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Egalitarianism Old and New[ϖ]

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According to conventional wisdom, policies that reduce economic inequality have adverse effects on long-run macroeconomic performance, reducing incentives to work, save, and invest. However, some recent econometric studies suggest that there may not be a trade-off between equality and efficiency, that a more equal distribution of resources may actually enhance productivity and economic growth. A new school of economists – the "asset egalitarians" – argue that opaque markets, inefficient resource allocation, and sharp inequalities of wealth are mutually reinforcing. If asset ownership were less concentrated, these economists insist that productivity would rise, and the need for incentive-dampening policies of income redistribution would diminish. **JEL: A13, D31, D63 and H23**.

1. Equality and Efficiency: The Big Trade Off and the "Old" Debate

In 1975, Arthur Okun published a slim, but classic volume entitled *Equality and Efficiency: The Big Trade Off*. Okun dramatized the conflict between these objectives by inviting his readers to suppose that income redistribution is accomplished by transferring money from rich to poor in "leaky buckets." Although some leakage is due to the cost of administering a tax-and-transfer system, the biggest leaks, according to the conventional view, are caused by the adverse effects of high tax rates on labor supply, saving, and investment, along with the "moral hazards" that are created by generous schemes of social insurance. The lesson for egalitarians was, to put it bluntly, "you can divide the pie more equally, but if you do, the pie will shrink."

Economists with egalitarian sympathies have offered three principal responses to "the big trade off." In the first place, some argue that the price effect of an increase in marginal tax rates, which reduces the opportunity cost of (untaxed) leisure, will be offset in some measure by the income effect, as the marginal utility of earnings rises when after-tax income falls. Second, Okun and others have pointed out that if

aggregate saving is too low because of high taxes on wealthy households, this can be remedied by a fiscal policy in which the government runs budget surpluses; while the central bank holds interest rates down to promote investment. Third, and finally, many liberal economists simply grant that greater equality results in less output or slower economic growth, but willingly accept this outcome for any of the following reasons: 1) greater equality increases social welfare because of the diminishing marginal utility of income; 2) the market distribution of income is unjust because of unequal employment and investment opportunities; and 3) sharp inequalities of wealth and income are incompatible with the common life that is essential to democracy.

Much of the contemporary debate over tax policy in the advanced economies is conducted, on the one side, by liberal economists who praise the market's efficient allocation of resources, but condemn the sharp inequalities of income it generates, and, on the other side, by conservative economists who insist on the following points: the price effect of tax increases dominates their income effect; running large budget surpluses is not a plausible strategy for increasing saving because of the government's appetite for expenditure; and market incomes reflect the productive contributions of those who earn them. Although these conservative propositions contradict the foregoing liberal claims, it is important to notice that both sides in this debate hold a generally favorable view of the market's capacity to efficiently allocate resources and, with a few exceptions, acknowledge some trade off between equality and efficiency.

2. Recent Empirical Findings Regarding The Big Trade Off

If there were, in fact, a well-defined trade off between equality and aggregate economic performance, we would expect to see a strong positive correlation between inequality and such performance measures as per capita income, the rate of growth in per capita GDP, and the rate of growth in productivity. Yet there seems to be no such relationship. Quite the contrary, several recent studies have found negative correlations between economic inequality and various criteria of macroeconomic performance. For example, Bowles and Gintis (1998) detect a negative relationship between income inequality and the long-term rate of GDP growth per employed person in ten advanced economies. Similarly, Persson and Tabellini (1994) find that inequality and growth in GDP are negatively correlated in a cross section of sixty-seven countries as well as in long time series for nine advanced economies. Further, Alesina and Rodrik (1994) find that countries with a relatively high degree of initial inequality experienced relatively low rates of growth in GDP per capita, and, more precisely, that inequality variables had significant negative coefficients in growth regressions that controlled for a country's initial level of income, education, and capital investment.[1] Although one recent study (Forbes 1997) challenges this negative relationship between income inequality and aggregate economic performance, further studies (Birdsall and Londono 1997; Deininger and Squire 1998) have found an even stronger negative association between inequality in the distribution of wealth and various measures of macroeconomic performance.

Although one cannot conclude from these studies that equality always promotes productivity and economic growth, it seems clear that sharp inequalities of wealth and income are not conducive to superior macroeconomic performance. But why should an unequal distribution of wealth and income be an impediment to growth in output and productivity? One plausible answer (Palley 2001) is that if

[1] Benabou (1996) surveyed a number of other cross-country studies that reached the same conclusion.

wealth and income are highly concentrated, aggregate demand will be chronically weak, which will constrain growth in output and investment and, therewith, improvements in productivity. This Post-Keynesian account of equality's contribution to efficiency is consistent with the superior performance of the advanced capitalist economies during the post-war "golden age," when per capita incomes were more equal, and output and productivity growth more rapid, than during any comparable time period. There is, however, another view of the positive association between equality and macroeconomic performance that has emerged in recent years, one that focuses on the supply side of the economy.

3. Imperfect Information, Inefficient Markets, and Inequality

One of the most important developments in contemporary economics has been the appreciation of imperfect information and its effects on the organization of the firm and on the scope and functioning of markets. When corporate managers know more about their firms than their stockholders do, when the productivity of individual workers cannot be easily ascertained at low cost, and when banks cannot reliably assess the trustworthiness of borrowers, then markets do not function as they would if every agent had complete information regarding these and other matters. Moreover, some economists now contend that this divergence between the workings of real-world markets, which are characterized by imperfect information, and the perfect markets of the textbooks has important implications for "the big trade off."

To understand some of these implications, we may begin by taking account of the fact that a great many economic activities involve contractual arrangements under which individuals, often without significant property holdings of their own, use the productive assets of more advantaged individuals under specified terms and conditions. Examples of this kind of arrangement include labor contracts in which workers operate equipment in exchange for wages, rental contracts in which tenants pay landlords for living quarters, and share-cropping contracts in which tenant farmers are allowed to grow crops on the owner's land in exchange for a share of their harvest. Yet writing such contracts is not without cost and writing contracts that cover every contingency is not possible at any cost. Furthermore, there are conflicts of interest between workers and plant managers, between tenants and landlords, and between sharecroppers and landowners. In particular, workers, renters, and tenant farmers have no interest in the residual value of the assets they use. Hence, property owners must often incur significant monitoring costs to ensure that their assets are well-treated and, in the case of workers, to make sure the firm's equipment is used productively.

Two points, though controversial, deserve emphasis. First, the need for these sorts of contracts arises, at least in part, from the unequal distribution of wealth. If wealth were more evenly divided, so workers who wished to start their own businesses had access to the necessary capital, so renters could become homeowners, and so sharecroppers could become land-owning farmers, then contracts between propertied and property-less individuals would arguably recede in number and importance. Second, if wealth were more equally distributed, resources devoted to monitoring the conduct of property-less workers, renters, and sharecroppers could be redirected to more productive uses. Other things remaining the same (which, admittedly, is question-begging here), greater equality in asset ownership would improve efficiency by aligning incentives and interests, and by reducing monitoring costs (Bowles and Gintis 1998).

Now it may be objected that if these, more egalitarian forms of enterprise were, in fact, more productive than existing arrangements, property-less individuals could simply borrow money to purchase productive assets and proceed to produce at lower costs than "hierarchical" firms. The trouble with this argument, however, is that while such credit would be forthcoming in a perfect capital market, it is not forthcoming in real-world capital markets, which, plagued by asymmetric information, do not make credit equally available to everyone.

For many productive activities, there is a minimum threshold size or cost necessary to get started. This initial lumpy investment may be the cost incurred in moving from the country to the city, or the enrollment fee necessary to enter a training program, or the minimum acreage required for profitable farming. Yet, while there are doubtlessly many less advantaged individuals who could profit from these opportunities if they had the necessary start-up capital, imperfections in the credit market prevent them from doing so. When the repayment of loans is not costlessly enforceable, and borrowers have more information about their prospects for success than lenders, banks will impose collateral requirements on loan applicants in the belief that the required collateral will only be forthcoming for the most promising projects. In their actual effect, however, collateral requirements foreclose many promising investment opportunities that would otherwise be undertaken by disadvantaged individuals. Some empirical support for these propositions is provided in Hubbard and Kashyap (1989) who found that farm investment in the U.S. decreased with declines in net worth, and in Blanchflower and Oswald (forthcoming) who found that individuals with an inheritance of £5,000 (about $10,000) are twice as likely to become entrepreneurs as those less fortunate.

Similar impediments face less well-endowed individuals who would like to sell shares in a new enterprise (Hoff 1998). In this case, the problem arises because potential investors cannot be sure that aspiring entrepreneurs will supply the effort required for success unless they retain a sufficiently large stake in the enterprise. Having very little wealth, the aspiring entrepreneur would have to take out a relatively large loan in order to induce potential shareholders to risk their capital in the enterprise. But from the bank's perspective, the larger the loan, the smaller is the entrepreneur's stake in the business, hence the lower is the likelihood the would-be entrepreneur will supply the productive effort necessary for success. Unable to borrow an amount sufficient to induce investors to buy shares, the would-be entrepreneur must turn to less productive endeavors, which both reinforces economic inequality while at the same time constraining output and its rate of growth below their potential.

Incomplete insurance markets limit the risk pooling and hedging opportunities available to asset-poor households. While mutual funds and other modern investment vehicles allow wealth holders to diversify their holdings, it is not possible for property-less workers to similarly allocate "bits" of their labor across a variety of endeavors. In theory, workers should be able to hedge against all kinds of risks. For example, suppose a worker were able to scrape together the funds necessary to enter a training program for welders. Further, suppose this worker is confident in her own abilities, but worries about the future of welding as a profession. If there were an insurance market in which this aspiring welder could hedge against the risk of, say, declining wages for welding as an occupational category, she could pursue a career in this profession without taking a risk she cannot afford to bear (Shiller 1995). In the absence of such an insurance market, however, she may choose a safer, but less productive occupation, which means the economy's

total output will less than it could have been.

In the labor market, employers often find it too costly to devote a great deal of time and effort to evaluating the productivity potential of individual job applicants. Rather than taking such pains, firms will sometimes use more easily observed correlates of productivity, such as the possession of a college diploma, as a basis for hiring decisions. Alternatively, firms may find it cost effective to rely on the average productivity of identifiable groups rather than trying to carefully assess the productivity of specific individuals. Insofar as the average productivity of privileged groups is greater than the average productivity of disadvantaged groups, and insofar as these groups are easily distinguished, the best jobs will go to members of privileged groups even if employers are unprejudiced. Moreover, as long as hiring decisions are based on the average productivity of groups, individuals who belong to low-productivity groups will under invest in their human capital because they will not earn the full return on their investment. Here again, inequality is both self-reinforcing while also being a drag on aggregate economic performance.

At first glance, it might seem that employers could reduce hiring and monitoring costs by creating incentive schemes so that all workers found it advantageous to work productively. Such incentive schemes include piece-rate remuneration in lieu of hourly wages, profit-sharing, and commission payments based on sales. Under each of these arrangements, employees receive higher incomes in some years and lower incomes in other years. Yet while these incentive schemes could result in both higher profits and higher expected incomes for workers, the year-to-year variation in labor income may entail more risk than workers can afford to bear. If workers could borrow to smooth their income stream, however, they could earn higher income on average, while drawing on lines of credit at attractive interest rates to pay expenses during bad years. But because imperfect information, moral hazard, and a lack of collateral prevent such income smoothing, many forms of mutually advantageous cooperation are foreclosed, and the average income of workers is less than it would be under conditions of complete information.

To summarize, sharp inequalities of wealth leave many less advantaged individuals without the productive opportunities enjoyed by more privileged individuals – the savings necessary to invest in education, training, or self-employment; access to credit for the purpose of investing or income-smoothing; insurance contracts that would allow workers to hedge and pool risks in the same manner that wealthier households can. In the absence of these opportunities, many of which are foreclosed by imperfect information and incomplete markets, asset-poor individuals often lack the incentive or wherewithal to invest in human and other forms of capital, which has an adverse effect on aggregate output and its rate of growth, while at the same time perpetuating the inequality of wealth and income that gives rise to these unwanted macroeconomic outcomes. If we assume that work effort, innovation, the maintenance of capital assets, and trustworthy behavior cannot be fully specified in enforceable contracts, then a less concentrated, more egalitarian distribution of property, wherein workers own firms, renters own apartments, and share croppers own land, may very well improve an economy's overall efficiency.

4. Limits of the New Egalitarianism

The "New Egalitarians" have given us a novel and, I believe, fruitful perspective on "the big trade off" by showing how incomplete information, inefficient markets, and economic inequality are mutually reinforcing. As it turns out, the efficiency of various organizational forms and markets, as well as the

productivity of labor and capital, depend on how unequally wealth is distributed within a society. Moreover, these economists have set forth plausible arguments for their claim that real-world economies could be restructured in ways that would favor both equality and productivity.

Of course there are limits to the New Egalitarian vision, and I would be derelict if I didn't mention, in particular, one conservative interpretation of the interrelationships among asymmetric information, the organization of the firm, and the unequal distribution of wealth in a market economy. Imagine an employee-owned firm in which revenues are divided equally among the workers. If there are n workers, then each one will receive only 1/n of whatever value he or she adds to the firm's output, while incurring the full cost involved in creating this marginal value. If the cost of this effort is greater than 1/n of the benefit created, it will not be advantageous for the worker to add this value. Instead, he will free ride on the efforts of other workers, a strategy which, if pursued by all of the firm's workers, will be the road to ruin. Couldn't this problem be solved if the workers were to watch over one another to make sure no one was shirking? Yes, provided that keeping close tabs on other workers were costless. However, if this kind of surveillance is unpleasant, then each worker will again find it rational to free ride on the monitoring efforts of other workers, which is, of course, just a more roundabout road to ruin. Finally, couldn't the workers hire managers to monitor their efforts? They could, but who would then monitor the monitors?

A conservative response to this dilemma holds that some agent must have a claim to the firm's residual income and capital value, otherwise no one will have a sufficient incentive to organize and oversee the efforts of employees (Alchian and Demsetz 1972). In this case, the infinite regress of monitoring is brought to a halt by giving the ultimate monitor an incentive "to monitor himself." In effect, the workers give up their egalitarian cooperative for a hierarchical firm in order to free themselves from the mutually destructive free riding that attends the equal distribution of the cooperative's income. On this view, an unequal distribution of wealth contributes to efficiency because there must be a residual claimant with a large stake in the firm, and only a person with a modicum of wealth can bear the risks involved in owning an enterprise. To reject this imperative is, in effect, to forego the organizational form that makes possible economies of scale and the massive efficiencies it entails, a very big trade off indeed.

If economists with egalitarian sympathies find this conservative argument compelling, the case for liberal policies of income redistribution may have new appeal. After all, the highest growth rates in the history of Western capitalism, i.e., the boom of the post-war golden age, were accompanied by what was one of the most ambitious redistributions of income in the world's history. Moreover, a liberal economist could well argue, in response to the New Egalitarian focus upon the inefficiencies caused by inequality under conditions of imperfect information, that many programs of the welfare state, such as government-subsidized training programs, financial assistance for the college-bound children of less advantaged families, unemployment insurance, the mortgage interest deduction, the Earned Income Tax Credit, and a multitude of other social insurance programs, already address, however incompletely, many of the market failures cited by the defenders of asset egalitarianism. That said, there is no reason why liberal economists with egalitarian sympathies should not help themselves to some of the provocative ideas advanced by the New Egalitarians.

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NEW feature for the BNE!

From time to time the BNE will provide a preview of a full Book Review with a much shorter Book Note. The first of these Book Notes on Joseph Stiglitz's ***Globalization and its Discontents*** *appeared with Issue No. 59 and was written by Alieu Senghore. The full Book Review on that book authored by Mak Arvin appears below.*

Book Review:

Stiglitz, Joseph E. (2002). Globalization and its Discontents. Penguin Books: London. PP 288. ISBN 0-141-01038-X

The Bretton Woods conference of July 1944 was part of an effort to rebuild Europe after World War II and save the world from future economic depressions. It called for the creation of three international economic organizations: The World Bank, the International Monetary Fund (IMF), and the World Trade Organisation (WTO). The World Bank was charged with reconstruction and development, while the IMF was given the task of ensuring global economic stability through governing international financial relations. The WTO, with responsibility for international trade relations, did not come into existence until 1995, although its predecessor the General Agreement on Tariffs and Trade (GATT), designed in 1947, did succeed in reducing tariffs on international trade.

This book by the 2001 Nobel Laureate in economics takes a critical look at globalization – defined as the removal of barriers to free trade and the closer integration of national economies – and the role that the Bretton Woods institutions have played in the process. However, most of the analysis focuses on the IMF, beginning with a demonstration of how over the years the Fund has expanded its mission outside its core mandate, regarding practically all global economic matters as falling within its domain. For example, the Fund gives its initial approval (which comes with IMF-imposed conditions on the country) in instances where the World Bank provides a structural adjustment loan to a developing country. The IMF was supposed to focus on crises, but its interference is now widespread.

There were other changes as the ideas and intentions, which were behind the creation of the IMF evolved. The Fund was founded on the Keynesian belief that markets often did not work well, requiring international pressure on countries to engage in expansionary policies to stimulate their economies. Today's IMF, on the other hand, typically provides funds only if a country adopts policies such as cutting deficits, and raising interest rates and taxes, practices that could have deleterious consequences for an already contracting economy. Those who have managed the Fund in recent years essentially view governments as a problem – and are quick to offer 'free markets' as the solution to the woes of the developing world. Preaching free and fair trade, the IMF and WTO have asked developing countries to open up their markets to the goods of industrialized countries, while the latter have kept their own markets protected through subsidies and other measures.

There is mismanagement on another front: Stiglitz ably demonstrates that the financial and capital market liberalizations advocated by the Fund have been premature for many countries (including those in East Asia and the former Soviet Union), contributing to global instability.

The ideas expressed by Stiglitz in this book and through a series of articles he wrote following the Asian financial crisis have already sparked controversy and debate within the profession. Criticisms of Stiglitz come from the free market advocates, naturally and most notably from the IMF economists (see, for example, http://www.imf.org/external/np/vc/2003/021003.htm). On the other hand, supporters, largely economists studying market imperfections, as well as many development specialists, have joined Stiglitz in voicing concern over IMF's policies (see, for example, the remarks by John Williamson at http://www.iie.com/publications/papers/williamson0602.htm).

Even those unfamiliar with the economics of imperfect information will

find the arguments advanced by Stiglitz in the second half of the book quite compelling. For instance, there is a lucid exposition of the IMF's bungling over its handling of bankruptcies. It is natural to assume that if a lender makes a bad loan, he bears the consequences. The IMF, on the other hand, repeatedly provides funds for governments to bail out Western creditors. Those creditors, counting on an IMF rescue, have sub-optimal incentives to ensure that the borrower will be able to repay. At the same time borrowers, believing an IMF bailout, are encouraged to incur excess risk. Evidently IMF's policies do not appear to take into account these standard moral hazard problems.

At the end of the work, Stiglitz offers a series of suggestions for reforming the international governance system and giving globalization a more human face. These include bankruptcy reforms, acceptance of the dangers of premature capital market liberalizations, improved banking regulations, better responses to crises, and a more just international order. In particular, Stiglitz advocates a need for the IMF to return to its original mandate of providing funds to restore aggregate demand in countries facing an economic recession, as well as promoting transparency (openness of and access to information) in its operations. Related to this, he also favors a more translucent international governance system where decisions are not made behind closed doors and where they are subject to public scrutiny. Fundamentally, Stiglitz would improve the workings of the IMF, the World Bank, and the WTO by suggesting that they do not make decisions based on ideology and politics, and by giving a greater voice to the constituents in the developing world. In all, Stiglitz articulates a more balanced version of how market-based economic policies, together with political and social reforms, can enable developing countries to share the benefits of the global economy.

This is a readable book free of the technical jargon that mars similar volumes written on globalization. Obversely, those interested in the history and the various disciplinary meaning of the concept of globalization will be dissatisfied with Stiglitz's somewhat narrow definition of globalization (as compared with, e.g., Malcolm Waters' in *Globalization*, 1995). Nonetheless, the fact that the volume is written by a knowledgeable insider (former chairman of the Council of Economic Advisers under Bill Clinton, and former chief economist and senior vice president at the World Bank) makes it immensely valuable.

It is apparent throughout the book that Stiglitz is not against market fundamentalism – but how to improve markets that do not work perfectly due to asymmetric information and a host of other problems. After all, no one has written more on the importance of markets, incentives, and information than Stiglitz. He clearly shares the sentiments of many economists who feel that globalization has brought important benefits to poorer countries, but who are also disappointed that the global governance institutions (particularly, the IMF) have failed many countries in economic development, stabilization, and trade. In sum, the author's unsparing criticism of the wrong-headed actions made by these entities make this brilliant book obligatory reading for anyone interested in global politics and international relations.

Mak Arvin

ϖ *The views expressed here are personal to the author and do not necessarily reflect those of the other staff, faculty or students of this or any other institution.*

Forthcoming Conferences:

June 17-18, 2004: A conference with the title Institutions and Policies for the New Europe is being held in Portoroz-Koper, Slovenia. The general aim of this conference is to

discuss institutional innovations and policy reforms that would be necessary for a viable and successful enlarged Europe. The relevant JEL codes are: E, H, K, O, P and Z. Further information available at: http://www.gov.si/umar/conference/2004/index.html

July 5-10, 2004: A conference with the title Budapest Workshop on Behavioral Economics is being held in Budapest, Hungary. Several leading exponents including Roland Benabou are presenting. The relevant JEL codes are: A,B, H and K. Further information available at: http://www.iza.org/en/calls_conferences/CallCEU_04.pdf

July 14-16, 2004: Call for papers by the Centre for Efficiency and Productivity Analysis at the University of Queensland, Australia. They invite papers on all aspects of productivity and efficiency measurement, production management and production economics. The papers may be theory, methodology or applications. Relevant JEL codes are: A, C, D, L and O. Further information from: http://www.uq.edu.au/economics/appc2004/

August 30-31: A conference with the title The Economics of Information and Network Industries will be held in Kloster Seeon, Germany. The relevant JEL codes are: D, L and Z. Further information available at: http://www.uni-kiel.de/ifw/konfer/konferin.htm

August 30-September 1, 2004: A conference focusing on the needs of small and medium sized enterprises will be meeting in Lefkada, Greece. The relevant JEL code is M. Further details may be found at: http://www.atiner.gr/

September 2-3, 2004: A conference with the title and theme of Economics and the Analysis of Biology and Biodiversity will be held at Kings College, University of Cambridge, UK. The relevant JEL codes are: H, K, O, Q, R, Z. Further details may be found at: http://www.bioecon.ucl.ac.uk/Kings/BIOECON_WorkshopV_Reg.doc

September 2-3, 2004: A workshop with the theme of Governance, Competence and Economic Organisation in the Knowledge Economy will be held in Bristol, UK. The relevant JEL codes are: B, L, M, O. Further details may be found at: http://www.uwe.ac.uk/bbs/research/research/sib/boundaries.shtml

September 3-4, 2004: A workshop with the title of Conduct of Monetary Policy under Uncertainty: A comparison of Central Banks will be held in Bonn, Germany. The relevant JEL codes are: A, C, E, F, G, H, I, J, L, N, O, P, R. Further information available from: http://www.infer-research.net/

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Gowan, P. *The Global Gamble - Washington's Faustian Bid for World Dominance. Published by Verso 1999. Reviewed by* ***Brian Grogan****.*

Shiller, R.J*. Irrational Exuberance. Published by Princeton University Press 2000. Reviewed by* ***Ivan K. Cohen****.*

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