

Economic justice as a development strategy

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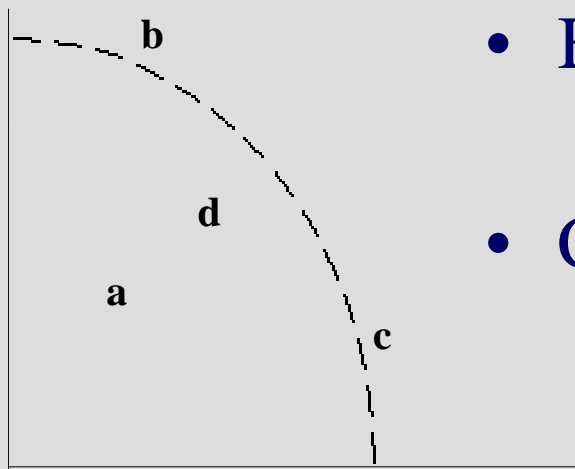


Degas, A la Bourse

Samuel Bowles, Santa Fe Institute

Overview of the issues: The efficiency equality trade off?

Efficiency



Equality

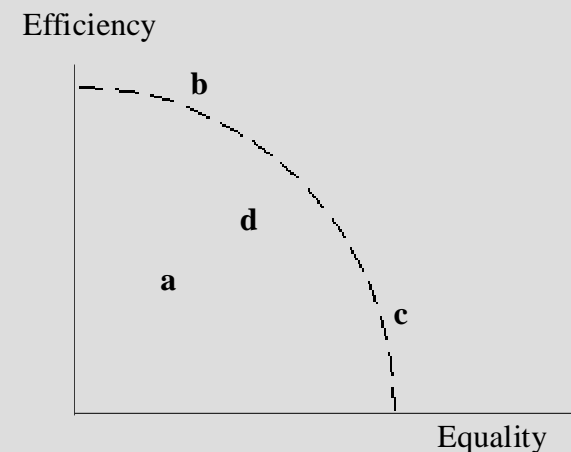
- Conventional wisdom:
 - I: wealth inequality is irrelevant for questions of efficiency (FT, Coase)
 - II: the efficiency equality tradeoff (EET)
- Empirical studies (x country & cases)
- Behavioral economics
 - Reciprocity, inequality aversion & altruism
- Contract theory
 - Wealth, signaling and residual claimancy
 - Wages as an incentive (carrots and sticks)
- The burden of inequality: guard labor and impediments to cooperation
- Future: Equality & cooperation in the knowledge-based economy.

Conventional wisdom (microeconomic theory version): the efficiency-neutrality of wealth inequality

- Fundamental theorem of welfare economics: given complete contracts (no “externalities”) competitive equilibria are Pareto efficient irrespective of wealth endowments.
- Coase theorem: if there are no impediments to bargaining, bargained allocations will be Pareto efficient irrespective of the assignment of property rights.

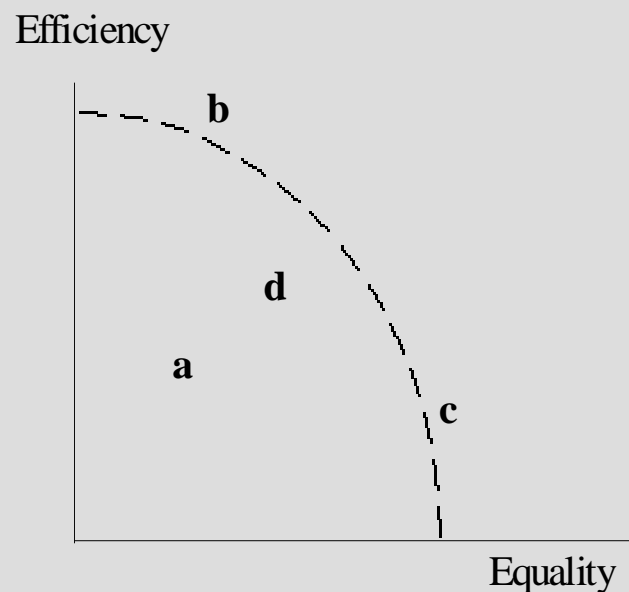
Conventional wisdom (public policy version): the efficiency equality trade off.)

- Key question: is the economy at a point like **b** or **c**? Or are we at a point like **a**



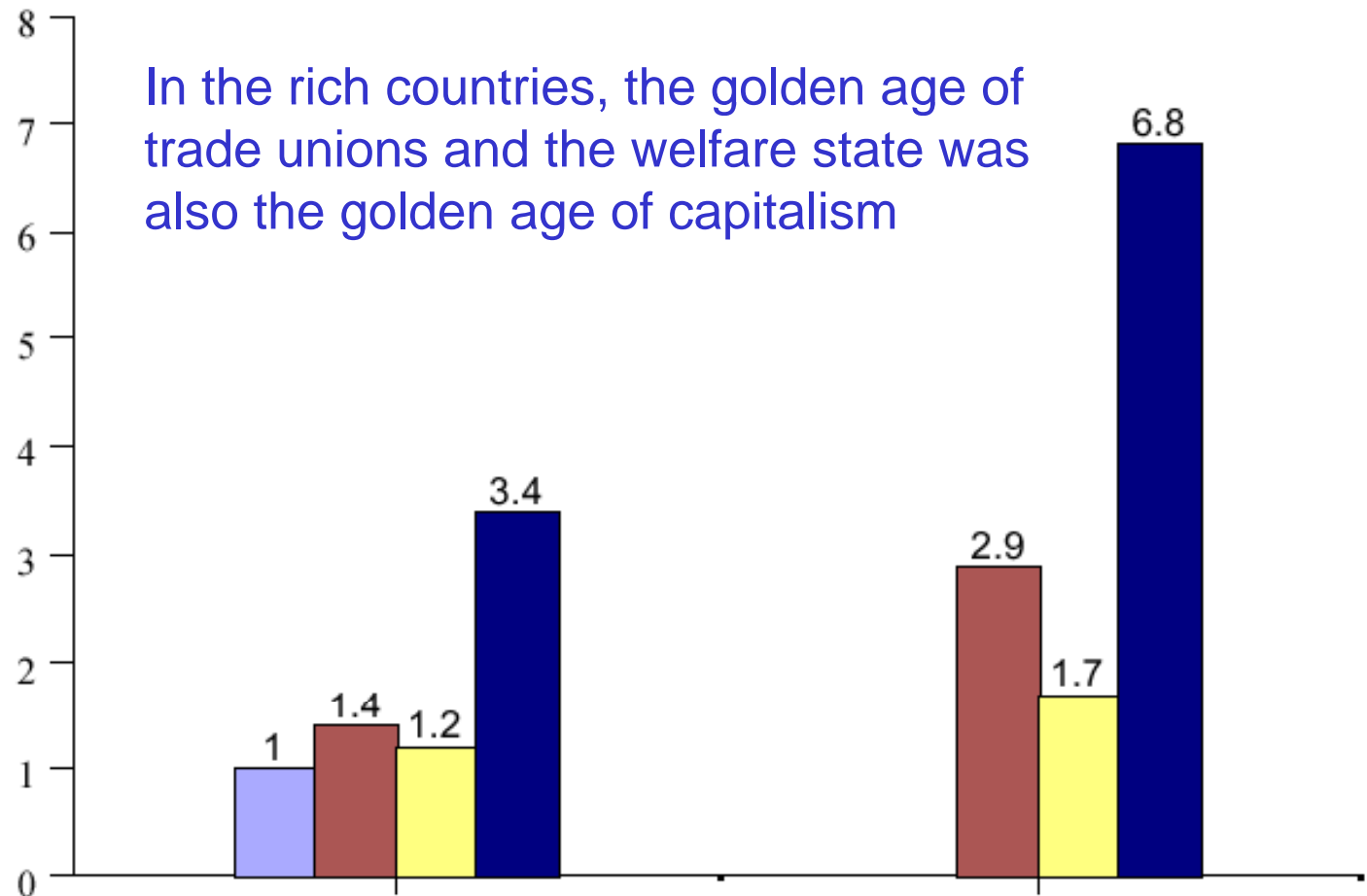
Quiz: What will you find in every introductory textbook, but which could not be found in reality? Answer? Unicorns?

- No, the answer is the efficiency equality tradeoff (some biology textbooks do not mention unicorns).
- Early (1980s) warning: East Asian tigers and Latin American turtles
- Econometric evidence
- History



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average annual growth rate (percent)

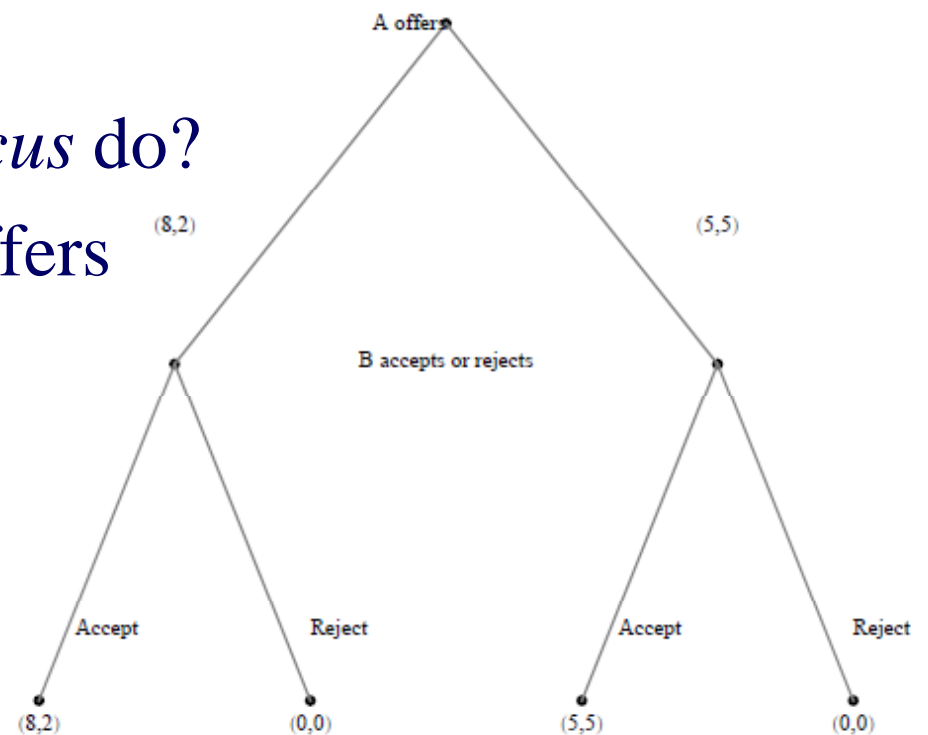


. Growth and Investment, 1820-1979



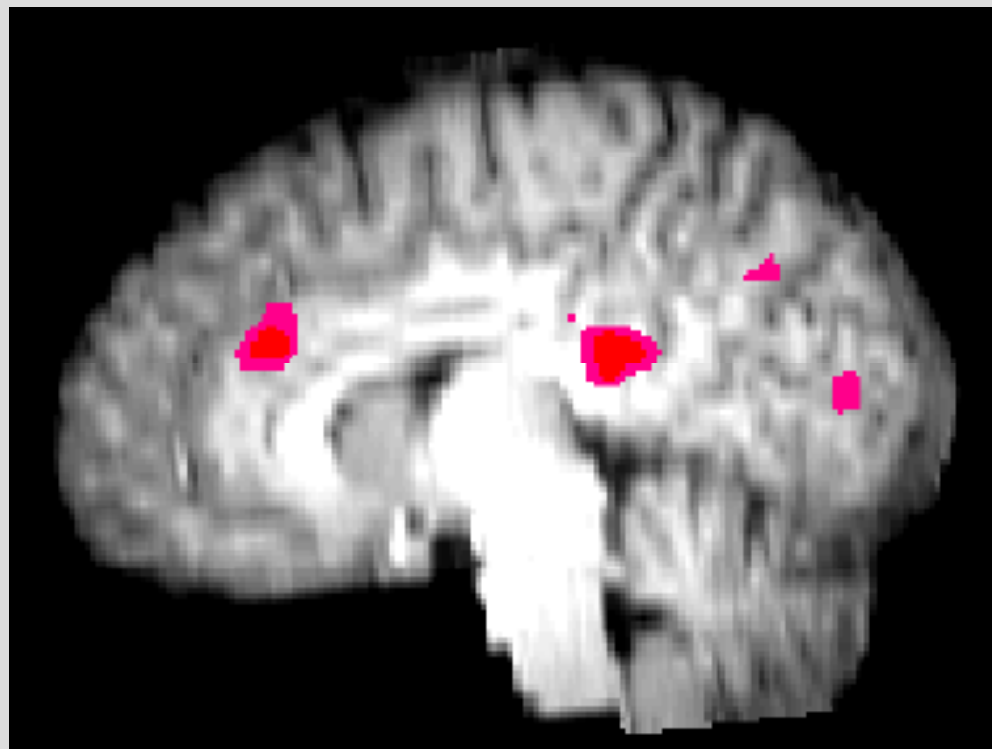
The new economics: the behavioral revolution (good bye to *Homo economicus*)

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- An iconic experiment: the Ultimatum Game
- Proposer makes offer
- Responder accepts or not
- If not both get zero
- What would *Homo economicus* do?
- Real people reject “unfair” offers
- Hello to *who? Homo what?*



The new economics: human behavior and the economics and politics of inequality and redistribution

- The take home message: Many people hate injustice; enjoy contributing to more just outcomes, and are willing to pay a lot to punish those who are unjust.
- New behavioral foundations for an *economics* of equality :
 - Inequality aversion
 - Reciprocity
 - Altruism
 - Self interest
- .. And politics of redistribution



The new economics of contracts: credit markets

- Incomplete contracts in credit markets: the promise to repay is not enforceable if the borrower is bankrupt.
- Results of incomplete contracts in credit markets
 - Those without wealth are excluded from borrowing
 - Those with limited wealth borrow at higher costs and can finance only smaller or superior projects.
- Thus superior projects that would be undertaken by those with limited wealth are not financed while inferior projects of the wealthy are financed.
- As a result policies that redistribute wealth may enhance the productivity of the economy, by improving the quality of the average projects that are financed.
- Recognizing untitled wealth of the poor (e.g. de Soto) may backfire if credit markets are not competitive.

The new economics of contracts: labor markets & production

- Why did Henry Ford double wages and reduce hrs (1914)?
- Incomplete contracts in labor markets: the promise to work hard is not enforceable (because information on work effort is asymmetric: workers know it but employers do not).
- Results of incomplete contracts in labor markets
 - Employers devote what otherwise would be productive resources (supervision, surveillance equipment) to monitoring workers.
 - The Nash equilibrium wages and effort are both too low.
 - Too much stick. Not enough carrot.
- A work ethic and reciprocal motives can attenuate the problem, but not if wages are considered to be unfair.
- Ownership of the firm by workers would reduce the monitoring problem (they have information on each other's effort) but typically is unfeasible given workers' exclusion from credit markets.

The burden of inequality: Guard labor

- *The efforts of men are utilized in two different ways: they are directed to the production or transformation of economic goods, or else to the appropriation of goods produced by others. V.Pareto (1905).*
- *it is lamentable to think how a great proportion of all efforts and talents in the world are employed in merely neutralizing one another. It is the proper end of government to reduce this wretched waste to the smallest possible amount, by taking such measures as shall cause the energies now spent by mankind in injuring one another, or in protecting themselves against injury, to be turned to the legitimate employment of the human faculties...J.S. Mill, Principles of Political Economy (1848)*

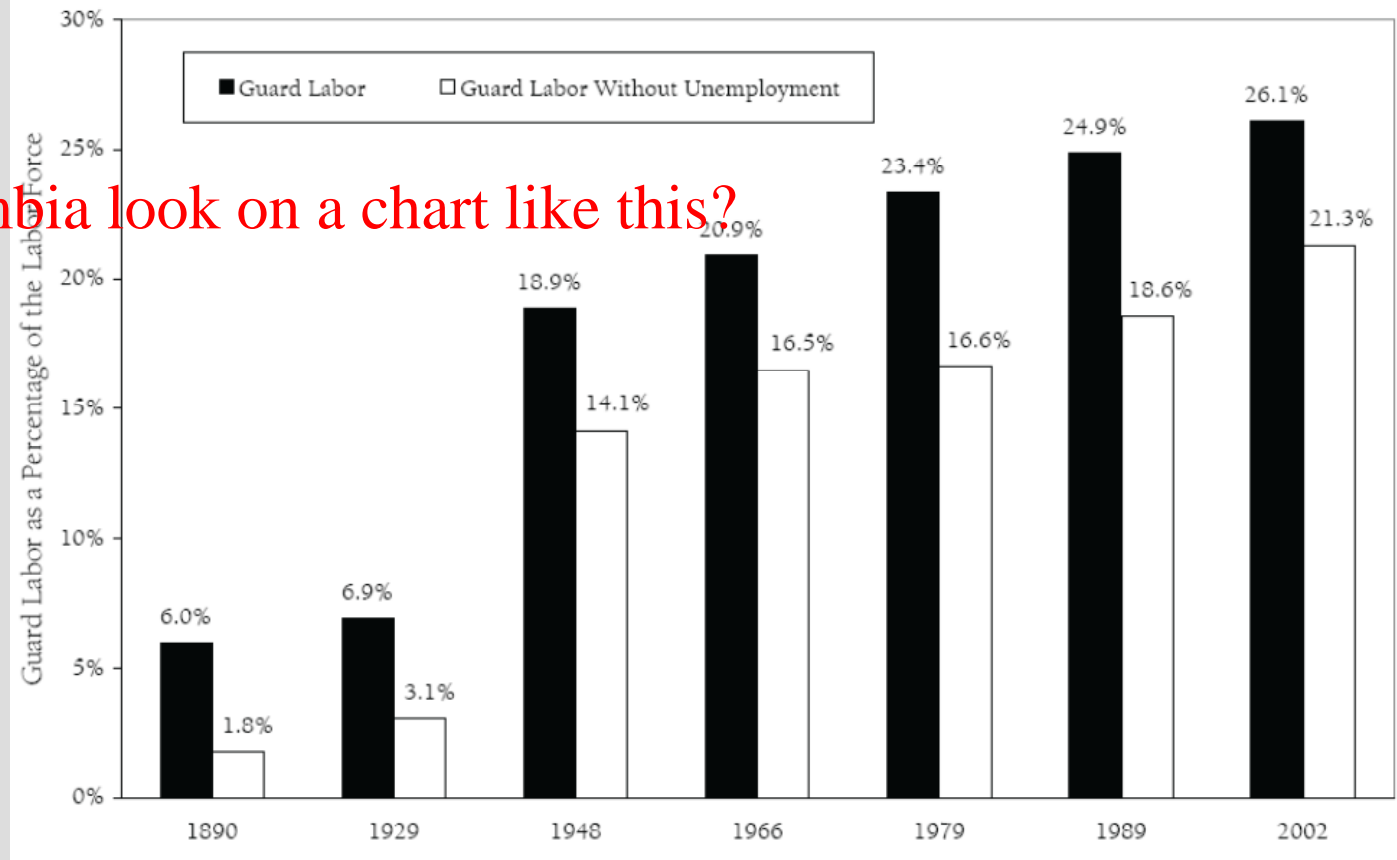
Guard labor: production of goods and services and reproduction of institutions and power relationships

- Guard labor: labor devoted to the use of power to advance distributional claims and to perpetuate the economic institutions of a society.
- Guard labor is unproductive in the classical sense (not that it is unnecessary; but it does not enter a production function for the goods making up final demand)

Guard labor in the U.S. 1890-2002

How would Colombia look on a chart like this?

Figure 1: Guard Labor United States 1890–2002
Note: Our unemployment number is the excess of measured unemployment over an estimate of frictional levels.



Guard Labor: supervisory labor, private guards, police, judicial and prison employees, military and civilian employees of the department of defense (and those producing military equipment), the unemployed, and prisoners; all as percentages of the labor force

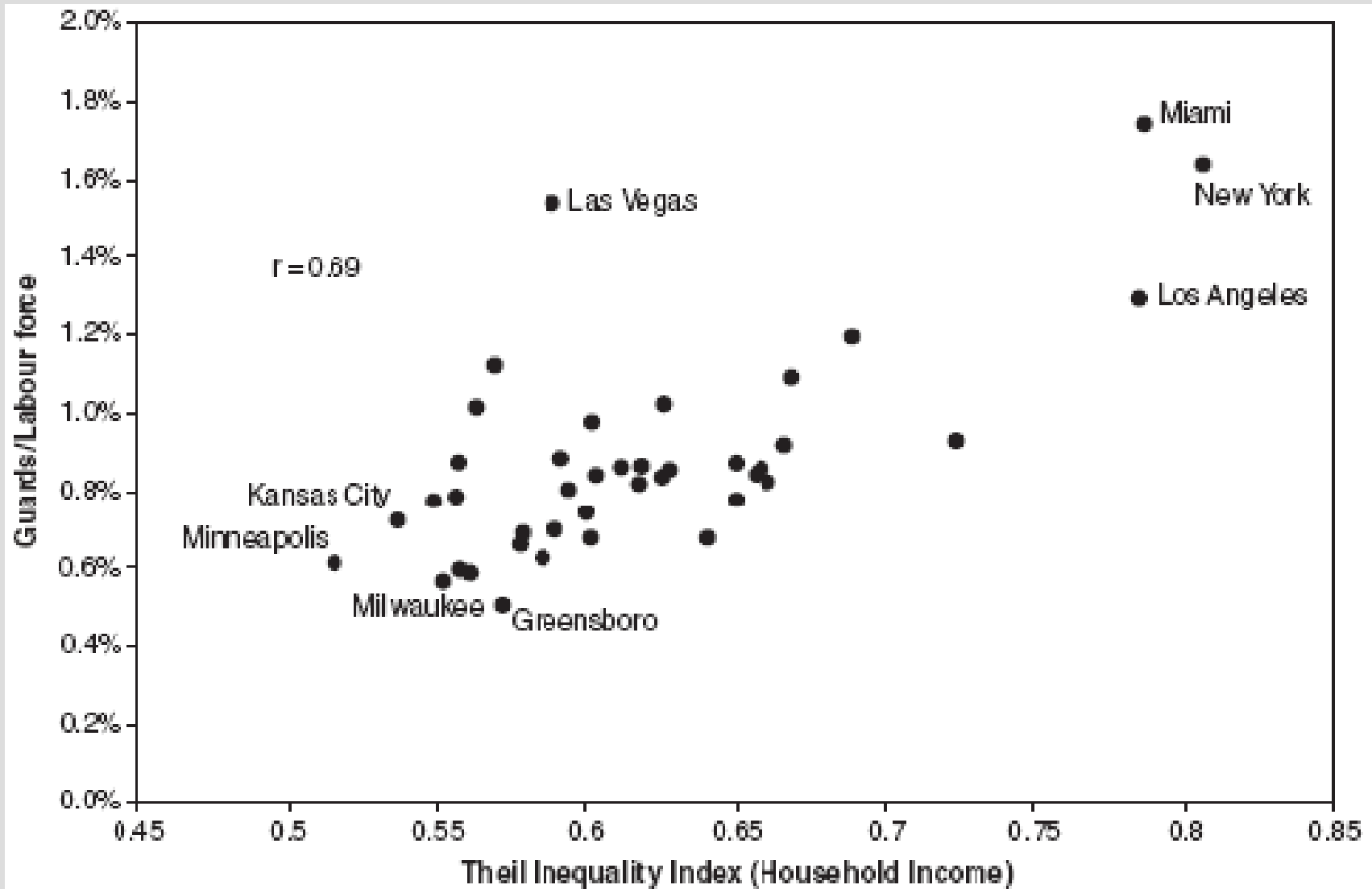


Figure 1.2 *Income inequality and private security personnel as a fraction of a city's labor force*

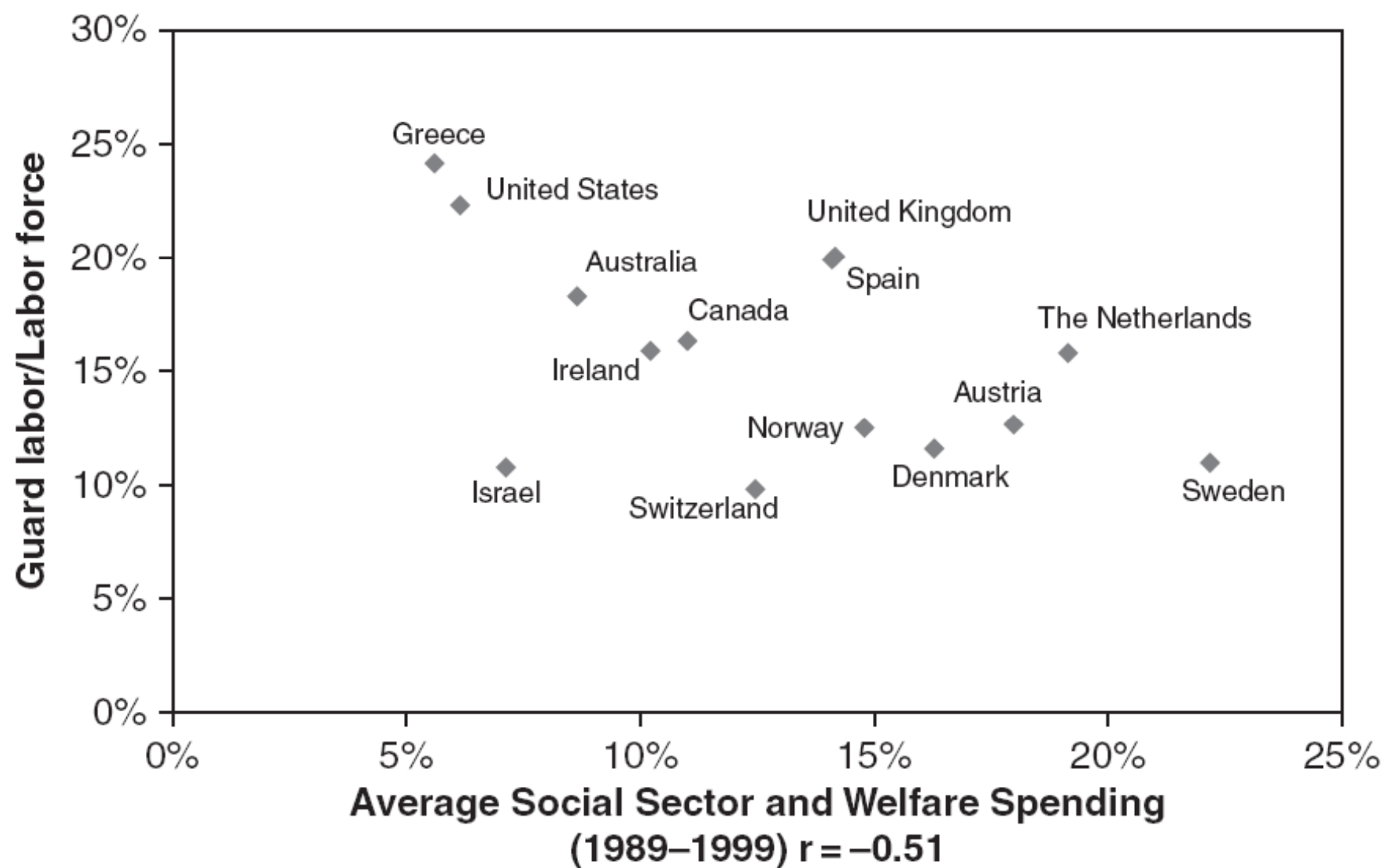


Figure 1.5b *Teachers vs. guards? Social spending and guard labor.* Source: Bowles and Jayadev, (2007).

Recapitulation (from the previous slides)

- As a result policies that redistribute wealth may enhance the productivity of the economy, by improving the quality of the average projects that are financed.
- A work ethic and reciprocal motives can attenuate the misaligned incentives of wage labor, but not if wages are considered to be unfair.
- Ownership of the firm by producers would reduce the monitoring problem (they have information on each other's effort) but typically is unfeasible given exclusion from credit markets of those with limited wealth.
- But even if wealth were redistributed; producer-owners would be reluctant to take risks unless they were protected from risks through more extensive social and economic insurance

Egalitarian asset distribution as a development strategy

- The logic: how we govern the economy is limited by wealth inequality, and greater equality wealth would allow superior governance structures.
- Examples: policies to promote employee ownership of firms, productive borrowing by the less wealthy, high quality education for all, abolish or substantially limit intellectual property rights.

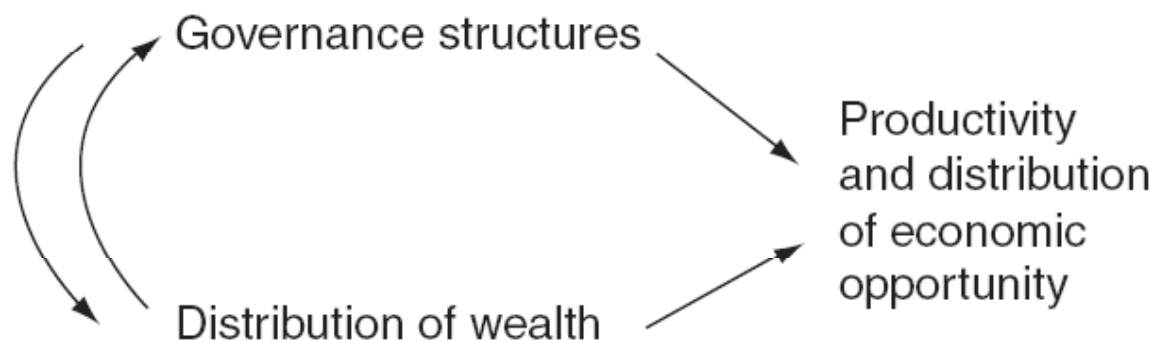


Figure 1.1 *Governance structure, wealth inequality, productivity, and inequality of opportunity*

The new economics of redistribution

Productivity enhancing asset redistribution:

- Where the actions taken by someone cannot be subjected to contract, property rights should assign residual claimancy over the income streams and asset values resulting from the *contested and non contractible* aspect of the interaction to the person performing or providing that aspect.
- The only efficient way this can be done is by assigning ownership to the person providing the contested and non contractible aspect.
- If this person is wealthy the efficient assignment of ownership by means of private exchange is unimpeded .
- Otherwise the efficient assignment may require a redistribution of assets by means of a governmental intervention (e.g. land, residences, capital goods).
- Such a redistribution if well designed will be productivity enhancing

Productivity enhancing egalitarian asset redistribution: rationale and caveats

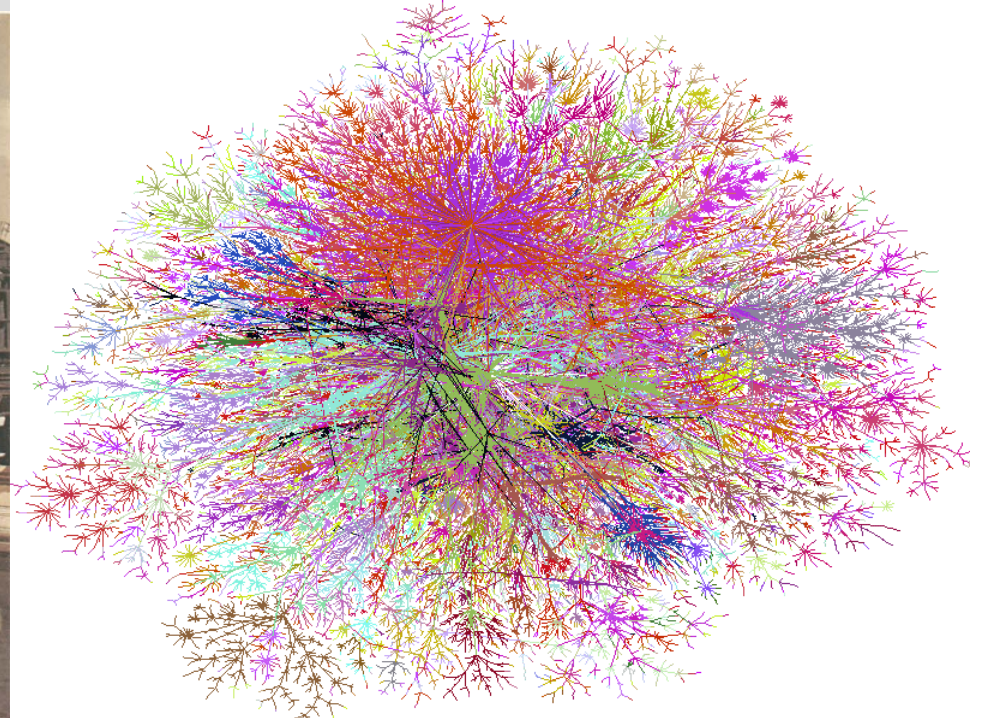
- Assigns residual claimancy to those providing the non contractible aspect of exchanges (reduces the incomplete contract problem)
- Facilitates trust and consensus on the division of the gains to cooperation (remember the Ultimatum Game)
- Reduces the demand for unproductive ‘guard labor’
- Caveats:
 - The real efficiency equality trade off: only the very rich are approximately risk neutral; redistributing assets to the less well off could reduce risk taking.
 - An expanded role for incentive compatible insurance to reduce the risk exposure of less wealthy owners, and hence encourage more risk taking

A menu of policy paradigms, depending on the diagnosis and the distributional strategy

	Trickle down	Trickle up
Supply side	Washington consensus	Productivity-enhancing egalitarian asset redistribution
Demand side	Investment- or export-led Keynesian models	Wage-led or social expenditure-led Keynesian models

A new economics of equality and redistribution for the weightless (knowledge-based) economy

- Burden of inequality: substantial in the economy of grain and steel
- It will increase in the weightless economy as the problem of incomplete contracts becomes more acute and hence the importance of cooperation (rather than fear and greed) increases.

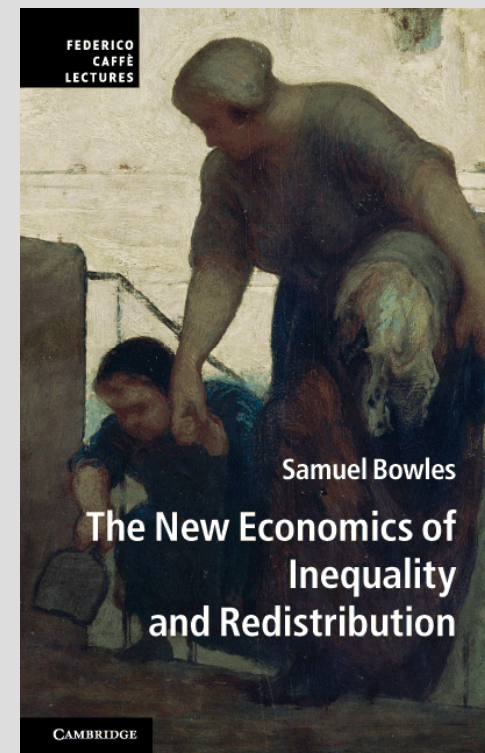


Less than a year ago I ended a talk at a conference of Latin American economics students with the following challenge:

“Asset redistribution and cooperation in the knowledge based economy:

It sounds good!.lets do it!

A free online Spanish language edition of the *New Economics* (but only if *you* make it happen)



Thanks to

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La Nueva Economía
de la Desigualdad y la
Redistribución



Samuel Bowles



- Free online edition (thanks to Juan Camilo Cadenas of U de los Andes, and his cooperative team) <http://bowlesmicroeconomia.uniandes.edu.co/>

Microeconomía Comportamiento, Instituciones y Evolución

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