

**Toward a *Political* Institutional Economics:
Kapp's Social Costs, Lowe's Instrumental Analysis,
and the European Institutional
Approach to Environmental Policy**

***Sebastian Berger
and
Mathew Forstater***

This paper proposes that K. William Kapp's "Theory of Social Costs" and Adolph Lowe's "Instrumental Analysis" are complementary analytical frameworks that contribute to the formation of a unique and practical approach to institutionalist economics. In particular, we employ a Kapp-Lowe synthesis to address questions of environmental policy, about which both scholars were deeply concerned. The result is what may be called a distinctively European "Political Institutionalism" that transcends mainstream arguments for market solutions, and makes environmental policy an effective instrument to reduce social costs. The paper concludes with a proposal for further research investigating the potential of this integrated Kapp-Lowe approach.

Kapp's Theory of Social Costs

In his significantly prescient work, *The Social Costs of Private Enterprise* (1950), Kapp defines social costs as that share of the total costs of production that the individual enterprise is not held accountable for, and which it shifts to third parties, society as a whole, or future generations in the form of harmful consequences and damages (Kapp [1963] 1977, 13).

Whenever social costs are shifted onto economically and politically weaker sections of society without compensation, a redistribution of the costs of production, hence real income is involved. (Kapp 1972b, 16)

Sebastian Berger is a Lecturer at the University of Missouri-Kansas City, and Mathew Forstater is an Associate Professor of Economics and Black Studies at the University of Missouri-Kansas City. This paper was prepared for presentation at the Annual Meeting of the Association for Evolutionary Economics in Chicago, IL, January 5-7, 2007.

Kapp's theory shows that social costs are to a large extent a non-market phenomenon because the relations between production, the environment, and the individual, are not voluntary market relations, but involuntary one-sided relationships forced on the individual. The individual cannot escape them and they happen "behind his back." Environmental pollution is synergetic with pollutants mixing in the ecosystem in a way that makes it impossible to determine responsibility. Moreover, pollution is cumulative; once thresholds are passed, the effects are out of proportion relative to their cause. Social costs originate because firms are not held responsible for the full cost of production. The profitability of many investments would cease altogether if producers had to pay the full costs. Because of asymmetric power relations, the bearers of social costs are usually too weak to defend themselves against this cost shifting.

According to Kapp, social costs reflect above all a misallocation of resources resulting from an institutionalized economic calculus that induces economic units to take inadequate account of harmful environmental effects of their investment (including location) and production decisions. This purely formal rationality in decision-making is based on the information provided by market prices together with the principle of profit maximization and cost minimization by means of cost shifting. In this instituted process, investment decisions depend on net present value, which gives an incentive to shift costs to the future to diminish their discounted present value. Kapp shows how this institutionalized economic monetary calculus leads to a path of economic growth and profit maximization via premature resource depletion rather than environmental goals. The self-reinforcing nature of economic institutions leads to cumulative, ever increasing social costs.

They [social costs] are damages or diseconomies sustained by the economy in general, which under different institutional conditions could be avoided. [. . .] if these costs were inevitable under any kind of institutional arrangement they would not really present a special theoretical problem. [. . .] to reveal their origin, the study of social costs must always be an institutional analysis. Such an analysis raises inevitably the question of institutional reform and policy. (Kapp 1963, 186)

Linking Kapp's Approach with Lowe's Instrumental Analysis

We now take a closer look at Lowe's Instrumental Analysis in order to point out links to Kapp. In his "Remarks" ([1980] 1987) on receiving the Veblen-Commons Award, Lowe makes his views on economic science explicit. While supporting Veblen's definition of evolutionary science ("a theory of a cumulative process of adaptation of means to ends") he advocates an evolutionary way of thinking in regard not only to the object, but also to the method of economic analysis. This is necessary due to changes in socio-psychological and institutional factors. Unlike the natural sciences,

there is no invariance of the object of inquiry in economics (Lowe [1980] 1987, 228-33), because the economic system is an open system in which reciprocal interlacements and cyclical flows change socio-ecological and economic variables (Löwe 1935; Lowe 1969, 9-10). Since the publication of *On Economic Knowledge* (1965), Lowe's major theoretical concern has been the means-ends relation, which means shifting attention to the theory-practice relationship, aiming at preventing unwarranted developments through public controls (Krohn 1996, 91, 173-4).

Lowe advocates that the goal of economics should be to discover the suitable means for the attainment of previously stipulated ends. The ends are treated as known goals and are established through political decisions. Hence, according to Lowe, the first task for economics is Instrumental Analysis, which evaluates different paths by which the current state can be transformed into the terminal state (Lowe [1980] 1987, 228-33). In other words, in his "Political Economics" the role of theory is to instrumentally devise means, such as public controls. The latter would provide a set of suitable controls to establish the context and behavioral patterns suitable to attain societal macro-goals, which are highly amenable to the incorporation of bio-physical limits (Forstater 1996, 60, 109, 116). This is important because from the late 1960s onward, Lowe incorporates environmental factors into his analysis (Forstater 2004, 19), which focused on the constant side effects of technical change and structural upheavals resulting from that change. Hence, not short-term interventions, but comprehensive long-term planning and intervention are proposed (Krohn 1993, 115). This "working backwards" from a politically defined goal is what the subtitle *Political Economics* is all about (Krohn 1993, 153). Importantly, it has been shown that Lowe's focus on "knowledge for goal seeking" is a version of C. S. Peirce's method of inference "abduction" because it treats the future state of the system as known, by defining in political terms the goals to be reached, and works out a plurality of possible paths to achieve it (Forstater 2004, 25-8).

By the time he finished *On Economic Knowledge*, Lowe was aware that his Instrumentalism aimed at a revision of traditional economics (Krohn 1996, 91, 173-4). It tries to reconnect the economic process with the essential components of the sociopolitical world (Krohn 1993, 154). Lowe, however, did not depart entirely from the traditional ways of argumentation because he only discussed the modal rules for a goal-adequate path, not the ethical standards for economic action (Krohn 1996, 149). This is why Lowe's Instrumentalism is not presented as totally "new," but incorporates new elements, identifies something implicit and unrecognized bringing it into full consciousness, elaborating its possibilities and promoting its potential contribution (Forstater 1996, 116, 118).

Lowe's Instrumental Analysis bears similarities and is highly complementary with Kapp's theoretical framework for reducing social costs. Kapp expresses his agreement with Lowe's *On Economic Knowledge* in two letters to F. Pollock dating from 1966 (Pollock Correspondence, Kapp Archive),¹ and in an unpublished version of his article *The Open System Character of the Economy* (1976):

the new task of economics would be to elucidate the manner in which collectively determined social goals and objectives could be attained in the most effective and socially least costly manner. [. . .] This brings our notion of normative economics close to that of political economics: the theory of controlled economic systems as developed by Adolf Loewe [sic] *On Economic Knowledge* [. . .] also R. L. Heilbroner [sic], "On the Possibility of Political Economics." (Kapp 1976 20)

According to Kapp, social costs show the open system character of the economy that induces physical and institutional causal chains in the form of non-market relationships and secondary distribution. The amount of social costs that is taken into account depends on the power structure of society because vested interests are affected. Therefore, social costs can only be reduced significantly in a social evaluation of the relative importance of social costs and benefits, which carries elements of political decisions as to social purposes and goals. Kapp elaborates a process that consists of different stages of societal goal formulation, conflict mediation, and democratic decision making between the affected groups of society (Kapp [1974] 1983).

In this approach, Kapp applies Dewey's pragmatic Instrumentalism to policy making, which shows how all crucial decision-making must invariably include an exploration of the goals pursued both as far as their content and their implications are concerned (Kapp 1965, 59).

[. . .] the instrumental elaboration of the paths to be followed, the choice of means in its broadest sense, both belong to the rational setting of objectives and their rational achievement, i.e., rational in the light of empirically testable criteria. [. . .] The logic of the determination of objectives is added to the logic of the achievement of objectives by the introduction of means suited to the objectives. When political economics is oriented towards the preservation of life and providing the means of existence [. . .] it includes the exploration of what is necessary and possible and, in the form of political action, deals at the same time with the question of how appropriate reforms may be used to realize sets of objectives that have been recognized as necessary and found social acceptance. (Kapp [1968] 1985, 112-3)

According to Kapp's approach, policymaking requires flexibility that must guide the exploration of ends and means in their changing natures. Search for alternative possibilities and prognosis of alternative courses of action take place in interrelation with the choice of ends and the formulation of right action. These are progressively specified on the basis of comprehensive feasibility studies, i.e., scientific research efforts designed to provide information through a simulated prognosis of

events. The quality of the plan depends on how well the information used in the simulation can anticipate the real outcome. Constant use of feasibility surveys is a precondition of the success of the plan. This means that the policy maker has to deal with questions as to the role and nature of modern science, technology, input mixes and production functions, which cannot be taken as given but are dependent variables (Kapp 1965, 64-73).

Implications for Environmental Policy

An integrated approach of Kapp's Theory of Social Costs and Lowe's Instrumental Analysis bears implications for environmental policy aiming at a reduction of social costs and bringing the system onto a suitable path for achieving a sustainable economy. The starting point has to be the elaboration (i.e., vision) of goals, and Kapp argues that the political process has to arrive at priorities in light of objectively defined human needs and requirements, including the quality of life. What is required is nothing less than the scientific definition of fundamental requirements of human life and survival, and ecological sustainability as integral parts of the constellation of goals. Particular aspects of the quality of the environment, such as air or water, must be an end in itself, because they are existential human needs. By subjecting them to scientific inquiry, the universal values of existential human needs (Steppacher 1994) can be objectified and transformed into social minima and maximum tolerance levels for pollution. Once they are determined, social minima allow evaluating and exploring different means and ends in light of their differing costs and benefits, their effects on the physical and social environment, and hence, their effect on the satisfaction of human needs. One way to measure social costs is in terms of existing deficiencies by comparing the actual state of pollution with the maximum permissible concentration of pollutants (per time period and within a particular geographical region). These environmental standards are arrived at by defining social minima based on a definition of human needs, such as minimum requirements for clean air.

[. . .] we suggest that the substantive definition of social costs and social benefits is possible in terms of objective requirements [. . .] [because they] can be determined with a considerable degree of scientific method and objectivity. That is to say, the identification of social costs and social benefits calls for scientifically determined social minima [. . .] (Kapp 1963, 193-4)

Obviously, the neoclassical or Pigouvian approach based on "externalities" takes a different point of departure that relies on market prices. Kapp gives several reasons why socio-ecological values and needs cannot be adequately expressed in terms of market prices (Kapp 1972a). First, market prices are never "objective" but reflect private economic costs and profits that are an arbitrary outcome of the asymmetric distribution in purchasing power, conflict and compromise. Reliance on market prices usually leads to the morally least desirable option; namely, that the ones

with the greater purchasing power shift social costs to the poorest because it is “cheap and easy.” Starting from initially small differences, the market mechanism initiates a vicious circle of ever increasing unequal distribution via circular cumulative causation. Second, social costs are an all-pervasive phenomena, a kind of secondary distribution that not only concerns market actors but also the interests of society and future generations. Determining a discount rate for the social costs that are shifted to future generations clearly shows that fundamental moral issues are involved that cannot be left to markets. Third, one-dimensional market prices cannot reflect the heterogeneous processes in the ecological system. This would be necessary if market prices were to serve as an informational basis aiming at reducing social costs. Fourth, “internalizing” them via payments of “green” taxes does not make “pollution” go away and cannot replace the irreversibly lost quality of the environment. Ex-post remedial measures and indirect methods fall short of what seems to be required to protect or improve the quality of the environment.

Pollution effects are not minor side-issues and cannot be easily corrected by isolated *ad hoc* measures of legislative control, chosen and preferred because they are more or less compatible with the market system. [. . .] What has always been put in question by the phenomena of [. . .] social costs is the rationality of allocation and production patterns guided by market prices. (Kapp [1971] 1983, 124)

In view of the rapid deterioration of the environment, Kapp argues that ex-ante measures before pollution occurs will play an increasing role, as well as direct controls that stop pollution by prohibition and curtailment of the production of toxic materials. “Cases in point would be the [. . .] closing down of factories in selected areas with [. . .] unacceptable rates of pollution’ (Kapp [1971] 1983, 129). Kapp cautions that even direct controls are not the key answer to environmental disruption. Kapp underlines that nothing is more important than the planned development of technologies designed to reduce or eliminate environmental disruption. Technology must not be considered as an independent variable, but be defined in terms of societal goals or the satisfaction of individual and societal needs. The causal principle has to be replaced by that of the end result – a process in which explicit social norms become the starting point for environmental policy pertaining to technology. A major issue is the financing of government promotion of research ideas for green technologies. Part of governmental funds can flow into government research institutes, another part into industry’s considerable research resources. The most important thing, however, is the creation of legal and institutional prerequisites. Here, direct measures such as prohibitions, regulations and environmental standards must be applied, and appropriate organizations created to control them. (Kapp [1974] 1983).

In addition, Kapp proposes a more comprehensive economic calculus, which takes into account the short- and long-run social costs and potential benefits of

alternative patterns of resource allocation. Kapp argues that policymaking requires a system of accounting for the socio-economic and environmental impact, a diversity of socio-ecological indicators (Kapp [1972c] 1974). These reflect the present state and exigencies of the state of the socio-ecological system as an inventory of the total situation with the actual and potential dangers for human health and well-being, for social productivity and indeed for human life and survival. Only such a comprehensive accounting serves as an adequate basis for decision making that will reduce social costs. The informational basis of environmental indicators serves to establish environmental standards, and is a tool for continuous evaluation of the effectiveness of social control. Importantly, Kapp's main tenet is that environmental and economic development must go hand in hand. Trading them off is potentially self-defeating and harms the weakest the most. Kapp underlines that this approach to policy is neither an invitation to disregard costs, nor support for a technocratic approach, or the false assertion that socialism is a remedy for social costs.

Research Project: "Political Institutionalism"

The future research project aims at recovering the common roots of the Kapp-Lowe approach in "European" Political Institutionalism, and its potential for the further development of modern economics. Combining Lowe's Instrumental Analysis and Kapp's Social Costs approach opens the way for a comprehensive planning process for economic and environmental sustainability. Lowe's methodological alternative provides the guidelines for mapping out blueprints of potentially sustainable paths, while Kapp's analysis can be fruitfully integrated in both the planning and execution phases. But the Kapp-Lowe approach is a general framework that may be applied to a great variety and number of policy issues. It is our intention to further explore the details of this method and to apply it to additional problems of the contemporary political economy.

Notes

1. Being the economist of the Social Research Institute at Columbia and a member of the Frankfurt School, Pollock was a close friend of Lowe and Kapp. Lowe was the "liaison officer" who mediated the contacts between the New School for Social Research and the Social Research Institute (Krohn 1996, 144), and the latter was affiliated with the Social Research Institute and taught at Columbia.

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