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Economists are interested in the subjective values associated with the sources of individual satisfaction because of their concern with the economy's ability to allocate resources and coordinate production and distribution so as to create the greatest benefit to society. For many needs and desires, competitive markets are a relatively good means for determining and responding to individual preferences. There are, however, limits to this solution, because not all sources of satisfaction go through markets, and markets may fail in other ways as well. National product and income estimates as measured by market transactions are therefore incomplete and inadequate measures of overall welfare. Correcting for this by estimating values uncounted by the market can help, although this is often difficult, and at times virtually impossible.

STRENGTHS AND WEAKNESSES OF COMPETITIVE MARKETS

In order for an economy to "create the greatest benefit at the least cost as those benefits and costs are evaluated by the people who experience them," (93) it is necessary to aggregate individual preferences into global preferences. There is no completely objective unit of measure for doing this, but competitive markets can use money (the best available measure of subjective value) to perform this aggregation -- not for the entire range of needs and desires, but for that large subset that can be satisfied by consumer goods and services. The theoretical advantages of market economies derive from the fact that there is a market-clearing price for each good; this further implies that, for a given good, each purchaser attributes the same money-valuation (which is the price) to the last unit purchased of that good; and thus prices function as "signals that enable a perfectly competitive economy to utilize and allocate resources and productive methods in best conformity to consumers' preferences."[1]

When it comes to evaluating overall levels of satisfaction, however, competitive markets are seriously limited by a number of market failures. First, markets can only measure values attached to needs or desires that are satisfied within them, but many important economic goods and services, as well as costs or pains, do not reach people via markets. In addition, market prices only adequately reflect subjective valuations in situations of perfect competition, yet in reality most markets are imperfect. Consumer preferences can also be unreliable or undesirable, and may need to be overridden or corrected. Finally, production and consumption can have positive or negative side effects, or externalities, that are not measured by markets, but that may have significant impact on overall levels of wellbeing.

Each of these problems is considered in more detail below.

COLLECTIVE AND MERIT GOODS

Collective or public goods are equally available to everyone, but may be valued differently by different people. Some of these public goods are created by the asymmetric situation in which consumers compete with one another according to the ideal competitive model, while sellers often do not. When there is insufficient competition to force the latter to lower prices to the marginal cost of production, we find such forms of non-price competition as provision of customer services, agreeable shopping conditions and aesthetically agreeable displays. The buyers' response (e.g., preferring to shop in pleasanter, even if more expensive, surroundings) suggests that the buyers' marginal valuations can still be deduced from the market price; but the sellers' marginal valuations are overstated in these less than fully competitive situations.

"More important, more valuable, and much more numerous than the privately provided collective services just discussed are those provided by government and paid for out of taxes." (96) Here, the difficulty is to determine the appropriate nature and quantity to be supplied. In theory, public participation in the political process should yield some indication of their valuation of these goods, but this approach is tenuous. An alternative is to aggregate individual statements of willingness-to-pay for a good, but this too is impracticable, not least because of the incentives for people to mis-state their levels of preference depending on how they think the information is going to be used. No adequate solution to this dilemma is yet available.

Income distribution is a special kind of collective good because preferences for it are based on moral judgments, which are "bound to be much more nearly uniform than . . . judgments of personal gratifications and their sources." (97) Most people value some degree of equity, though not complete equality, since work incentives and opportunities to pursue superior economic status are also sources of satisfaction. Societies usually resolve these opposing impulses by pursuing equality of opportunity, and by promoting greater equity by raising people at the low end of the income scale above the poverty line, while leaving the rest alone.

The value of certain goods may not be sufficiently recognized by everyone, so it may be necessary to override markets and actively encourage their consumption. Consumption of these "merit goods" can be promoted through compulsion (e.g., mandatory contributions for social security and unemployment insurance), subsidization (e.g., for the arts), or free provision (e.g., health care in some countries). Another type of merit goods that also require market intervention includes goods or services, such as hospitals, that are valued even by those who do not use them. We might use the term "demerit goods" for harmful products (such as narcotics) where the user pays another cost for consumption, in addition to the purchase price. Informed opinion favors discouraging at least some of the market activities related to these "demerit goods."

ECONOMIES AND DISECONOMIES

Many goods and services can have side effects on third parties that are known as external economies or diseconomies. The benefits and costs of these externalities do not pass through the market, and so are not reflected in market prices. Health services and education generate external economies, while pollution and environmental degradation produce external diseconomies. The ideal way to correct for them is to supplement market prices, for example by imposing taxes or fines on producers equal to the cost of the diseconomy; however, estimating these costs can be difficult or even impossible, and enforcement is also problematic.

Work is a particularly important realm in which many nonmonetary side effects are experienced, both positive and negative. However, both the positive effects of challenging and responsible work, and negative impacts such as the tendency of technical progress to render work more monotonous and less satisfying, are often overlooked. Undervaluing worker satisfaction results in excessive emphasis on financial incentives. Both Keynes and Schumpeter also warned against "exaggerating the role of profit as the motive force of investment and growth." (100)

SCARCITY VALUES

As economies grow due to technical progress or expansion of the labor force, uneven changes in the balance of supply and demand are resolved by price changes. For goods or resources such as land that have fixed or decreasing supply, prices will always increase. Even more problematic is the case of fixed resources that are also collective goods, such as the atmosphere, beautiful settings, and fresh water supplies; these they have no market price, so rising prices cannot motivate conservation or adaptation. There is a danger that, without the warning of an increasing scarcity price, the response will be degradation of the resource rather than decreased use. For such goods, "their husbanding . . . cannot be left to the market but must be undertaken collectively, by the state." (102) Like external diseconomies, however, monetizing and internalizing scarcity costs -- the theoretically correct solution to this problem -- is difficult to impose in practice.

WELFARE AND GROWTH

Since price is taken by economists as a measure of the value attributed to goods by consumers, it is not surprising that they use the sum of the value of all market transactions -- national product or national income -- as an indicator of both the economy's performance and public welfare. However, while these may be good indexes of economic performance, their use as measures of welfare is much more problematic. One reason for this is that the satisfaction derived from a good is related not just to price, but to quantity and quality as well.

Another is that, when we increase the national product, we may incur some costs that are not measurable. Expanding output by means of increasing labor input has obvious implications for worker wellbeing; national product should therefore be expressed per annual work hours, but this is seldom done. In the short run, increased production can also be driven by allowing capital equipment and infrastructure to deteriorate, as the Reagan administration did, but this exaggerates the impression of economic prosperity while leading to long-term problems. The unmeasurable costs of economic activity such as decreasing equity of income distribution and negative environmental impacts must also be considered. For all of these reasons, indexes of national income or national product cannot be considered adequate measures of human welfare.

Notes

1. Editor's note: It is important to be clear that the value on which all consumers agree – that is, the price they are all willing to pay for the marginal unit consumed—does not imply identical subjective values for those marginal purchases, because money itself may be expected to have a very different subjective value to different people, depending on how much they have, what their needs are, etc. The allocation according to preferences cited here is, in fact, allocation according to effective demand.