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## SURVEY

# Theoretical foundations of sustainable economic welfare indicators — ISEW and political economy of the disembedded system

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## ARTICLE INFO

## Article history:

Received 11 September 2007

Received in revised form

11 February 2008

Accepted 16 May 2008

Available online 16 July 2008

## Keywords:

ISEW

Political economy

Service

Disembeddedness

Psychic income

Capitalism

## ABSTRACT

The conceptual foundations of the Index of Sustainable Economic Welfare (ISEW) are surveyed and critiqued. It is argued that the three underlying theories of community, psychic income, and social welfare economics supply certain theoretical foundations for the ISEW. The focal point of the theories is to evaluate the positives and negatives of economic growth, with the hope of achieving a practical measure of sustainable economic welfare. However, they are not as well developed as they should be: the three theories have partial, underdeveloped explanations of the benefits (services) and costs (disservices) generated in the system. The theoretical particulars of ISEW abstract from the workings of the capitalist system, because the ISEW advocates have not specified a society in the socioeconomic system which we currently have. Specifically, there is no underlying linked systems view of the disembedded economy — where the exchange economy tends to dominate other aspects of culture. Without a systematic understanding of the political economy of capitalism, the ISEW is potentially flawed in design. Therefore, there is a need to search for a critical approach to sustainable economic welfare. As a point of departure, it is better to have a political economy theory. The political economy of the disembedded system provides an alternative theoretical approach to ISEW.

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## 1. Introduction

It is widely recognized by ecological economists that the growth rate of GDP (gross domestic product) per capita is not a very good measure of welfare. GDP growth incurs costs such as the disturbance of ecological life-supporting systems, pollution, alienated labor, lost leisure time, and the loss of welfare for future generations. GDP may need to be modified as it provides an inadequate measure of social and environmental waste in the economic system. Hence, adjusting or modifying GDP to construct some sort of 'net value' of environmental and

socioeconomic welfare is potentially important. Good measures can offer critical insights where there may be conflict between the various spheres of economy, society and ecology. A well-devised indicator that measures the costs and benefits of economic growth over time may help. An indicator that attempts to measure "net income" is the Index of Sustainable Economic Welfare (ISEW) by [Daly and Cobb \(1989\)](#). Generally, the authors of ISEW add the monetary service benefits yielded by both the stock of consumer and public durable expenditures (while adjusting personal consumption for income inequality) and household production, minus the environmental and

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social costs associated with production, distribution and exchange.

An imperative question arises: are there any good theoretical foundations for the ISEW? Guenno and Tiezzi (1998, p. 11), authors of the Italian ISEW, stated that the “main limitation of indices such as the ISEW is ... their lack of theoretical foundation”. Eric Neumayer (1999, p. 82) also argues that the ISEW is not a theoretically sound indicator. Hitherto, there have been several efforts to provide such a foundation, particularly, by Philip Lawn (2003, 2006a) as a response to Neumayer’s (and others’) critique. Amongst the ISEW advocates, the emerging debate surrounding the ‘net income’ indices appears saturated in methodological (i.e. measurement) limitations, not in the theoretical underpinning. For instance, in response to recent criticisms, Clarke and Lawn (2006, p. 300, *emphasis added*) argue that “its apparent shortcomings ... are methodological and not theoretical in nature”. Nevertheless, Neumayer (2004, 2007) argues that there are conceptual problems for an all-in-one indicator which accounts for present well-being and future well-being (sustainability). In other words, the conceptual foundation of the ISEW and related indicators is chiefly unresolved in the literature. Also, the tacit knowledge amongst critics and advocates alike is that there has been no adequate theoretical foundation in the ISEW since its humble beginnings.

However, these conclusions may be premature because careful inspection of several key works reveals certain theoretical frameworks for ISEW. This leads to the introduction of the following hypothesis: ISEW has certain theoretical foundations. This paper will detail the conceptual foundations of ISEW by attempting to expand on the critical themes and fill any thematic gaps. A primary function of the paper is to interpret and apply theory. This is needed to establish a level playing field — to understand the evolution of similar sustainable economic welfare indicators and to present them in their best light. It is not only the purpose of this paper to give insight into the theoretical foundations of ISEW, but also to offer a critique if reasonable. But even if it is not possible to fill the gaps completely, it is argued that there are three underlying and qualitatively different theories of the ISEW.

The three ISEW theories will be made cogent in Sections 2, 3 and 4. In Section 2, a scrutiny of Daly and Cobb’s (1989) work reveals a theoretical framework — albeit somewhat concealed and fragmented — for ISEW. Thus, the first theory explores Daly and Cobb’s conceptual “economics for community” model for ISEW, which considers the costs and benefits to the whole community, not merely individual agents involved in a transaction. In Section 3, the second theory links Fisher’s concept of income to entropy: *entropic net psychic income*. This theory is important because it realizes that it is a cost to replacing worn out producer goods such as plant, machinery, and equipment. The third theory, examined in Section 4, suggests that ISEW is theoretically based on a *social welfare function*. Utilizing some principles of welfare economics, the ISEW integrates cost-benefit analysis with social choice theory, which incorporates various social concerns about welfare that are not adequately captured by individuals within the market place.

In order to promote specificity vis-à-vis the theoretical foundations of ISEW, Venn diagrams are utilized. The purpose of the Venn diagrams is to illustrate the similarities and

differences between the theories. The usefulness lies in the visual comparative analysis, specifically: How well does each theory link the spheres of economy, ecology and society? Indeed, the conceptual foundation of ISEW depends on the answer to this question. If ISEW is to be a meaningful indicator, a solid conceptual foundation that describes the prevailing socioeconomic system is essential.

However, we are going to show that the three theories are not as well developed as they should be. The heart of the inquiry rests in Section 5 — where we critically evaluate the theoretical frameworks of ISEW. It is argued that without a *systematic understanding of the political economy of capitalism*, ISEW is potentially flawed in design. At the very least, “society” must be historically placed vis-à-vis a specific socioeconomic system. Under a self-regulating market organization, the exchange economy tends to dominate other aspects of culture — opportunities for individual development are obtained mainly at the expense of others. This is known as the ‘disembedded economy’. It is argued that the conceptual foundations of Daly and Cobb’s vision of community, entropic net psychic income, and the social welfare function are problematic, because there is no underlying linked systems view of the disembedded economy.

Thus, the paper is structured into two major segments. The first part will supply the three theoretical foundations of ISEW. The second part furnishes a political economy critique of the theories. In both segments, we will use table headings to guide the analysis. This makes it easier for the reader, as each major heading summarizes the essential points at the beginning of each section. In Section 6, we conclude and comment on the findings. Here are the three theories, introducing the “economics for community — oikonomia” in Section 2 below.

## 2. Economics for community — oikonomia

**Table 1 – The ISEW is conceptually rooted in “Economics for Community”**

- |       |   |
|-------|---|
| (i)   | A realistic paradigm based on the <i>principle of internalization</i> . |
| (ii)  | In principle, income is based on <i>strong sustainability</i> .         |
| (iii) | Service to the community is founded on the <i>oikonomia</i> model.      |

According to Herman Daly and John Cobb (1989, p. 68), ISEW plays a small part in a necessary process that leads to a *paradigm shift in Economics*. Economics must be ordered to the needs of the real world (Daly and Cobb, 1989, pp. 7,20), and ISEW is set out to measure, albeit limitedly, how well the needs of the world are met. They devised the very first real ISEW for the US, over the 1950–1986 period.<sup>1</sup> Their work is significant because it was the first indicator assessing economic welfare with attention to income distribution, household labor and environmental destruction. They argue that accounting for sustainability is needed in a measure of welfare, especially when future generations are affected by the costs of climate change. ISEW is a necessary progression for the paradigm shift

<sup>1</sup> The compilation of ISEW was actually done by John Cobb’s son, Clifford W. Cobb.

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