ESSAYS ON THE NEW ECONOMICS OF INEQUALITY AND REDISTRIBUTION

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in collaboration with

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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 byproduct 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 17th century Diggers were occupying Saint Georges 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, P:iketty, 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 behavioural 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 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 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. Its 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 has 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 eleven 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 PhD 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 PhD exam or from the characteristically energetic challenges by seminar participants at the University of Chicago. They came, instead, from trade union members in the U.S. 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 background paper explaining the faltering performance of the U.S. 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 U.S. economy that Gordon, Weisskopf and I offered – that a productivity slowdown and profit squeeze occurred because the booming late 1960s and early 70s had erased the fear of getting fired, and 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 resources 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 U.S. and many other countries today, is not grease for the wheels of economic progress, it is 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 the 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 ensure 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 the concluding chapter, 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.

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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 Down-sizing.*

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