

# Shrinking Capitalism<sup>†</sup>

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A defining feature of capitalism is that work using privately owned capital goods is performed under the control of an owner or manager in return for wages, producing goods to be sold for profit. Does this describe the work done in the high-income economies of today—much of it knowledge and care based, and more than half of it in the public sector or unpaid? And where the description does fit, is this a good way of organizing production? We think the answer in both cases is “not really.”

The double entendre in our title is thus intentional: because the sectors of the economy in which this system of production works tolerably well are already small and shrinking, it is imperative on not only moral but also economic grounds to develop a paradigm for policies and institutional design that will shrink capitalism while sustaining innovation and economic dynamism. Rethinking current policy and institutional options is essential to preserving and enhancing freedom in a world in which the destruction of communities and social alienation of many citizens are fueling authoritarian movements.

Tools for doing this have been provided by the incomplete contracts and behavioral economics revolutions, which overthrew the vision of the firm and social interactions in the conventional Marshall–Walras tradition. Here we deploy these recent developments in economics to outline a framework for a well-functioning economy under contemporary conditions that is

consonant with values summarized by a broad concept of freedom and that goes considerably beyond a fair distribution of rising material living standards and is better able to support a more just, democratic, and sustainable society.

## I. Ethical Values, Economic Models, and Policy Paradigms

Successful policy paradigms combine a set of ethical values with a model of how the economy works, a property of which is that the pursuit of those ethical values contributes to the performance of the economy as represented in the model. Classical liberalism rested on commitments to order, antipaternalistic liberty, autonomy, and rule-utilitarianism. These were synergistic with its economic model based on competitive markets, private property, and cardinal utility (for paradigm comparisons, see online Appendix Table 1).

More recent economic paradigms, too, were founded on the synergy of complementary values and economic models. For Keynesian economists, a normative commitment to reducing economic insecurity and raising the incomes of the less well off through government programs and trade union bargaining was combined with a set of propositions about savings behavior, automatic stabilizers, and aggregate demand. Both the coherence and the rhetorical power of the paradigm depended on the fact that the pursuit of its advocates’ values via economic policy and organization would improve aggregate performance by supporting higher and more stable levels of output and employment.

In like manner, what has come to be called neoliberalism advanced a normative framework of negative freedom and procedural justice based on a complementary economic model. Cementing neoliberalism’s philosophy to its economics was the shared individualistic and amoral view of what people are like and a representation of how we interact in the economy that is confined to exchange under complete

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contracts on competitive markets. Extending the assumption of self-interested agents to the public sphere, their leading authors proposed a view of public choice in which governments and other collective actors such as trade unions are simply special interest rent seekers. In this model of the economy, the limited government advocated on philosophical grounds was also a necessary condition for a well-functioning economy.

Combining economic models and ethical values in a complementary manner is not by itself sufficient for a paradigm to succeed: for the advocated policies to work, the economic model must be a good enough approximation of the empirical economy. Just as a changing economic reality spelled the demise of classical liberalism following the Great Depression, the Keynesian paradigm was challenged by the stagflation of the 1970s. Similarly, disenchantment with neoliberalism mounted after the global financial crisis and with the urgency of the climate crisis.

Integrating democratic, egalitarian, and sustainability ethics and a more empirically based economic model in a successor paradigm to neoliberalism must start by reconsidering the standard model of the exchange process, namely, price takers buying and selling under complete contracts.

## II. Framing Economic Interactions as a Morality-Free Zone

Because in neoliberalism's economic model markets clear in equilibrium, each person's current transaction is worth exactly the same as her reservation option. As a result, every economic actor—whether an employee, a shopper, or a borrower—can exit her current relationship at zero cost. This effectively makes whatever one experiences in the exchange process (including at work) voluntary, thereby exculpating actions and relationships that would otherwise appear to be coercive or ethically suspect. In this model, for example, the term “economic democracy” is an oxymoron because there is nothing there to democratize.

As a result, this model granted a kind of moral extraterritoriality to economic interactions that suspends ordinary ethical judgments within its compass. The moral philosopher David Gauthier

describes it well: “the presupposition of free [market] activity ensures that no one is subject to any form of compulsion, or to any type of limitation not already affecting her actions as a solitary individual,” he writes (Gauthier 1986, p. 96–97); “[thus] morality has no application to market interaction under the conditions of perfect competition” (p. 93).

Ethical concerns and the public interest in economic matters were thus reduced to eliminating government interference in economic decisions, sustaining competition, and ensuring just procedures for acquiring assets. Kenneth Arrow writes, “Any complaints about [the market system's] operation can be reduced to complaints about the distribution of income . . . [but] the price system itself determines the distribution of income only in the sense of preserving the status quo” (Arrow 1971, p. 6).

Aside from such circumscribed concerns about distributive justice, prices would do the work of morals. The effect is to sideline a broader range of ethical values. Among these is a less restrictive idea of freedom, which goes beyond simple noninterference by a government. Such a view would be the basis for condemning the domination of one individual by another, as is common in the relationship between an employer and an employee in a capitalist firm (Pettit 2014).

Contrary to the apolitical conception of the firm in the Marshall–Walras approach, its political nature as a system of authority—a miniature planned economy—was established 80 years ago by Ronald Coase. He asked his readers to “note the character of the contract” governing employment: the worker “for certain remuneration agrees to obey the directions of the entrepreneur.” Indeed, Coase *defined* the firm by its political structure: “If a workman moves from department *Y* to department *X*, he does not go because of a change in relative prices, but because he is ordered to do so. . . . [T]he distinguishing mark of the firm is the suppression of the price mechanism” (Coase 1937, pp. 387, 389).

To Coase, what was special about the contract is that what the worker gives up—an unenforceable promise of obedience—is not what the employer needs in order to produce and sell goods for a profit, namely, labor effort. What, to Coase, transformed the promise of obedience into real work done is the political structure of the capitalist firm.

### III. The Economics of “Solved Political Problems” in Retrospect

While the Coasian firm was good economics, it was awkward for those wishing to wield the yardstick of freedom in defense of capitalism. Coase himself (in his Nobel lecture) recalls wondering at the beginning of his career, “How did one reconcile the views expressed by economists on the role of the pricing system and the impossibility of successful central economic planning with the existence . . . of these apparently planned societies, firms, operating within our own economy?” (Coase 1992, p. 715).

There was definitely something to democratize in the Coasian firm, and perhaps this helps explain why his idea never became part of the conventional late twentieth-century economic paradigm taught to undergraduates.

Long before Coase, for Joseph Schumpeter, establishing that employers exercise no asymmetrical powers over their employees became “a fundamental task of economic theory” (Schumpeter [1911] 1934, p. 21). As Oliver Hart observed, assuming complete contracts in the labor market did the job. “What does it mean,” he asked rhetorically, “to put someone ‘in charge’ of an action or decision if all actions can be specified in a contract?” (Hart 1995, p. 62).

And so most economists came to embrace the view that the employment contract did not differ in any substantial way from contracts for the exchange of cars or shirts, in which, for a price, the seller turned over a car or shirt, not some unenforceable promise to later provide these goods. By this vanishing act, what the philosopher Elizabeth Anderson calls the “private government” of the firm disappeared from economics (Anderson 2017).

The unrealism of this extension of the idea of complete contracts to the employment relationship was clear to lawyers, businesspeople, and employees. But in the middle of the last century, economists found it congenial because it eradicated politics from the process of economic exchange, avoiding the embarrassment of having to answer the question that had moved Coase to study the theory of the firm in the first place (remember this was the Cold War era).

There were political consequences of the intellectual environment constituted by the complete contracts assumption and the apolitical

view of economic interactions that it supported. It made advocating an expansion of workers’ voices in the conduct of their place of employment as difficult as it would have been to press the cause of unemployment insurance and other income-replacing transfers in the aftermath of the Great Depression, had the concept of aggregate demand not become part of the economic vernacular. The same would be true of advocating a libertarian stance toward government in the absence of the perfectly competitive economic model that provided support for the idea of Smith’s invisible hand.

As a result, the left and center of the political continuum took up social democracy by default. It laid primary emphasis on a general improvement in material living standards and distributive justice, ends that social democratic parties and unions pursued to great effect. But a casualty was the once-vibrant critique of the social structure of the workplace as a violation of commonly held democratic norms that power should be accountable and limited. Lost also was the recognition that the hierarchical structure of the firm impedes the development of human capacities essential to a well-functioning democratic society.

Whether this narrowing of the economic lens was a bug or a feature of the model depended on one’s political interests. Referring to a contractual relationship as an “economic transaction,” here is Abba Lerner’s ledger: “An economic transaction is a solved political problem. Economics has gained the title of queen of the social sciences by choosing solved political problems as its domain” (Lerner 1972, p. 259).

On the cost side of Lerner’s ledger was the then already small and increasingly restricted domain—the world of complete contracts—over which the queen ruled. Since then, the domain has been further reduced by the noncontractual environmental effects driving the climate emergency. This is also occurring because fewer workers are employed in producing physical objects where determining the quality of the object exchanged or the task done is relatively easier than in many services. (Agriculture, mining, and manufacturing now employ less than one in seven in the United States.)

Modern information processing, including surveillance technologies, is permitting more complete contracts, as in ride hail, delivery, and other parts of the gig economy where

compensation approaching piece rates is feasible. But from an empirical standpoint, these new opportunities for more complete contracting are minor compared with the massive shift of work into caring, education, security, knowledge production and distribution, and other services in which it is particularly difficult to contractually link pay to the worker's contribution to output.

And so, in light of these ongoing structural changes in the economy, by the time the neoliberal paradigm took hold in the economic policies of the 1980s and 1990s, economic theory had already moved on. By then it was widely recognized that contracts are incomplete not only in the labor market but also in the credit market, and in the market for goods or services that vary in quality in ways that are difficult to measure. Much of the interest in the behavioral revolution stemmed from the recognition that social norms such as work ethic or truth telling sometimes can substitute for contractual completeness.

#### IV. Bringing Power and Social Norms Back into Economics

Given disciplinary boundaries, it is not surprising that less attention was given to the normative implications of the new theory. Among these, we will explain, is that the new microeconomics brought power and social norms back into economics and that this could provide the synergies between ethics and economics essential to a new paradigm capable of both advancing a more ethically powerful critique of the capitalist economy and exploring alternatives.

We begin with the critique. Where contracts are incomplete—whether it be between employer and employee, lender and borrower, or the seller and buyer of a good whose quality cannot be specified in an enforceable contract—the actual terms of the exchange depend on both the social norms of the participants and the kinds of power they can exercise. The exchange thus becomes political and norm-based as well as economic in nature and therefore subject to evaluation on grounds not only of efficiency and fairness but also of the broader value of freedom.

These exchanges are represented by principal-agent models with the lender or employer as principal and the borrower or employee as agent. The notion of economic interactions as a morality-free zone is undermined by four results of these models.

*The principal has power over the agent.* The relationship between principal and agent is political in the sense that the de facto terms of the exchange are determined by the threatened imposition of sanctions (namely, termination of the transaction by the principal). Termination is costly to the agent because, in order to induce hard work, the prudent use of borrowed funds, and so on, the principal has offered terms to the agent such that she receives a rent—a deal better than her next best alternative—as long as the transaction persists. The use of a threat to withdraw this rent to advance the interests of the principal in conflict with the agent is recognizably an exercise of power.

*Abuse of this power may be costless to the principal.* In this relationship, the principal can inflict first-order costs on the agent at virtually zero cost to himself. The employer, for example, sets the conditions under which the employee works, including exposure to sexual harassment, racial insults, and hazardous materials. Having done so in a way that maximizes profits, the employer incurs only second-order (that is, virtually zero) costs in reducing the employee's security from insult and danger along these dimensions.<sup>1</sup>

*Social norms are essential to realizing mutually beneficial transactions.* Because the effectiveness of this exercise of power by principals is limited, social norms—such as a work ethic or a commitment to truth telling—are essential to the functioning of labor, credit, and other markets where contracts are incomplete.

*The resulting allocations are inefficient.* The Nash equilibrium resulting from profit maximization by the principal and utility maximization by the agent is both Pareto inefficient and technically inefficient. There exist different outcomes (in the labor market, for example, different levels of wages and work effort) in which both principal and agent would be better off (and no one affected would be worse off). And taking the Nash equilibrium as the status quo, it would also be possible to revise the employer's labor discipline strategy—reducing monitoring and raising wages, for example—such that the

<sup>1</sup>This result follows from the envelope theorem. The intuitive version is that the top of a hill is flat, so moving a small amount away from the top (variations in the conditions of work) has virtually no effect on the altitude (the firm's profits).

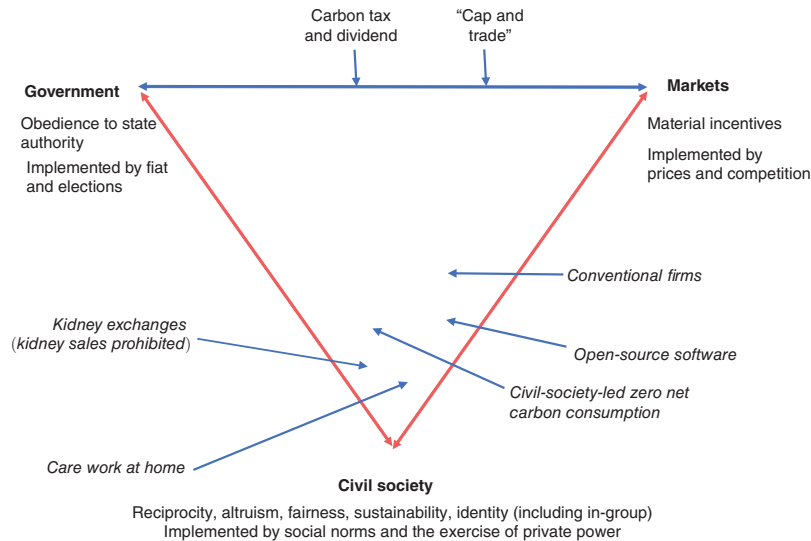


FIGURE 1. AN EXPANDED SPACE FOR CRITIQUE AND ALTERNATIVES

same output could be produced with less of one input (monitoring) and not more of any input.

The salience of power and social norms in principal-agent relationships does more than make the exchange process political and social as well as economic; it provides the basis of new demands and institutional designs. For example, the workplace (and, by extension, much of the rest of the economy) becomes an arena in which a new paradigm could press the claims of democratic accountability—ranging from enhanced individual rights of workers to employee ownership—in the context of what political scientist Robert Dahl termed the “arbitrary and sometimes despotic power of the rulers of economic enterprise” (Dahl 1977, p. 9).

Recognizing that social norms are essential to the working of markets also invites our consideration of alternative forms of economic organization that, rather than undermining norms of solidarity and cooperation, would more effectively cultivate, mobilize, and benefit from common intrinsic motivations and other-regarding preferences. And finally, the inefficiency of the current arrangements indicates that organizations based on less hierarchical and unequal interactions may be more effective in terms of economic performance

in an increasingly knowledge- and care-based economy where the incompleteness of contracts is particularly pronounced.

## V. Expanding the Space for Critique and Alternatives

The contribution of the economic model of incomplete contracts and behavioral economics is not to reveal aspects of work and exchange that were previously unknown. Scholars in management studies, industrial sociology, and psychology, as well as in economics, have documented them. What it does instead is to open up a space in economic discourse in which values of dignity and democracy and other demands of an enhanced concept of freedom have standing, and to provide an analytical lens for considering measures to advance these values, such as Keynes’s concept of aggregate demand became an essential part of the post–World War II policy and normative paradigm aimed at reducing economic inequalities.

This expanded space is shown in Figure 1, where the blue line illustrates the state space of policy and institutional options in the conventional restrictive “more or less government” menu of policy choices. A location in the space provided by the third pole—civil



society—has the same meaning as one on the bipolar blue line.<sup>2</sup> Alternative paradigms and the institutions that they advocate are located on the triangle with those closer to a given vertex, placing greater emphasis on the aspect associated with that vertex. Thus, laissez faire would appear at the upper right, central planning at the upper left, and a communitarian paradigm at the bottom.

The problem with the single blue line is not what is there—markets and government will remain essential—but what is entirely missing. The first is any recognition of the main results of modern mechanism design, namely the intrinsic limits of incentives and governmental fiat especially in addressing the challenges of non-market social interactions such as problems of climate change and the spread of epidemics. The second, from a descriptive standpoint, is that it misses the essential role of the private exercise of power and of social norms in undergirding a modern economy.

The government-market axis also is limiting because it provides no space for the critique and design of alternatives to the exercise of unaccountable power in institutions that are neither states nor markets—namely, firms, families, and other private bodies.

Exploring the nongovernment nonmarket dimensions of our institutional and policy options as illustrated in Figure 1 is essential to the construction of a new paradigm. This requires imagining and explaining how the pursuit of a broader concept of freedom and the cultivation of the associated norms of solidarity, fairness, reciprocity, and sustainability would enhance the functioning of a successful modern economy.

We invite economists and others to rise to this challenge.

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<sup>2</sup>Similar tripartite representations of the regulation of social interactions, broadly construed, have been suggested: for example, plan, market, reciprocity (Kolm 1984) or bureaucracy, market, and clan (Ouchi 1980). For Elinor Ostrom, the third dimension was local, informal self-government (Ostrom 1990).