The New Economics of Inequality and Redistribution

Economists warn that policies to level the economic playing field come with a hefty price tag. But this so-called "equality–efficiency trade-off" has proven difficult to document. The data suggest, instead, that the extraordinary levels of economic inequality now experienced in many economies are detrimental to the economy. Moreover, recent economic experiments and other evidence confirm that most citizens are committed to fairness and are willing to sacrifice to help those less fortunate than themselves. Incorporating the latest results from behavioral economics and the new microeconomics of credit and labor markets, Bowles shows that escalating economic disparity is not the unavoidable price of progress. Rather it is policy choice – often a very costly one. Here, drawing on his experience both as a policy advisor and an academic economist, he offers an alternative direction, a novel and optimistic account of a more just and better working economy.

Samuel Bowles heads the Behavioral Sciences Program at the Santa Fe Institute. He has taught economics at Harvard University, the University of Massachusetts, and the University of Siena. He is the author, most recently, of *Microeconomics: Behavior, Institutions, and Evolution* (2004), *A Co-operative Species: Human Reciprocity and its Evolution* (2011, with Herbert Gintis), and articles in *Science*, *Nature*, the *Quarterly Journal of Economics*, the *Journal of Public Economics*, and other academic journals. He has also served as an economic advisor to US presidential candidates Robert F. Kennedy and Jesse Jackson, and former South African President Nelson Mandela, and has taught crash courses in economics to trade unionists, community activists, and others.

Federico Caffè Lectures

This series of annual lectures was initiated to honor the memory of Federico Caffè. They are jointly sponsored by the Department of Public Economics at the University of Rome, where Caffè held a chair from 1959 to 1987, and the Bank of Italy, where he served for many years as an advisor. The publication of the lectures will provide a vehicle for leading scholars in the economics profession, and for the interested general reader, to reflect on the pressing economic and social issues of the times.

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Samuel Bowles

in collaboration with

Christina Fong, Herbert Gintis, Arjun Jayadev, and **Ugo Pagano**

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For
Gerald Cohen (1941–2009) and
David Gordon (1944–1996)
in memoriam

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Preface

Radical egalitarianism – the dream of equal freedom – is now the orphan of a defunct socialism. The unruly and abandoned child of the liberal enlightenment had found a home in nineteenth-century democratic socialism. Protected and overshadowed by its new foster parent, radical egalitarianism was relieved of the burden of arguing its own case: as European socialism's foster child, economic and political equality would be the by-product of an unprecedented post-capitalist order, not something to be defended morally and promoted politically on its own terms in the world as it is.

It thus fell to reformists, be they laborist, social-democratic, Euro-communist or New Deal, to make capitalism livable for workers and the less well-off, a task they accomplished with remarkable success in some of the advanced economies. But in the process, the egalitarian project was purged of its utopian yearnings. Its objectives were narrowed to the pursuit of a more equal distribution of goods and formal equality of political rights. The "world turned upside down" that Gerrard Winstanley had promised as the seventeenth-century Diggers were occupying Saint George's Hill near London was not to be; workers and farmers would have to settle for a world smoothed out. Over the years even this project has encountered increasingly effective resistance and experienced major political reversals. The century-long decline in the income shares of the very rich in virtually every country on which we have adequate data came to an abrupt halt in the final quarter of the twentieth century (Atkinson, Piketty, and Saez 2011). In many of the world's largest economies – the US, the UK, India, China, and others – the economic fortunes of the very rich regained much of their lost ground.

Is egalitarianism passé? I think not. Surprisingly, two reasons to doubt the prevailing "equality pessimism" come from economics.

The first is the demise of the self-interested *Homo economicus* as the reigning behavioral model in economics, brought down by the onslaught of experimental and other evidence showing that people willingly share even when big money is at stake, and that they avidly punish those who treat others unfairly, even if they have to pay in order to do this (Bowles and Gintis 2011). The fact that large fractions of experimental subjects exhibit what are termed *social preferences* including altruism, reciprocity, and even "inequality-aversion" invites a reconsideration not only of the political feasibility of egalitarian policies but also of the economic feasibility of cooperative production and other institutional alternatives.

The second reason to question equality pessimism is a revolution in the economic theory of contracts (Stiglitz 1987, Laffont 2000). Economists have sidelined the once-conventional assumption that contracts and markets are complete, meaning that everything that is transacted in an exchange is specified in a contract that is enforceable at no cost to the exchanging parties. This seemingly technical adjustment in economic theory led inexorably to big changes in the take-home message. This is that, where it really matters, Adam Smith's invisible hand is broken: market failures are endemic to exchanges that are central to the workings of a capitalist economy – labor and credit markets. It's getting harder to treat the failures of *laissez-faire* as mere caveats to be taken up in the last week of the semester (if there is time) and illustrated by bucolic external economies like Farmer Jones' bees pollinating Farmer Bell's apple orchard or public goods like lighthouses. The big news for the economics of inequality is that, as we will see, market failures can sometimes be attenuated by an egalitarian redistribution of wealth and decision-making power.

These two new developments – the first about what people are like, the second about how people interact – have far-reaching ramifications. But surprisingly, these new economics of social preferences and incomplete contracts have not been consistently applied to the study of public policies to achieve economic security and distributional justice. *The New Economics of Inequality and Redistribution* does this. The result is a rejection of equality pessimism and an affirmation that egalitarian redistribution, if properly implemented, is not only good economics – because it can improve incentives for high-level performance in a modern economy – but also winning politics – because it embraces people's generosity and ethical commitments. If I had to do a bumper sticker for the new economics of inequality it would be: INEQUALITY: IT DOESN'T WORK AND PEOPLE DON'T LIKE IT.

The ideas that I present here did not originate in my study or in a university seminar room. For the most part they occurred to me while I was attempting to address difficult questions of economic policy and political strategy that were pressed on me either by policy-makers and political activists or by my own inability to explain the most basic economic facts that I observed around me.

By age 11 I had noticed how very average I was among my Indian classmates at the Delhi Public School – in sports, in school work, in just about everything. How does it come about, I asked my mother, that Indians are so much poorer than Americans, if we cannot run faster and calculate sums more accurately than Indians? Her reply was not very convincing. After years of study and a Ph.D. in economics, the answer I gave when my Harvard students asked the same question was not much better.

Nor did that training equip me to provide Dr. Martin Luther King, Jr. answers to a series of questions concerning the economics of inequality, poverty, and racial discrimination that he asked a group of young economists as he was preparing for the Poor People's March in 1968 just prior to his death. The most difficult questions about economics I have ever been asked did not come on my Ph.D. exam or from the characteristically energetic challenges by seminar participants at the University of Chicago. They came, instead, from trade union members in the US clothing industry attending a crash course in economics who wanted to understand the economic impact of the North American Free Trade Agreement, and were not satisfied when I responded with some blackboard economics that, on reflection, I too realized was wrong. When President Nelson Mandela asked me and the other members of a commission he had appointed to design policies and institutions to, as he put it, "erase the footprints of apartheid" in South Africa's labor markets, I mumbled to myself "a tall order" and set to work on the hardest economics problem I had yet encountered.

The result, in the pages that follow, are not blackboard ideas waiting to descend from the ivory tower when suitably polished. It was the other way around. The econometrics papers I wrote on inequality in US education were stimulated by unanswered questions in the background memo I wrote at the request of Senator Robert Kennedy when he was running for president. When a coalition of trade unions and progressive groups asked David Gordon, Thomas Weisskopf, and me to write a memo explaining the faltering performance of the US economy in the 1970s and to suggest strategies that might mitigate its impact on workers and the less well-off, we eventually devoted years to what became a series of replies. The academic papers resulting from this collaboration that eventually appeared in the *American Economic Review* and the *Brookings Papers on Economic Activity* were merely by-products of the exercise, not its purpose.

Truth in advertising requires me to reveal that I lack the people skills necessary to influence public policy, which is why my day job has always been at the blackboard and the keyboard. When I warned Senator Kennedy not to promise the voters that his educational programs would dramatically reduce inequality unless they were coupled with an assault on wealth inequality and racism, another member of his "economics brain trust" chided me (to general nodding by the other brain trusters), "Sam, everyone else in this room is trying to build America up! You're tearing it down!" When I proposed employment subsidies and other market-based jobs policies to combat the rampant joblessness in South Africa's economy, a leading trade unionist publically branded me an "enemy of the working class." The diagnosis of the ills of the US economy that Gordon, Weisskopf, and I offered – that a productivity slowdown and profit squeeze occurred because the booming late 1960s and early 1970s had erased the fear of getting fired, and that labor discipline suffered as a result – gave us the moniker "blame-the-workers economists."

Hoping not to collect any new epithets, but in any case undeterred, in this book I explore policies to implement a more egalitarian distribution of wealth and power without compromising economic efficiency. In the next chapter I provide an overview of an economic strategy based on recent evidence and models showing that the level of economic inequality in the US and many other countries today is not grease for the wheels of economic progress, but sand in the gears. My joint work with Arjun Jayadev presented in the chapter provides a striking example. We show that highly unequal economies (and cities) devote a very substantial fraction of their productive potential to what we call *guard labor* charged, roughly, with keeping the lid on rather than producing goods and services.

Because its objective is to raise productivity (output properly measured per hour of work) rather than total output and because its primary means are a redistribution of wealth and power rather than a redistribution of income, I call this strategy *productivity-enhancing asset redistribution*.

Living standards are ideally measured by what people can do rather than what they have (Sen 1999), and this depends not only on the appropriately measured goods and services available to them (including environmental amenities), but also on the amount of their free time, and other intangibles. Increased productivity permits greater access to either goods and services or free time, or both, making productivity enhancement rather than output growth a more attractive objective.

In Chapter 2 I draw on new developments in the theory of incomplete credit contracts to give an example of how such a strategy might work.

In the next two chapters I address the impact of the increased international mobility of goods and capital on the feasibility and effectiveness of policies designed to insure greater economic security and equality of opportunity. Chapter 3 shows that, while globalization alters the environment in which egalitarian policies work, it makes productivity-enhancing asset-based redistribution a highly effective strategy. The primary obstacle to such policies is political, not economic. Chapter 4, which draws on work with Ugo Pagano, addresses the impact of globalization on the new politics of the welfare state.

In Chapter 5, I use research jointly conducted with Christina Fong and Herbert Gintis to explore the implications of the behavioral economics revolution for understanding the political economy of redistribution. The fact that many people, perhaps most people, are committed to fairness even if it will cost them something suggests a new politics that recognizes the ethical roots of support for redistribution as well as ethical (if sometimes uninformed) reasons for opposition.

I am grateful to my collaborators Christina Fong, Herbert Gintis, Arjun Jayadev, and Ugo Pagano. My former doctoral students Anders Fremstad, Alyssa Schneebaum, and Simon Halliday greatly improved the text. I would also like to thank the Behavioral Sciences Program of the Santa Fe Institute, the University of Siena, and the Russell Sage Foundation for support of this research. I am indebted to the kind staff and the tranquil surroundings of the Certosa di Pontignano for an optimal environment for reflection, research, and writing. The MacArthur Foundation's Research Network on the Costs of Inequality allowed a decade of sustained reflection on the topics raised here; I am grateful to Pranab Bardhan with whom I directed the network and to its members, and to the Foundation for making our collaboration possible. I developed many of the ideas here as a teacher in economics crash courses under the auspices of the Center for Popular Economics (Amherst, Ma.), the International Woodcutters of America (Vancouver, British Columbia), the New Democratic Party of British Columbia and the National Union of Miners (South Africa). I am grateful to all of these organizations and the participants in their programs. Robert Rowthorn's comments on the entire text resulted in numerous improvements. A final thank-you goes to Maurizio Franzini, MarioTiberi, and the other organizers of the Federico Caffè Lecture in Rome, which I delivered in 2007, the response to which stimulated my writing this book.

I dedicate this work to my departed friends Gerald Cohen, who provided solid philosophical foundations for modern egalitarianism, and David Gordon, who laid out the economics of a just and democratic society. More than outstanding scholars, they were also engaged in changing the world, as the titles of their last (posthumous) books attest: *Why Not Socialism?* and *Fat and Mean: The Corporate Squeeze of Working Americans and the Myth of Managerial Downsizing*.

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