible to start the count at five hours and pay at the marginal product rate only for the three additional hours' work. What, if anything, is paid on top of this is arbitrary. It could be either more or less than five times the marginal product (which is what he would be getting if the count started from zero). Whether he is paid more than this or less could depend upon whether he is considered to be too poor or too rich.

What *is* necessary in addition to paying the marginal rate from the arbitrary starting point, is that he be given sufficient incentive to come and do the five hours' work and then get the marginal product for the additional three hours.

Such a procedure is illustrated in Figure 2, which consists of Figure 1 with a vertical line put in to show the chosen zero point for counting the units to be paid for at the marginal product rate. A sufficient incentive would be the unshaded area in the rectangle to the left of the zero line. The shaded area represents "unnecessary payments"—resources that are available for improving the division of income without interfering with consumer sovereignty.

Economists will recognize in this a way of formulating the propositions on marginal cost pricing developed by Ronald Coase and James Buchanan. This may not be so obvious at first because they were more concerned with the symmetrical phenomenon relating to the demand curve rather than to the supply or marginal cost curve. They were dealing with the unnecessary benefit to the buyer of the product, rather than with the unnecessary payment to the supplier of the factor.

In Figure 3, the zero line is moved over all the way to the point of intersection. This illustrates the limiting (and therefore completely impractical) case of complete elimination of all inequality as described in my *Economics of Control*. This would call for estimating how much each individual in the society would be able and willing to earn, given his special skills and abilities, and imposing on him a lump sum tax equal to the excess of this over the average income of the whole economy. If this could be done, he would earn the estimated income, and after paying the lump sum tax

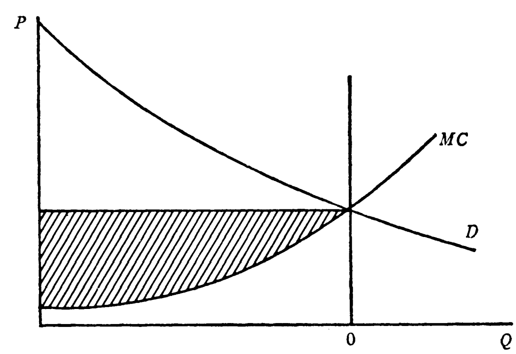

FIGURE 3

he would be left with the same as everybody else—the average income—and there would then be no inequality at all. This, of course, is only an exercise in economic analysis. To the degree that the zero line cannot be moved over all the way, we are left with necessary or *functional* income inequalities.

Extreme inequalities of income or wealth are thus not essential accompaniments of marginal price mechanisms and therefore do not provide a valid reason for giving up their use. Furthermore, the poorer people are, the more important is it that what they do have should be used in the most efficient way to satisfy their needs; and this calls for consumer sovereignty.

If there is extreme inequality it may very well be more important to do something about the inequality than about improving the efficiency in the use of what resources are left for serving the poor, even though such a redistribution of income could not be eased by the payment of compensation. However, if one is concerned about raising the level of the poor, rather than with reducing the wealth of the rich, a far more promising approach is to concentrate on growth of productivity and on full employment. Redistribution from the rich to the poor, even if it is done with the greatest skill in protecting functional inequalities, can only transfer, at the most, some 10 or 20 percent of the national income from the richer to the poorer, and this only once and for all. Growth of productivity has, during this century, more than quadrupled (i.e., increased by more than 300 percent) the income of the poor as well as of the rich.

A fifth attack on consumer sovereignty comes from critics at the opposite pole from those who find it too difficult to abstract even momentarily from the evils of income inequality. This is from a cult of "objectivity" that exaggerates the desirability of scholars recognizing and containing their prejudices, into a demand that they limit themselves to propositions completely free from any moral or ethical content and from any interpersonal welfare comparisons. This essentially amounts to a refusal to consider any significant welfare problems since it is very hard to think of any policy to benefit some people which would not also bring some damage to others.

Finally, among the current deprecations of concern with consumer sovereignty is its rejection on the grounds that it concentrates on the *individual* instead of considering *society* as an organic whole with its higher purposes to which the narrow interests of the individual should be subservient. Sometimes this is adduced in the name of all humanity, sometimes in the name of an even wider world spirit or collective mind. More often it is found in the narrower context of the interests of a race or class or nation.

These are, of course, matters of philosophy or religion—matters of faith on which the economist as such has no special professional competence. Most economists, however, have conducted their studies on the assumption that individual human beings (and other animals) but no races, classes, nations or other social groups have the sense organs, the nerves and the brain mechanisms which are capable of feeling pain and pleasure or gratification and frustration—that races, classes, nations, and other social groups are only collections or combinations of individuals for particular purposes. These may be of the highest importance for the individuals involved, but it is only the individuals who can experience welfare or the lack of it. Economists, therefore, generally disregard such philosophical downplaying of the importance of consumer sovereignty.

There is, however, a much more serious problem currently facing those concerned with consumer sovereignty than the exaggerations of the imperfections and the ideologically fueled attacks I have just considered. This is the case of *public goods*.

Public goods are goods which cannot be provided for some without being provided for others. The normal market mechanism for achieving consumer sovereignty is therefore inapplicable. Those who would benefit from the provision of such goods will not pay for the benefits because they can enjoy them without paying if they are provided for anybody else. Everybody will wait for somebody else to buy them and hope to enjoy a free ride.

This is not a new problem. Indeed, in the beginning, before the invention of property rights, *all* goods were public. It did not pay anyone to improve on traditional procedures because any resulting increase in output would be free to everyone in the tribe. It did not pay anyone to build a house if he could instead find someone who had built one and then move in with him (or kick him out). Only with the establishment of privatization, or property, was the decentralization of decisions necessary for efficient production made possible. Our problem now is that the invention and application of the special devices needed to *privatize* the public goods have lagged behind the great increase in production of goods of all kinds. Privatizing is nothing more than establishing the institutional arrangements by which the individual or group who pays for the benefit gets it and the one who does not pay for it does not get it.

Among the reasons for such lagging in the art of privatizing public goods have been the philosophical and sentimental hangups against marginalism and markets. Thus there is no shortage of automobiles because we have to pay for them. They have been privatized. There was a shortage when the price was held down during and after World War II and the (new) motor cars were insufficiently privatized. They did not go to those who needed them more than the alternatives they bought—which were no easier to produce. There is, however, a shortage of space on the roads for the automobilies because we have not yet arranged to make people pay for the road space in the way they have to pay for the gasoline. Road use has not yet been privatized. There is no shortage of refrigerators (in countries where the price is free to be set by the market), but there is a shortage of houses into which to put them because we have partially deprivatized housing into a semipublic good by preventing the market price from operating to induce builders to provide enough more houses and users to economize in their use. We also suffer from faulty ways in which the price mechanism is used, as when the telephone and electric power companies, who are not able to keep up with the demand, follow habits developed when there was excess capacity and continue to encourage a greater use of the overstrained facilities by charging lower rates for larger users. This, too, is in large part in response to the popular prejudice against marginal cost pricing, in cases of this kind presumably because the marginal cost is very high.

There is, at present, a surge in the importance of public goods that perhaps qualifies as a critical transformation of quantity into quality. It arises from the current concern with ecology and the pollution of the environment. We have all suddenly been made aware of the finite nature of our planet—so beautifully expressed in Boulding's phrase "spaceship earth."

A similar crisis can be supposed to have occurred when Adam was expelled from Eden. Labor, which had not been needed before, became a scarce and economic good. This is the meaning of "by the sweat of thy brow shalt thou eat bread."

Products that require labor for their production became valuable, and this encouraged their economic production and discouraged their wasteful consumption. For this, the sower of the seed had to have security in reaping the crop.

With the use of tools for production, these too, like the crops, had to be protected from free use by anyone who saw and coveted them. Private (or group) property had to be established in a complex system of rights and duties in connection with tools or capital goods.

Another crisis occurred when the increase in population made productive and nearby lands scarce and conflicts arose for its use. Abraham and Lot had to agree to move off in different directions. The God-given freedom of all men to hunt and pick berries from the land had to be limited by the privatization of land rights.

What is happening now is that we have moved to the ends of the earth—and not only horizontally. We are discovering ecology—that the rivers are not infinite sources of clean water, that the ocean itself is not an infinite receptacle for our garbage, and that the air is exhaustible too. But we have not yet developed and applied the techniques required for the privatization of these limited resources. The development of proper charges for damage done by polluting the environment in the same way as proper charges have been developed for the damage done by using up other scarce commodities will turn these public goods into private goods, with the social benefit from the resulting care in their preservation and use.

However, not all public goods can be privatized. There will still be services which, if provided for some, are inevitably made available for all. The market mechanism cannot work. Everybody will refrain from buying them in the hope someone else will. And nobody will be willing to pay the total cost of a benefit to all.

Where this is the case, agreement is necessary for combined action. This is what government is for. A citizen will agree to be compelled to contribute to the cost of a project, provided enough others also are compelled, so that his benefit exceeds his contribution (or tax). I see no reason for expecting such nonprivatizable services—such inherently public goods—to become more important in the future. It is our failure to privatize where privatization is possible, and even our ideological deprivatization where it has already been achieved, that is responsible for most of these ills.

There will nevertheless remain public services that are not amenable to this type of decentralization and the refinements of market adjustment to individual preferences just cannot be achieved. Decisions have to be made in the large by legislative or administrative bodies and we are back in the realm of politics. Majorities will override minorities unless the minorities are able to impose their will on the majorities. Attempts will, of course, be made to avoid dissatisfactions, especially if they could lead to revolts. But we cannot have the nice adjustments by which each can get what he wants without this affecting what others get. We will not have solved the political problem by converting it into an economic problem.

I may conclude by mentioning the one situation in which the marginal economic mechanisms are unnecessary. This is where everybody has as much of everything as he wants. Such a state of affairs is sometimes called communism (as distinct from socialism which claims to be the path to communism because it will become much more productive than capitalism). Sometimes it is called anarchism, since there is no need to protect any ownership of property, and it is usually discussed by people who believe that it is only material deprivation that causes anyone to harm any fellow man. To avoid an unnecessary quarrel we may call it simply the state of plenty. But it is not clear that the so-called capitalist countries are less socialistic than the so-called socialist countries, or that the latter are much less capitalistic than the former. Furthermore, the so-called capitalistic countries—the Western democracies—seem to continue to be more productive than the so-called socialist countries—the Eastern one-party dictatorships. The West might then reach the state of plenty before the East. Unfortunately, there are no signs that either is getting anywhere near the goal. So far, demand everywhere has kept pace with the increasing supply while the limitations of spaceship earth make it questionable whether there will continue to be much improvement in the overall condition of life or whether the level that has already been reached in the West is even achievable for the world as a whole.

Perhaps the only possibility of a state of plenty lies not in the increase of goods, but in the reduction of wants. If a culture of simple living on Ghandian lines should be universalized, it might indeed be possible to provide fully for the requirements of all. Those political problems that can be solved by appropriate compensations, namely, those that can be converted into economic problems, would then all be solved, and we would indeed enjoy the euthanasia of economics and of all the calculating that many find so hateful.

There are, however, still some important provisos. The Ghandian reduction in the demand for goods must not be accompanied by a corresponding hippie reduction in willingness to work at what will still need to be produced. The market mechanism might still need to be retained to indicate to producers what they can produce and how, and the whole adventure must not be swamped by a continuing increase in population. With these provisos a state of plenty could be reached and even maintained. But this would still leave unsolved the political conflicts, the truly and incurably public issues, with conflicts whose spells cannot be broken by translating them into economics.