

PONTIFICAL COUNCIL  
FOR JUSTICE AND PEACE

**SOCIAL AND ETHICAL  
ASPECTS  
OF ECONOMICS**

*A Colloquium  
in the Vatican*

2<sup>nd</sup> Edition



VATICAN CITY 2011



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IN THE MEETING OF 5 NOVEMBER 1990**

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## PRESENTATION

The Pontifical Council for Justice and Peace is glad to publish what can be called the ripe gleanings on the Seminar we had the pleasure of organizing on the 5<sup>th</sup> November 1990 with a group of highly distinguished economists whose names and academic qualifications can be found in the list at the end of this volume.

I would like to emphasize here our gratefulness to our guests, who generously suspended their professional engagements, academic or otherwise, for some days to join us in Rome, in what I do not hesitate to describe as a teaching session. There is no need to insist upon the fact that neither Cardinal Etchegaray, our President, nor Msgr. Martin, our Under-Secretary, nor indeed myself, know much about the intricacies of present economic science, both theoretical and applied.

The whole point of the Seminar consisted precisely in this: well aware of the fact that a thorough involvement of specialists in economics is needed in order for the Social Doctrine of the Church to respond adequately to its task, particularly at the present time, we wished to initiate, in this way, what we expected would be a fruitful dialogue, mutually enriching. Pope John Paul II, in *Centesimus Annus* (No. 59) has stressed the same point, mentioning the “interdisciplinary dimension” of the Church’s Social Teaching and the need for a “dialogue with the various disciplines concerned with man”.

On this occasion, however, it is the Social Teaching specialists who have learned and have become more capable, I am happy to say, of doing their own job.

Our guests kindly accepted to send in their reflections and more developed analyses as a follow-up to the meeting. It is this collection of various essays of different size and structure that we are now publishing, thanks to the untiring collaboration of Professors Ignazio Musu and Stefano Zamagni, already closely linked to our Pontifical Council (the first one as a member). To both of them belongs the merit of organizing and directing the meeting, as well as preparing the present publication, which they have kindly accepted to introduce with a technical synthetic paper. We here state publicly our gratitude.

It should be known that both the idea for the Seminar and the impulse to have it actually convened, comes from the Holy Father, who wished in this way to put into practice, somehow *ante litteram*, what he later expressed in *Centesimus Annus* (*ibi supra*).

He made manifest his interest and personal commitment to the dialogue thus inaugurated by inviting the distinguished participants to his table. And I believe we will all agree that the hour and a half spent in his company was the high water mark of our Seminar.

4 November 1991

✠ Jorge Mejía

*Vice-President*

*Pontifical Council for Justice and Peace*



## INTRODUCTION

*Prof. Ignazio Musu and Prof. Stefano Zamagni*

The contributions published in this volume represent the outcome of a Seminar organized the 5<sup>th</sup> November 1990 in Vatican City by the Pontifical Council for Justice and Peace in preparation of the centenary of the Encyclical *Rerum Novarum*. The aim of the Seminar was that of involving a group of worldwide distinguished economists in a frank and informal discussion on some aspects of the relation between ethical values and the economic reality that are considered particularly important for the social doctrine of the Church.

The appropriateness of this initiative was confirmed a few months later by the new Encyclical *Centesimus Annus*; in number 59, Pope John Paul II writes:

The Church's social teaching has an important interdisciplinary dimension. In order better to incarnate the one truth about man in different and constantly changing social, economic and political contexts, this teaching enters into dialogue with the various disciplines concerned with man.

The lively discussion touched on a number of issues formerly submitted to the invited participants in a questionnaire (the questionnaire immediately follows this Introduction because many contributions refer directly to specific points in it). The themes proposed for the discussion can be summarized in two groups: the first

group is of a more general and theoretical nature; the second refers instead to problems of the current economic reality. Topics in the first group include the relations between economic systems and ethics, between market and public intervention in the economy, between economic efficiency and distributive justice. Topics in the second group refer to the problem of transition from centralized planned economy to a market economy, the gap between North and South in the world economy, the interdependence between economic development and the environment.

As will become clear from reading the contributions, although different points of view have been used in approaching the proposed themes, there has been a unanimous consensus about the importance of the ethical dimension in the organization of the economic system. It is not our intention to review or even summarize here the different points made and the various positions which emerged. What we would like to do here is simply to point out some open questions on the economist's agenda, to which it may be worthwhile paying attention in future research. These open questions assume the form of unresolved tensions both between objectives of economic institutions and between different economic realities.

A *first unresolved tension* relates to the role of the market, compared to other social institutions, in promoting the possibility for each human person of expressing himself or herself fully within societal life. Our societies are complex structures whose members enjoy simulta-

neously equal rights but unequal wealth. We are members of the “citizens’ club” in which we recognize each other as equal (one head, one vote, as J.S. Mill insisted) and, at the same time, we are members of the “market club” which obeys rules that, in practice, may differ from those modelling relations between citizenship and property, between rights to do or to have something on the one hand and abilities and opportunities to exercise these rights on the other hand. If each of us is at least of equal worth to every other person insofar as we are equal members of the “citizens’ club”, the problem lies in the simple fact that an individual’s different endowment of resources and opportunities may render the value of his/her equal liberties futile or irrelevant.

It has become therefore imperative to speed up the passage from a concept of “negative freedom” (i.e. freedom from coercion and impediments) to one of “positive freedom”. Negative freedom is important, but it is only a necessary condition to provide positive freedom. Economists know that, while the market mechanism is effective for attaining negative freedom, it by no means automatically guarantees the attainment of positive freedom.

Indeed, liberty as a value is not defined, nor does it become real, unless the distribution of liberties is specified. At least two conditions should therefore be met in order to cope with this tension between market and citizens’ clubs. *First*, market as an economic institution cannot be separated from a democratic political system. *Second*, the market mechanism should work according to

rules that reduce to a minimum the conflict with the requirements of equal citizenship. It should be noted that this establishes a role for government in the economic system, that of providing and then enforcing appropriate rules for the market game.

*Another unresolved tension* that has surfaced recently in contemporary economies concerns the trade-off between efficiency and equity. The conviction that this trade-off exists is deeply-rooted in economic theory. Alfred Marshall expressed the Bentham dilemma as follows:

Assuming that a more uniform distribution of welfare is desirable, to what extent does this justify changes in the institutions of ownership or limitations to free enterprise, when this leads to a reduction in global wealth?

More recently Arthur Okun summed up the prevailing point of view:

All attempts to divide the cake into equal parts reduce the size of the cake... Money has to be carried from the rich to the poor in a bucket with a hole in it. Part of it simply disappears on the way.

Underlying the thesis that efficiency and justice are in opposition is the idea that, while market forces can guarantee the former, they are not able to solve problems regarding the latter. Hence a pragmatic justification of the market as being still the most efficient system of socio-economic organization, even if it can be accused of producing injustice, and a proposed division of labour between the market guaranteeing efficiency and



the State guaranteeing justice. This point of view refers to the fundamental theorems of welfare economics above the possibility of keeping production of wealth conceptually distinct from the distribution of wealth.

We claim that this view is at most unsatisfactory and at least too simplistic. *First*, there have been, and there still are, situations where both efficiency and equity can be improved by government intervention when markets do not work properly: one example is that of the so-called “keynesian unemployment” caused by excess supply both in products and in the labour markets.

*Second*, it is true that (especially in a short run perspective) redistribution may lead to losses of efficiency and that the pursuit of efficiency may be favoured when attention to redistributive aims is lacking; but it is also true that, as recent acquisitions in public economics show, in economies where wealth is badly distributed, serious incentive problems arise, and this is a threat to efficiency; on the other hand, attempts at redistribution, other than lump sums, may improve efficiency when they are also aimed at correcting negative externalities.

More generally, it has been shown that in economies with incomplete information and with incomplete markets, government interventions may improve matters on both fronts, efficiency and equality, provided the government is able to overcome its potential failures in attaining common good objectives due to the pressure of sectorial interests.

We refer to the widening gap between the North and South of the world, and in particular to the problem of

hunger, as the most dramatic example of tensions existing in the economic reality. The global poverty problem is pressing, and we believe it inadequate to reply that some generations hence the problem will be solved, if only we rigorously adhere to the principles of a free-market. This position is especially untenable in an epoch, like ours, when the enormous expansion of productive capacity since the industrial revolution has made it possible, perhaps for the first time in history, to ensure that there is enough to feed everybody.

What message is to be drawn from this? That the final outcome of the economic process does not depend solely on the point of departure of those already involved in it. Without appropriate international rules of the market game, wealth can easily become, and in fact has become, a form of domination over peoples. This has immediate repercussions on the way in which international economic relations should be reorganized.

International aid should be more specifically devoted to provide the basis for developing human and technological potentialities in the less advanced countries; in particular, these countries should not pay for the mistakes the more advanced ones commit in their monetary policies (see the high interest rates and the debt question) or in the choice of the production pattern (see the exploitation of the world environmental resources). On the other hand, the process of development in the less advanced countries should undergo the necessary reforms in order to free itself from bureaucratic dead

weights and to benefit from the opening to the international trade system.

However, in order that this benefit may be attained in practice, advanced countries should be consistent with their support of the market system and not fight for protective measures for both products and labour that would hit developing countries. Moreover, international cooperation should be promoted in order to reduce the impact of reciprocal negative environmental externalities without hampering the development process in the less advanced countries.

We would like to conclude with a note about one important, and frequently neglected, role of theoretical reflection in the economic field. In recent years, the principal message of behavioural scientists has been that people act essentially out of self-interest. Biologists tell us that behaviour is ultimately determined by material reward, as the pressure exercised by the mechanism of natural selection tends to eliminate organisms that do not exploit all their opportunities for personal gain. Psychologists have come to a similar conclusion about material advantages in the learning processes.

Economists too stress the power of self-interest in explaining human behaviour not only in market transactions but also in interpersonal relations. Yet examples of behaviour that is not self-seeking and at the same time is socially productive are not hard to find. We are here at the heart of the so-called “dual hermeneutics” thesis between economic theory and economic actors:

theories about economic behaviour influence the way people actually behave, as agents tend to conform their behaviour to what the theory says about it; theories therefore do not only describe the existing behaviour but tend to modify it. As Eisenberg expressed it most effectively:

The movements of the planets are sublimely indifferent in our earthly astronomicals. Man's behaviour, however, does not display an equal indifference to man's theories about behaviour.

Thus, it is one thing to recognize that human behaviour may be motivated by self-interest and, in that case, propose adequate institutions to lead this motivation towards socially optimal outcomes; a completely different thing would be to state that behaviour inspired by values other than personal interests leads to economic disaster: this would not only be a false statement, but it would also be morally deleterious because, by encouraging us to expect the worst in others, it would bring out the worst in ourselves, eventually restricting the practical use of natural qualities such as trust and altruism.

The idea that moral behaviour produces negative results is groundless. Always, or at least from Adam Smith onwards, economists have known that the welfare of a society as a whole increases when its individual members respect one another's legitimate interests. Moreover, moral deeds often confer material benefits on their doers. That such benefits exist is an encouraging piece

of news, especially for those engaged, at various levels, in educational activities.



## QUESTIONNAIRE

*sent to the participants in preparation for the  
meeting of 5 November 1990*

1.1. Is it true and, if so, to what extent, that the characterization of rationality used in standard economics has the effect of reducing the influence of moral considerations and cooperative motivation on economic behaviour?

1.2. How might considerations of social cooperation affect our conception of rational behaviour and how might this influence the assessment of public policy?

1.3. Critics of capitalism sometimes call it an economic system that undermines moral imagination. On the other hand, a new school of conservative philosophy asserts the superior morality of capitalism over all other economic systems. Still other thinkers have always maintained that there is no relationship between capitalism and ethics: what can economic theory say about this issue?

2.1. To what extent is it theoretically sound to separate production of wealth from its distribution? In other words, is it true that whatever the distributive pattern, it

is always possible to achieve, under certain conditions, an efficient allocation of resources?

2.2. In particular, is it true that whatever the initial allocation of property rights, it is possible, under certain conditions, to achieve an *efficient* allocation of property rights? Or, is it true that the initial allocation of property rights is only relevant for the determination of wealth distribution among individuals but not for the organization of production which is determined by factors such as the technological characteristics of resources?

2.3. To what extent is the idea morally acceptable of an economic system where the achievement of efficient results can dispense the economist from the question of the *way* according to which these results are obtained? In other words, from an ethical point of view, is it possible to separate a discourse on efficiency — which is a value — from a discourse on the ways by which that same efficiency is obtained?

2.4. It is a source of concern that one of the causes of the success of the modern large firms is that people working within them leave outside the firms that plurality of plans and/or ideas which it is possible to implement in the context of a market economy and accept the authority of some people formulating a plan on the basis of a single model. But, if, within the firm, some form of authority can do better than the market, the organizational answer to these concerns cannot be the



market itself. How can we reconcile this assessment with the idea of a superiority of the market? What form of internal decentralization of decisions and of democratic control of that authority do we need as an answer to such concern?

3.1. What is the proper way to conceptualize poverty in a developed economy? Is it enough to consider poverty exclusively as “privation of something”?

3.2. Developing countries vary greatly in their experience of industrialization. What explains this enormous diversity of experience? Can one say that the experience of NICs has provided the empirical fuel for the incentive-based approach? Or does a closer examination of their experience support a much broader explanation?

3.3. The decade of the 1980s will be remembered as one of unfulfilled expectations for developing countries. In particular, growth has not been high in countries recipient of IMF-WB funds. Is it enough, to restore long-run growth, “to get prices right” and to reduce State intervention by the strong incentive-based approach? Is it fair to say that we need a new international economic order to cope with the problems of LDCs?

4. “The problem is that Marxists only told us how to convert a capitalist economy into a planned economy, but now we have to face a completely different problem which never occurred in the past: how to convert a

planned economy into a market economy” (I. Angelov, March 1990).

“We only have to look up the textbooks of outstanding macroeconomists to know what we have to do. I would wish the Austrian School of Economics would enjoy the same high appreciation in the West that we give to von Mises, von Hayek and others” (v. Klaus, Minister of Finance of Czechoslovakia, March 1990).

These two observations characterize the span of opinions about the feasibility of reforms in a relatively short period of time.

It is well known to economists that during the transitional process, at least during its initial phase, one should expect set-backs, deterioration in standards of living and so on. These temporary negative results are always associated with a *spontaneous* transition. Which role could and should the State play in order possibly to eliminate these shortcomings? Can one conceive a sort of trade-off between lengthening the transition process and reducing its inconveniences? Can the economist forget about the human costs of transition and limit him/herself only to an assessment in terms of the final goal? In a hypothetical economic agenda for a transition scheme, which steps should have priority?

5. That the market has unleashed powerful forces that clearly have acted to degrade the environment has been widely lamented. At the same time, growth proponents have traditionally seen environmental concerns as blocking projects that had the potential to raise living standards significantly. Conflict and confrontation be-

came the “modus operandi” for dealing with this clash of objectives. However, the climate for dealing effectively with both concerns has improved dramatically in recent years. Not only have growth proponents learned that, in many cases, short term wealth enhancement projects which degrade the environment are ultimately counterproductive, but environmental groups have come to realize that poverty itself is a major threat to environmental protection.

How can economic incentives be used to provide the kind of signal that will make sustainable development possible? Since the power of economic incentives is certainly not inevitably channelled towards the achievement of sustainable growth, which kind of control could be suggested to achieve environmental growth? Which other approaches, apart from the economic incentive approach, has the economists’ community to offer the policy-maker to cope with environmental issues?



## **Moral Thinking and Economic Interaction**

*Prof. Kenneth J. Arrow*

In this statement, I will examine the role that moral thinking and obligation play in the field of economic interactions. The economy is a major part of society, the foundation of many forms of well-being, and, if not the expression of man at the highest realms of moral and cultural being, the material basis for them. How individuals interact in the market, then, is an important part of moral and religious obligation.

### 1. MORALITY IN THE PERFECT MARKET

Economic analysis has found it a convenient to start with the assumption of what it calls a “perfect market”. This is an abstraction, but one with a good deal of power in understanding the economic systems of the real world. It is also a convenient origin for the moral analysis. For neither economic nor moral analysis can one stop with the perfect market.

The assumptions which define a perfect market include the following: (a) there are no advantages to increased size, so that there is no barrier to firms which see an unusually good profit opportunity; hence, no such profit opportunities can remain in existence long, and profits therefore tend to a minimum; (b) individuals

and firms may not be certain of the future, but they are all equally uncertain, so that none has special knowledge denied to others; and (c) there are markets for all ways by which one individual can affect the welfare of another for good or ill.

The modern economic system is based on private property in the means of production (including the ownership of labor by the workers). Transfers of goods and services are mediated through prices. Under the assumption of a perfect market, it is shown by economic analysis that the outcome is efficient, that is, there is no other way of using the resources available so as to make everyone better off. Individuals do not then injure others except through voluntary exchanges in which the injured party is compensated through payments of one kind or another.

Are there any moral problems if the assumptions of a perfect market hold? I think one has to distinguish two ways of expressing morality in this context. One is morality in individual conduct. Here it seems to me there is no moral obligation. Every trade is fair. One might voluntarily choose to sell something for less than the market price or to buy or hire at an above-market price or wage. In these cases, the seller or buyer, respectively, is incurring a loss. It is hard to see why there is a moral obligation, though of course one might choose to do so because the other party is especially needy or deserving.

But it must be emphasized that the distribution of income that emerges from a competitive system with perfect markets may be very unequal. Ultimately, income is

derived by the sale of assets, including labor and labor skills. Different individuals may be endowed very differently with skills because of genetic and familial differences and endowed very differently with property because of inheritance. In even the most advanced economy, there are disadvantaged individuals who have difficulty meeting their basic needs while others have wealth beyond any reasonable possibility of use. There is a strong ethical imperative for redistributing income from the wealthy to the needy. This imperative may be partly met by voluntary redistribution, and it is noteworthy that the very language we use shows the high value we place on giving; we call it “love,” which is the root meaning of “charity,” or “philanthropy,” or “righteousness,” the strict translation of the Hebrew word “tzedakah.”

But clearly such redistribution will necessarily be very limited. Individuals may be willing to give if they are assured that others will give. The resources of the State are essential to effective income redistribution through a tax system that puts a larger fraction of the burden on those best able to bear it and through welfare and other redistributive measures designed to put a necessary floor to the satisfaction of basic human needs. There are, of course, efficiency limits to the possibilities of redistribution through State taxes and transfers. Both interfere with incentives and therefore with efficiency. But the tendency in the last decade in many advanced countries to decrease the taxes on the wealthy has shown no obvious gains in efficiency while poverty has increased.

## 2. MARKET IMPERFECTIONS AND THEIR MORAL IMPLICATIONS

Each of the three assumptions in the definition of a perfect market is violated in practice to a greater or lesser extent and each violation creates moral obligations. These operate on individuals, but they are best expressed as social norms, created and expressed in part by the religious and other institutions which express the moral laws which should guide our conduct. In many cases, they need further the sanctions that the government can provide through laws which supply both incentives and a clear statement of social norms, agreed on through democratic processes. I will discuss the consequences of the violation of each assumption.

*Advantages of size.* In many, though far from all, sectors of the economy, there is a greater efficiency in production on a large scale. There are a number of consequences. The first is that there will be market power. Firms will grow, because they can compete more effectively with the lower costs associated with large scale. Hence, there will be few firms or even only one on a single market. The pressure to drive profits to a minimum will be abated; firms may be able to charge high prices without losing their market to competitors. In some cases, such as electric power or telephones, most nations have responded to this threat by regulation or nationalization. In other cases, there may be moral pressure to keep prices down, but, except in special cases, this is unlikely to be effective. Still, the overall burden of excess monopoly profits seems to be small in advanced



economies, though much more considerable in developing countries, where the markets are smaller and the large firms, aided by State help, correspondingly more powerful.

A large firm may also be the sole buyer of some inputs, particularly of labor. The major employer in a small town comes to mind. Such a firm may have the power to keep wages and living conditions down. Here, even more than before, there is a role for social norms of morality to restrain the abuse of power.

A third outcome of advantages to size is that the firm becomes complex and hierarchically organized. Within the firm, there are personal expressions of power and subordination. There are certainly moral obligations for restraint in the way power is used. But in most economic systems the worker has, after all, a choice of firms to work in, so that the market itself imposes natural limits on the undue exercise of authority. I do not therefore consider the organization of the workplace to be one of the major problems of inequality and injustice.

*Inequality of information.* This is a pervasive characteristic of any complex economy, whether operated by command or by the market. A typical example is that a producing firm generally knows the quality and safety of its product more than most buyers. There is clearly an obligation to reveal this truth, even at the expense of profits, for the market will generally do very poorly in sorting out the facts when the buyers are uninformed.

Similarly, the firm knows, by experience, the safety conditions in its plants more than workers can. Hence, the conditions that the market works well are violated, and moral obligation should take its place.

The State can intervene, and, in recent years, has done so. But regulation is not an adequate substitute for a recognition of the firm's moral responsibility. The State can only become informed by inefficient and costly inquisitorial tactics and then imperfectly. Like all regulations, safety and quality regulations work best when the great majority of those regulated obey the rules voluntarily.

Financial markets also reflect the need for integrity and the opportunities and temptations to misleading statements and concealment of truth. After the excesses of the 1920s, severe regulation inhibited inappropriate behavior, but the relaxation of moral standards and an overvivid exaltation of the markets and of the value of greed in the last decade have led to new abuses, not only in the United States.

*Externalities.* This technical term from economic theory has now passed into the popular lexicon. Contrary to one of the assumptions defining a perfect market, firms and households affect each other not only through the goods and services they buy and sell but also through their channels. Firms and households dump wastes into the air and the water, both streams and ground water, and these wastes travel elsewhere. They create health hazards, kill wildlife, animal and vegetable, dirty beautiful scenery, and obscure vision. These

are not the results of voluntary exchanges, but costs imposed on others. The moral obligation to prevent such injuries to others should be joined to legal obligations and controls.

### 3. CONFLICT RESOLUTION

The market then is not the universal arbiter. Actions of individuals must be governed by moral considerations of consequences and by legal controls. But many actions require agreement of several participants, and these are reached by negotiation in which each one gives up something to the other to achieve a mutually beneficial outcome. The process of collective bargaining between labor and management illustrates an institutionalized form of conflict. Another of more recent vintage is the location of sites for disposal of wastes, particularly toxic wastes. They are needed for everyone, but no one wants them nearby.

Conflict is inevitable and, to some extent, even desirable. But it must be thought of as leading to a resolution. Frequently, the psychology and bargaining tactics of the individuals lead to a stalemate in which everyone is worse off. Wars illustrate the frustrations and losses of unresolved conflict on a still bigger and more deadly scale than those in the economy.

One can analyze the rational reasons for resolving conflicts to achieve gains for all. But without a moral commitment to understand the values sought by the others many conflicts will remain unresolved.

#### 4. CONCLUSIONS

The efficiency of the market is a very powerful tool for social progress and the improvement of the economic status of all including the poor. Certainly, the failures of command economies have reinforced our views on that score. But the successes of the market should not lead to the view so frequently drawn that pure selfishness is economically optimal. When there are advantages to size so that power to control the market exists, when individuals can inflict harm on each other or even do good for each other in ways that are not penalized or rewarded in the market, or, above all, when economic agents have private knowledge, then there are moral obligations to use these advantageous roles for the benefit of others. And beyond all these, there is an obligation best expressed through State action, to rectify the market-given distribution of income to achieve more for those whose talents are not enough rewarded by the economy to live a decent human life.

## **Economic Transformation and Economic Justice\***

*Prof. Anthony B. Atkinson*

The issues raised by the Council are wide-ranging and my note makes reference to only a selection of the important questions posed to us. The general theme is the relation between economic justice and the transformation of economic systems into a market economy. This is particularly motivated by the recent developments in Eastern Europe, but the analysis is cast in general terms and should not be interpreted as applying specifically to the position in Eastern Europe, about which I am not qualified to talk.

One of the striking features of the discussion of Eastern Europe among Western economists (and I stress here *Western* economists, since colleagues in Eastern Europe may have a different view) is how little attention is paid to the distributional consequences of economic Transformation. This is as true at the micro-economic level as at the macro-economic level. With the emphasis being placed on the creation of markets, on the privatisation of enterprises, and on the encouragement of entrepreneurship, little attention appears to be paid to the likely impact with regard to inequality or poverty.

\* Revised version of a statement to the Pontifical Council for Justice and Peace, 5 November 1990.

The objective of improving the efficiency of the economy appears to be given priority over that of distributional justice. Irrespective of whether one agrees or disagrees with this priority, it is desirable that there should be clarity about the underlying reasoning and its implications. For this reason, I examine here the strengths and weaknesses of three lines of argument by which priority to efficiency may be justified.

### PROCESS NOT OUTCOME

The first line of argument views the process rather than the consequences as the criterion by which economic and social organisation is to be judged, taking as its touchstone the voluntary nature of individual participation. A market economy, with voluntary exchange, is then a legitimate process, providing that the initial point of departure is seen as “fair”. Any resulting distribution of gains and losses has to be accepted. The transformation to a market economy is the legitimisation of a country’s economic system, and there is no justification for subsequent government intervention.

This is a powerful argument, but it rests on strong assumptions. The proviso that “the initial point of departure is fair” is one that is hard to define or to verify. The terms on which State enterprises are sold or given away may confer initial advantages. What about those who hold foreign currency or have economic links outside the country? The slate cannot be wiped completely clean, nor is it necessarily desirable that it should be. A currency and banking reform that gives everyone an equal amount of the new money may be unfair to different age groups, in that people may have legitimately acquired assets for life-cycle reasons. Or, what

happens to the pension rights of those who have worked for many years in now-bankrupt State firms?

Nor will it necessarily be accepted that redistribution be limited to the initial period of the transformation. The distributional outcome of the market process may not be of direct concern, but may have indirect consequences. In particular, the outcome of the free market may call into question the legitimacy of the political process. The political liberalisation which has accompanied economic transformation in most (but not all) countries means that political as well as economic behaviour has to be considered. Voluntary acceptance may place limits on the disparities in incomes and wealth which can be tolerated. A widening gap between rich and poor may call into question the degree of social cohesion, not least between geographical regions or ethnic groups, and threaten political stability.

## REDISTRIBUTION EX POST

A quite different line of argument is that which sees a role for distributional policy but only once the economic transformation has been completed. Redistribution comes not at the outset, to ensure a fair initial point of departure, but once economic success has been ensured. On this view, the priority is the establishment of a working market economy, and it is only once this has been achieved that corrective redistribution can be contemplated.

This argument can appear persuasive, particularly when accompanied by evidence of considerable scope for improved economic efficiency. But at its heart is a separation of efficiency and distribution which cannot necessarily be justi-

fied. It is the same separation that underlies “standard” public finance, taking as its reference point a competitive economy which — leaving aside externalities — satisfies the conditions for efficiency. Taxes and transfers are then introduced to “correct” for distributional concerns.

However, the experience of Western economies has demonstrated the limits to such corrective redistribution. To the extent that the preintervention situation is efficient, the use of income taxes, or the payment of income-related transfers, distorts the allocation of resources. The quantitative extent of such distortion is debated. It may well be small in relation to the improvement in economic justice. But the perception of the costs of redistribution has been a powerful factor limiting the scope for taxes and transfers. Again the sustainability of government policy in a democracy has to be considered. The electorate may not vote for the taxes necessary to finance redistribution. Moreover, the ability of a national government to pursue redistributive objectives may be limited if those expected to be contributors are able to emigrate or otherwise avoid taxes. (For example, it is likely to be difficult for national governments in the European Community to impose effective capital taxation given the freedom for capital mobility.)

The limits to ex post redistribution mean that equity considerations have to be taken into account in the design of the economic transformation itself. Leaving it until economic efficiency has been achieved is too late. In this respect, it is important to emphasise the extent to which the form of economic organisation is a matter for choice. Pure market capitalism is not the only alternative. There are other ways in which economic liberty can be achieved. And the choice be-



tween different types of economic system may have profound economic consequences. A society, for example, in which there is a partnership between labour and capital, at either macro or micro-level, may well have a less unequal distribution of income.

### A DYNAMIC VIEW OF EQUITY

A third view is that redistribution is necessary neither at the outset, nor after the transformation is complete, if our concern is with poverty, rather than inequality. On this argument, a market economy will ensure a faster rate of growth than under the previous regime. The benefits from this growth may not be shared equally, but some part will “trickle down” to the poorest, and, in time, they will be better off. Any redistributive measures will slow the rate of growth, and be to the ultimate disadvantage of the poor.

This argument shifts the perspective from concern with inequality in general to concern focussed on the poorest. Such a more focussed concept of equity may enjoy wider support, but the proposition as a whole needs careful examination. It is not evident that all measures to redistribute income have a negative effect on the rate of growth. The provision of an adequate safety net may make people more willing to set up in business, or to take risks as entrepreneurs, or to train for a job where employment is uncertain. The existence of minimum wages may increase the incentives for firms to train their workers.

Secondly, the poorest are not a homogeneous group. With a dynamic perspective of equity in particular, one has to take account of the impact on different generations. The fact that

incomes may be higher in the year 2010 is of little consolation to today's pensioners. Distributional equity is a matter of justice *between* generations as well as *within* generations.

Thirdly, economic growth may be measured in terms of the standard of living, but the final concern is with the *capabilities* of a person, or family, to pursue their desired activities. Goods are only an input into this process; and the goods required to carry out a specified activity, like going to work, may change over time as the overall level of income in the economy rises. In time, for example, children may find it difficult to keep up with their peers at school without access to a home computer. This brings out how living standards are interdependent. People may become poorer simply because others have become richer. For example, goods on which the poor rely, such as public transport, may become less readily available because others can now afford superior products, such as a private car. To the extent that this happens, economic growth may not have the beneficial distributional consequences predicted, and we may have to consider the distribution of income as a whole.

## Appendix

NOTE FOR THE MEETING OF 5 NOVEMBER 1990

This note takes as its starting point the economic transformation of Eastern Europe (Question 4) and the issues of social justice evoked in Question 2. It then goes on to consider the concept of poverty (Question 3).

It is striking how little the distributional consequences of change in Eastern Europe have entered into public discus-

sion. With the emphasis being placed on the creation of markets, privatisation of property and on macro-economic imbalance, little attention has been paid to *who* will benefit from economic transformation and to the likely performance of the new regimes with regard to inequality and poverty.

The neglect of economic justice may arise for several different reasons. First, the introduction of a market economy may be seen as ensuring in itself a “fair process”. Providing that the initial point of departure is also seen as fair (which, of course, raises many questions — such as the way in which State assets are sold), then any resulting distribution of gains and losses is legitimate. From Plato onwards, however, it has been recognized that there are limits to the disparities in income and wealth which can be tolerated in a democratic society. A widening gap between rich and poor in Eastern Europe would call into question the degree of social cohesion (not least between geographical regions and ethnic groups) and threaten the political liberalisation.

A second reason for neglecting distributional consequences is belief in the “trickle down hypothesis”, according to which all will benefit from the economic transformation. The bottom 20% may have a smaller share of total income, but they will in absolute terms be better off. How far this general impact on living standards can be achieved is yet to be seen, but it is evident that increased unemployment’ as in Poland, will require the introduction of effective income maintenance. And the evidence of the past decade in the United Kingdom and the United States suggests that improved aggregate economic performance may provide little or no increase in the real incomes of the lowest income groups.

A third reason for discounting the distributional issue is the assertion that inequality is “inevitable” and that a redistributive policy is largely “ineffective”. With the retreat of the State from an interventionist role in the economy, it is argued it has given up the principal instruments with which to influence the distribution, and the evidence from OECD countries indicates that the Welfare State has only limited impact. To this argument two replies may be made. To begin with, the form of economic organisation is itself a matter for choice. Pure market capitalism is not the only alternative. A society in which there is a partnership between labour and capital — at either macro or micro-level — is likely to have a less unequal distribution of income. As far as the Welfare State is concerned, the differences between Scandinavia, West Germany and France, and the United States indicate that the degree of redistribution is as much a matter of political choice as of technical possibilities.

The issue of who benefits from economic reform arises most acutely in the subject of poverty. Here too one finds very different views with regard to Eastern Europe. On an optimistic view, the situation is expected to improve. Put bluntly, on this view, poverty was widespread under Communism, not least because of the unavailability of goods, and it will be reduced by the all-round prosperity of the market economy and the elimination of shortages. On a pessimistic view, the position of the poor had been protected by subsidies for essential items, by public provision of housing and medical care. The elimination of such public provision will not be compensated by rising money incomes for those who lose their jobs or whose pensions have been eroded. The po-

situation of women will become particularly difficult as their labour market opportunities worsen.

Both of these views focus on the availability of goods and services. However, even if one sees poverty purely in terms of *standards of living*, one has to recognize that the ultimate concern is with the *functioning* of the person or family, to which goods are an input. The goods required by a person in order to carry out a specified activity (like going to work) may change. Children may find it difficult to keep up with their peers at school without access to a home computer. This brings out how living standards are interdependent and how we cannot assess the situation of the poor without regard to the general level of incomes. In a European context this is going to mean that poverty is increasingly seen on a cross-country basis — which in turn raises the critical question of the relation between poverty in a rich European community and its relation with low-income countries in the Third World.



## **Modern Economics and the Idea of Citizenship\***

*Prof. Partha Dasgupta*

The questions that have been put to us are wide-ranging, deep, and interlinked. This last makes it necessary to address them together, not separately. At the same time, it would be presumptuous of me to try and address them all even though they are related. I simply don't have the expertise. In what follows I will therefore provide a brief account of how individuals, families and the wide variety of organizations we observe in different societies are perceived in modern resource allocation theory. It is a picture which has been developed over a number of decades. The central thrust of this theory, which is not so much a set of specific results as it is of a *way* of looking at the world, has a remarkable reach. In these notes I shall on occasion illustrate matters by drawing on examples pertaining to the poorest in poor countries. This is partly because I am in the process of

\* This is a slightly revised version of a note prepared for a meeting of economists called by the Vatican Council for Justice and Peace to respond to a number of questions regarding the way human agency is modelled in modern economics. The meeting was held at the Vatican on 5 November 1990. I am most grateful to the participants for their comments on the earlier version, most especially Jacques Drèze and Stefano Zamagni.

completing a book on the subject;<sup>1</sup> partly also because the poorest provide the most urgent context in which to deliberate economic matters.

## 1. AGENCY IN THE STANDARD THEORY

People working on modern resource allocation theory (I shall call it the standard theory henceforth) for the main part write for one another. An enormous number of the background assumptions, what one may call the ingredients of the underlying framework, are therefore left implicit. If the standard theory appears detached and cold (this isn't to say classical economics is attached and warm) it is mostly because writers usually wish to get down to the businesses of the day and feel no need to remind readers of the deeper motivations underlying their work. These motivations are judged by them to be in the public domain.<sup>2</sup>

The standard theory has both a thick edge and a thin edge. The thin edge can be construed as limiting itself to

<sup>1</sup> Titled: An Inquiry into Well-Being and Destitution.

<sup>2</sup> In his most generous remarks at the Vatican meeting on these Notes, Professor Jacques Drèze said he didn't think what I am calling the standard theory is at all standard (it is "non-standard" to use his expression), but that he hoped it would become the standard theory in the future. In this Note I am trying to give an account of the reach of modern economic theory. In doing so, I am trying to give as wide an interpretation of the subject as is possible without straining it. The fact that the picture I draw from the theory is not quite the same as the one drawn in economics textbooks does not matter for my purposes here.



an understanding of the more mundane, routine transactions individuals engage in while going about their lives. Commonplace private goods and services, like food, housing, clothing and *health-care*; public goods like law enforcement, national security; common property resources such as the atmosphere, rivulets and village tanks, the oceans and aquifers; and jointly consumable goods like knowledge, form the domain of its discourse. Organizations *which* are engaged in their production and distribution, such as the producing firm, joint stock companies, local and federal public authorities, are among its objects of study.

The thick edge is more ambitious. It attempts to provide an instrumental explanation of behaviour within a wider class of institutions, including for example marriage and the family, and the local community; and a broader category of human interactions, such as “gift-exchanges” and “norms of reciprocity”. It is easy to be uncharitable and to dismiss this thick edge as errant nonsense. But an honest assessment is that the theory, concentrating as it does on problems of resource allocations, offers valuable insights into certain aspects of these complex institutions.

In this sense the standard theory is almost self-consciously institutional. Even competitive general equilibrium theory (the standard theory applied to a particular set of circumstances) assumes the enforcement of a well-designed law of contracts and personal property, such as for example one’s bodily integrity. More fundamentally, it assumes the existence of a government ca-

pable of enforcing laws and providing protection to citizens against force, fraud, theft, and so forth. Indeed the reach of governments entertained by competitive general equilibrium theory is far more extensive than that of the Minimal State. The theory considers explicitly the distribution of benefits and burdens associated with the protection and promotion not only of negative, but also of positive liberties. The standard theory, both in its explanatory and prescriptive capacities, is concerned with *the* viability and efficiency of alternative systems of organization. A wide variety of political *philosophies* (ranging from the out-and-out utilitarian to the *thorough-going* deontological) find a central question addressed in it: the *implementation* of just procedures and allocations.<sup>3</sup>

A distinctive feature of the standard theory is its attitude towards government as an entity. It is seen purely as an *agency* of its citizens. This follows from the theory's primary concern with the *individual* and *his* flourishing. Social and economic institutions are seen in instrumental terms, as modes of organizing beneficial production and exchange, of goods and services necessary for pursuing our ends. Problems of resource allocation (and by this I mean both production and distribution through

<sup>3</sup> The problem of implementation has found some of its deepest expression, since the end of the Second World War, in the writings of Kenneth Arrow, John Harsanyi, Leonid Hurwicz, Tjalling Koopmans and James Meade; and more recently in the researches of, among others, Eric Maskin, James Mirrlees, Roger Myerson and Joseph Stiglitz. The remarks that follow in the text are probably all to be found in their writings, somewhere or the other.

time) are its central concern. It sees scarce resources to be a central determinant of individual well-being. That there are complementary determinants, such as motivation, and the capacity for being honest, and for love and loyalty, is never denied in the theory. One of the theory's contributions, I believe, has been in particular to show (lull these other determinants are not entirely complementary, that there are instrumental advantages members of a society would enjoy if people were, for example, honest. A society, in which honesty is nurtured, where dishonest behaviour is socially unacceptable, saves a lot on monitoring and enforcement costs. A classic problem in moral philosophy, whether moral behaviour is individually rational, is something that the standard theory faces squarely and fully. At the instrumental level, collective honesty saves considerable resources. Economics is often criticized for always reminding people that there are choices to be made. It is always seen as saying: "You can have this or you can have that, but you can't have both". Here is, however, a class of objects over which there is no such tension. Honesty is desirable in itself. But it also has instrumental virtues: it saves on resources which can be used for ends other than observation of compliance and of enforcement of contracts.

However, there is a collective problem society faces if at the individual level people are not *disposed* to behave morally. The standard theory provides a framework for explaining and further developing resource allocation mechanisms in a world where moral behaviour cannot

be taken for granted unless sufficient incentives are provided. Indeed, it can even calculate the overall resources society would save were people's dispositions to be different. There is absolutely no substance to the claim that the standard theory hypothesizes greed on the part of moral agents, and that in particular it demonstrates the economic superiority of a society in which greed is encouraged.

These aspects of the standard theory, I believe, should be incontrovertible. I want now to look at matters from a slightly different perspective and suggest that the central vision of society as developed in the standard theory (more accurately, that aspect of society which the theory studies and encourages us to give shape and importance to) is something more elusive. I mean that the standard theory encourages us to give expression to the overarching notion of *citizenship*, with its three constituent spheres: the civil, political and socio-economic.<sup>4</sup>

The civil element of citizenship consists of the rights essential for basic liberties. More fundamentally, it consists of the right to justice. Thus, civil society is the sphere of autonomous institutions, protected by the rule of law, in which men and women may conduct their business freely and independently of the State.

<sup>4</sup> I am borrowing the classification from T.H. Marshall's classic statement concerning the nature of liberal democracies. (See T.H. Marshall (1964): *Class, Citizenship and Social Development*, New York, Doubleday.)

By the political element I mean here the right of a person to participate in the exercise of political power, as a member of a body invested with political authority or as an elector of the members of such a body. And by the socio-economic element I mean a range that encompasses the right to a certain share of *resources*, to the right to share to the full in the social heritage, and live the life of a civilized being commensurate with the standards prevailing in the society in question.

It seems to me that a central insight the standard theory has offered us has been that a good citizen has to be a compartmentalized person. He has to be able and willing to strike a fair balance between his own claims and the claims made upon him by his family and by the wide variety of associations of which he is a member, including not only the claims that are made upon him by his “firm”, but also those resulting from his membership of the polity. This is a very hard thing to do, as all of us must surely be aware continually. On occasion we rise to the moment, on most others we fall, sometimes hopelessly. But the multiplicity of obligations remains, and the standard theory encourages us to assume our multiple obligations not all at once at all moments in our lives, but separately, as we step into our different positions. Thus the roles (and by this I mean motivation and norms of behaviour) I am encouraged to assume as a son, husband, father and friend are substantially different from those I am asked to assume when performing as a teacher, researcher, shopper and voter. I don’t think it is immediately obvious how very radical in

spirit this prescription really is, this injunction that we somehow “decentralize” ourselves each day of our lives into a number of selves. It is light-years away from the superficially more attractive prescription that we assume our complete selves at all times. I am not a psychologist, and so I cannot tell which is the harder state to assume. Leaving possible psychic costs to one side, what the theory tells us is that such a pattern of decentralization saves on resources. It thus widens the prospects of our being able to accomplish our projects and purposes.

## 2. RESOURCE ACCOUNTING

One of the great successes of the standard theory has been its ability to provide an explanation for why resources which are not accounted for in transactions will be misallocated. In an interrelated world it does not, of course, make much sense to talk of misallocation of one set of resources and not of the others. But for heuristic purposes let me assume it does make sense. Environmental resources often, by their very nature, suffer from a lack of “markets”. By this last I mean that rights to such resources are often so ill-specified that at the individual level there are no institutions providing interested parties the scope for negotiation over their use. (This is often described as an “externality”). The corresponding losses are something the theory is able to discuss, and this has been a central area of research in recent years. The efficacy of alternative institutional arrangements (and by this I mean resource allocation mechanisms) for

meeting such problems (from international bodies for global common property resources at one extreme, to village communities for local common property resources such as village grazing land and ponds at the other) have been much discussed in the literature. The argument that “economic behaviour” and “environmental concerns” are incongruent is simply false. More specifically, the suggestion that economic growth and environmental protection are at variance, is not true. The theory has explored at considerable length the manner in which environmental resources need to be valued as goods and services, so that their legitimate accounting occurs automatically when individuals and firms take decisions that affect the environment. Recent attempts at re-constructing national income accounts to include environmental resources is an expression of this line of research.<sup>5</sup>

### 3. SIZE AND DISTRIBUTION

One of the earliest achievements of economic analysis was the demonstration that the size and distribution of a society’s “output” are not independent of each other. (The pure “cake-eating problem”, much studied in

<sup>5</sup> Professor Karl-Loran Maler and I have recently gone into these issues at greater length (and most especially in the context of poor countries) in a recent paper, *The Environment and Emerging Developing Issues*, forthcoming in the World Bank’s publication of the proceedings of its 2nd Annual Conference on Development Economics.

classrooms, is not more than a class-room exercise.) A deeper achievement, an achievement of the standard theory, has been a precise demonstration of both their dependence on the initial distribution of rights. I know of no provable general statement within the theory (i.e. an identification of a set of general circumstances in which the statement is true) which states that there is a necessary conflict between the size of net national product (or more specifically, growth in net national product) and *egalitarian distribution* of the product. Nevertheless, there is no question that economists have often tended to concentrate their attention on those special circumstances where there is something of a conflict between, say economic growth and the distribution of income. I have no doubt there are many such circumstances. But I want now to argue that in poor countries there are strong reasons for thinking that there is a pattern of congruence between growth in net national product and less unequal distribution of net national produce.

This congruence comes about because of the physiological fact that something like 60% to 70% of our daily expenditure of bodily energy is in pure maintenance (what is called the *resting metabolic rate*). The remaining 40% to 30% is spent in work and discretionary activities. The argument that even if a person does not own any material assets there is always one asset which he has command over and which he can “cash in”, namely his innate labour power, is false and is dangerously false. The standard theory is able to show that unless an



economy is rich in the aggregate, decentralized resource allocation mechanisms are incapable of allowing *all* assetless people to exploit their potential labour power if the number of assetless people is large. The reason has to do with an intrinsic circularity in living: one needs food and care to be able to produce work, the sole means of obtaining food and care if one has no material assets. I cannot go into the details of this argument, which as it happens, is not counter-intuitive. But it is as well to emphasize here that the theory does make plain that in poor economies resource allocation mechanisms unbacked by any collective redistributive measures can easily disenfranchise a sizeable fraction of the assetless from their citizenship. By this I do *not* mean that such people are merely poor; I mean that they are destitute.

#### 4. ECONOMICS AND POLITICS

The way I have cast the standard theory here suggests an intimate connection between the political and economic realms of a society, a connection in the theory which may not be obvious on casual reading of it. But the two realms aren't the same, and if professional writings within the theory appear to treat the two entirely separately and to concentrate on the latter, it is I think a research strategy, nothing deeper. One implication of this compartmentalization is that it encourages us to allow our "economics" to influence our "politics" and not allow our "politics" invariably to influence our

“economics”. I think there is great virtue in this two-way influence.

## **Ethics, Efficiency and the Social Doctrine of the Church**

*Prof. Jacques N. Drèze\**

### I. ABOUT INDIVIDUALISTIC ETHICS AND ECONOMIC SYSTEMS

1.1. Undoubtedly, the practice of economic research and writings relies predominantly on “individualistic” and to some extent “materialistic” motivations for consumer-workers: (i) their preferences are typically defined on individual consumption-and-work handles, rather than on mere comprehensive “social states”; (ii) only individual preferences, as distinct from “group” or “class” preferences, are considered. The major exception to (i) is of course social choice theory: see, Arrow (1951) or Sen (1986). Another exception is provided by the highly abstract theory of... “abstract economies” — as expounded for instance in Shafer and Sonnenschein (1975) — where individual preferences are defined on the economy-wide allocation. *Hopefully, it remains understood that the restriction of the domain of preferences is a matter of*

\* Paragraphs 1 and 2 were written before the meeting on 5 November, and paragraphs I and 4 are taken from my participation in the discussion of that meeting.

*research expediency, not of rationality.* The notion of consistent preferences in decision theory probably embodies the concept of rationality on which most economists would fall back. In itself, that concept is broad enough; but applications are more restrictive. As for (ii), exceptions within accepted theory are less obvious... unless one wished to regard cooperative game theory as the answer.

Two arguments might be advanced in defense of current practice. One argument says that it makes little difference for practical purposes — so long as preferences over economy-wide allocations are “benevolent” (household  $h$ 's preferences over the alternative consumption patterns for household  $k$  agree with those of household  $k$ , *ceteris paribus*). In that case, the second welfare theorem (every Pareto-efficient allocation is a competitive equilibrium under suitable redistribution) still holds (Winter 1969). But that argument will not satisfy those who insist, for instance, on modelling a preference for equality; or preferences over the membership of coalitions (like firms or clubs, viewed as “hedonic coalitions” — see Drèze and Greenberg, 1980).

Another argument says that the broader definition of preferences makes a difference, but is too unwieldy for practical purposes. For instance, it makes sense that most young workers attach positive value to a stable employment relationship (or regular job), within which longer working hours are unattractive. But modelling such nonconvex (yet perfectly “rational”) preferences

raises technical difficulties, from which the research practice understandably shies away.

1.2. The relevance of the foregoing for a moral assessment of capitalism is twofold. First, narrow-based “individualistic ethics” underlie the claim that capitalism is endowed with an internal logic that brings about economic efficiency without infringement on ethical choices. But *that claim remains subject to major qualifications*. It has theoretical validity for an idealised Form of capitalism characterised by competitive clearing of a complete set of markets coupled with costless unlimited redistribution possibilities. In reality, economies of scale often lead to monopolistic competition; markets are incomplete, due to externalities, moral hazard or transaction costs, but also due to the logical impossibility of including future generations of consumer-workers in today’s market transactions; redistribution of wealth entails sizeable real costs, and is seldom implemented extensively. On all these counts, public intervention offers corrective possibilities; but such intervention almost invariably entails a trade-off between equity and efficiency — a trade-off that must be understood as an unavoidable component of real-world capitalism.

Second, still under narrow-based individualistic ethics, idealised competitive capitalism shares the efficiency-cum-ethical-neutrality property with other idealised economic systems, in particular market socialism (Lange 1938) and market labour management (Drew 1989) — or mixtures of these. *The relevant assessment must*

*be extended to real-world versions of these systems* — including some interesting mixtures, like France.

At that level, I personally regret that insufficient attention to market imperfections has led theorists to privilege a definition of the objectives of business firms in terms of financial returns, without parallel concern for their role as employers and producers of consumer goods.<sup>1</sup>

Also, broader ethical concepts (including preferences over organisational forms) should then be allowed to come into play, leading to a broader trade-off between equity and efficiency.

1.3. Two additional remarks are in order. First the ethical priorities that stand out most vividly, in Christian doctrine and in substantive theories of justice alike, concern basic human rights and the welfare of the least privileged members of society. Giving content to these priorities is an ever-present challenge; no economic system can substitute for moral commitment towards

<sup>1</sup> As a lighter touch in this rather pompous note, let me quote from the serious *Economic Journal* (Drèze 1985): “It is striking that, in the sixties and early seventies, so much attention was devoted to portfolio problems, and so little attention to labour contracts, in spite of the fact that uncertainties about labour income are much more significant than capital gains or losses, for most people. This is perhaps revealing of the geographical concentration of our profession. In my experience, when European economists from different countries meet socially, there comes a time when they discuss salaries. When American economists meet socially, they eventually discuss the stock market; whereas Israeli or Indian economists discuss credit conditions”.

meeting that challenge. (Perhaps the only solid economic lesson of relevance is that, in the long run, technological progress and productivity growth are the main determinant of our *potential* ability to meet the challenge a potential that seems far from fully exploited, if we look around the world today).

Second, it is commonplace that economists disagree extensively about the practical significance of market imperfections. It is a healthy division of labour that some researchers devote their energy to tracing the relevant implications of some imperfections, whereas others bring out the latent mechanisms whereby some (other) imperfections are overcome. But the message captured by students, decision-makers or laymen is often confused. We must remain attentive to the risk that our pedagogy may detract attention from real issues, especially when giving content to ethical priorities is at stake.

## 2. ABOUT DISTRIBUTIVE ETHICS AND PRODUCTIVE EFFICIENCY

2.1. “Is it theoretically sound to separate production of wealth from its distribution?” For many purposes, the answer is “yes”; and it is easy to list examples of welfare losses due to departures from that simple rule (as when preferential public utility rates, rent controls and the like are used to modify the personal distribution of income...). But there also exist realistic cases where the answer is “no”.

To illustrate this point, I would like to draw on my recent research in an area that is both relevant to the centenary of *Rerum Novarum* and of immediate policy concern in market economies or economies “in transition” — namely, wage rigidities and unemployment. Wages define simultaneously the price of labour, which guides input choices by firms, and the income of workers, which deserves protection from random fluctuations, to the extent that other agents can supply mutually efficient insurance, Market wages cannot, by themselves, sustain simultaneously productive efficiency and risk-sharing efficiency. Three facts play a role: (i) the future is uncertain, and this applies in particular to the marginal product of labour at given levels of employment (ii) prospective entrants to the labour market seldom sign today contingent contracts for future employment; (iii) average employment subsidies are costly, and marginal employment subsidies are difficult to administer; these forms of intervention are little used. Combining these three elements, in an otherwise entirely well-behaved neoclassical framework, leads to an important conclusion: it is generally not efficient — quite aside from any distributive goal — to let the terms of employment contracts (wage and salary schedules) fluctuate according to the law of supply and demand on spot markets; competitive wage flexibility entails inefficient risk-sharing; it is *generally* more efficient to limit *wage flexibility*, so as to avoid excessive increases or decreases even though the limited downward wage flexibility entails inefficient unemployment in (well-defined)



unfavourable circumstances; efficient unemployment benefits make that unemployment voluntary.<sup>2</sup>

This conclusion — which I for one regard as central to an understanding of observed downward wage rigidities — leads us logically to analyse simultaneously “the production of wealth and its functional) distribution”. I must stress the fact that the conclusion at hand is a characterisation of (second-best) efficiency — even though it has the appearance of being inspired by a distributive goal (the protection of workers’ incomes in bad times). Indeed, I have chosen my example carefully to illustrate the potential fallacy of separating productive efficiency from distribution (here, risk-sharing efficiency).<sup>3</sup>

2.2. I wish to draw three additional lessons from my example. (i) My example hinges on the practical impossibility of relying on markets to reconcile productive efficiency with risk-sharing efficiency, In the presence of successive generations of workers. The theory of implicit labour contracts, mentioned in footnote 2, teaches us that contractual arrangements within firms are susceptible of circumventing that impossibility. Thus, within the firm, some form of contracting (not reducible to

<sup>2</sup> This conclusion is a transposition to successive generations of workers of the reasoning developed in “implicit labour contracts” theory; see, e.g., the survey by Rosen (1985).

<sup>3</sup> The criterion of “ex ante Pareto efficiency” used here is related to the “social contract” or “fairness” approach to the theory of justice; see Rawls (1972).

authority) can do better than the market — and provides guidelines for policing the market.<sup>4</sup>

(ii) The idea that downward wage rigidities have something to do with the protection of workers' incomes in bad times should not come as a surprise. What is perhaps more surprising is the apparent novelty of the claim that such protection is called for on efficiency grounds alone — albeit *ex ante* efficiency.<sup>5</sup> Could it be that excessive theoretical concern with idealised models, and excessive reliance on the associated separability of productive efficiency from distribution, had concealed the obvious? Fortunately, theoretical advances in more realistic directions remain susceptible of throwing new light on socially relevant issues. Economics is not a dismal science!

(iii) It is well known that persistent unemployment results in upgrading of hired labour (Okun 1981) and concentration of unemployment among the least-skilled workers — whose (minimum) wages ultimately display the most significant downward rigidity. Yet the positive value of regular jobs is apt to be particularly significant for that group. There remains scope for giving content to our ethical priorities in favour of the least privileged workers, by devising more efficient ways of reconciling

<sup>4</sup> The relevance of contracts for the theory of the firm goes back to Coase (1937).

<sup>5</sup> I am *not* claiming that observed wage rigidities correspond closely to efficient rigidities; but the latter need to be properly understood, if we are to attempt a comparison.

the protection of their incomes with productive efficiency and full employment.

### 3. ABOUT THE SOCIAL DOCTRINE OF THE CHURCH

3.1. *What, if anything, do economists expect from the moral and spiritual leaders, with regard to economics and ethics?*

As a Catholic, I have given much *thought* to that question, and my answer is clear-cut. I *expect the Catholic Church*, including the Holy See, *to remind us relentlessly of the special attention paid by Jesus Christ, in his daily life as well as in his teaching, to the poorest, the least privileged, the most excluded.*

The views expressed at our meeting confirm that most of us economists agree on the merits of a “preferential option for the poor”, as a value judgement and as a foundation for the theory of justice. We seem to agree that priority concern for the poorest outweighs considerations of economic efficiency, provided the means proposed to attain that goal are effective and not counterproductive.<sup>6</sup>

<sup>6</sup> As a further attempt to introduce a lighter touch in this pompous note, I may quote George Stigler (1988, p. 5) on the role of economists in denouncing fallacious philanthropism. He writes:

“My favorite example of the skeptical economic mind was a gifted Irish economist-lawyer named Mountifort Longfield. It was the custom of well-to-do people in some areas of England to buy wheat in periods of acute scarcity and resell it to the poor at half the price they had paid. Clearly these people were acting out of pure altruism; in 1834 Longfield

But it is not enough to endorse the principle of priority concern for the poorest. Beyond the principle, we need commitment and content.

(i) *Commitment*: as stressed by several participants, the issue of political feasibility cannot be neglected; our political commitment to eradicate poverty remains far too timid and determined activity by individuals and groups is needed to build it up; moral and spiritual leadership is essential to foster such action and sustain more determined policies.

(ii) *Content*: the concern for the poorest needs to be translated into more specific programs and effective policies; otherwise, the principle remains vague and sterile; examples of scientific research going in that direction include the work of Jean Drèze and A. Sen (1989) on *Hunger and Public Action*; as well as work on unemployment, mostly by European economists concerned with the concentration of unemployment among the young yesterday, the least skilled today...

argued (in his *Lectures*) that they were also acting in pure or nearly pure futility. The reason was simple: Given the shortage of wheat until the next harvest, the only way the poor could be helped was by having the well-to-do eat less – economics respects the laws of arithmetic. Mere transfers of money would not create wheat before the new harvest and indeed, as Longfield ingeniously showed, they would only enrich the grain dealers. The poor would end up paying as much of their own money for wheat as if no one had sold it to them at half price, and only the initial holders of wheat would gain. This most benevolent of actions was the most incompetent of actions.”

3.2. Looking back at the questionnaire in that light, I feel that the issues of greatest urgency at this time are:

(i) *First and foremost, poverty in Sub-Saharan Africa*; it is dramatic to see a whole continent stagnate (if not regress) at near starvation levels; I do realize the immense difficulty of generating faster stable growth in that area; yet, there are specific problems where public action is possible — in particular, hunger and the public debt; these problems do not seem to receive today the political priority *which* they deserve.

(ii) *Next, the safety net in Eastern Europe*, for those who will suffer during the transition process; the problem is clearly recognized, and the historical record of Western Europe is there to illustrate the need of strong public programs of health, education and welfare in market economies; can an adequate safety net be financed, and how? We have not heard enough on that score; aid (not loans) from the West would seem needed, but that demand competes with those of Africa and other underdeveloped countries; perhaps more attention should also be given to ways in which Western European business firms could contribute to the promotion of *employment* in the East.

As a Catholic, I do not expect the Church to prescribe solutions to these problems; but I expect Her to remind emphatically the richer nations that the fight against poverty:

- has taken a definitely transnational dimension;
- requires imaginative new approaches that are not naturally fostered by markets;

— requires moral commitment from citizens, politicians... and economists choosing research topics!

In that spirit, I find it gratifying

— that the transnational dimension of the poverty problem is stressed in such encyclicals as *Populorum Progressio* and *Sollicitudo Rei Socialis*, both of which plead for world solidarity (and stronger International Agencies) in coping with poverty and underdevelopment;

— that unemployment is emphatically stigmatised as an evil in *Laborem Exercens*, where the right to work is presented as a basic human right. Contrary to some economists, who look at income maintenance programs as a more realistic alternative than full employment, the Bishops of Belgium, Canada, France, the US (and no doubt other countries as well) have stressed that unemployment benefits are definitely not an acceptable substitute for jobs.

3.3. The foregoing departs in no essential way from the development of the social doctrine of the Church, as presented for instance in Carrier (1990).

There is more, however — as evidenced both by the social teaching of the Church and by the list of questions proposed for our meeting.

Side by side with the priority concern for the poorest, there is the concern for the dignity of all men, with a concept of human dignity enriched by the Revelation that we are all God's children and brothers in Christ. Applied to our field, there is thus a parallel concern that

economic organisations should contribute to fuller lives for all.<sup>7</sup>

It would be a distortion, I think, to claim that this parallel concern is reducible to the priority concern for the poorest, by arguing that “fuller lives” are ultimately lives where love and charity find their expression in concern for the poorest. At the level of social and economic organisations, the promotion of human dignity for all is not coextensive with the eradication of poverty.

The potential difficulty of a practical conflict between the two concerns is not unexpected. For instance, in formulations of the theory of Justice like that of John Rawls (1972), the “leximin” principle of ordering societies according to the welfare of the least privileged is not easy to justify, precisely because it does not reflect properly the general welfare of the entire population.

The practical conflict arises in our daily lives as well. Whether, and if so how, it should be dealt with explicitly in the social teaching of the Church is an interesting question that deserves further thought.

#### 4. ABOUT A THIRD WAY

It is a good thing that official pronouncements repeatedly emphasise that the social doctrine of the Church does not aim at defining a “third way”.

<sup>7</sup> “The Church calls for a constant revision of all systems according to the criterion of the dignity of the human person” — quoted from Carrier (1990, p. 39).

It was stated at our meeting that “there is no third way”. At the same time, the Western European model was presented, implicitly or explicitly as a sort of intermediate way between socialism and the wilder, less solidaristic blend of capitalism in the US.

The experience of Western Europe in striving for a Welfare State and for building enough social protection into private ownership market economies is significant. After witnessing the vulnerability of European economies to macroeconomic shocks, the sluggishness of self-corrective mechanisms and the inadequacy of policy responses, we must conclude that there is a need to improve the European model further — both for more economic efficiency, conducive to faster growth benefiting all; and for more effective protection of the poorer during recessions. And we must recognize that very little progress has been made toward implementing a form of solidarity for development and eradication of poverty in the Third World.

In that sense, the need to define a better approach to economic organisation for the benefit of all men and of the whole human person remains as acute as ever.



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## **Ethics, Distribution, Incentives, Efficiency and Markets**

*Prof. Peter J. Hammond*

*Preliminary.* Let me begin, if I may, on a personal note. Ever since my economic studies began back in 1967 I have wanted to understand *how* economic systems and policies could be made to produce better results than they often seem to in practice. Indeed, I suppose that this was really my original motivation for changing from mathematics to economics. Right at the start of my career, I therefore acquired an interest in “welfare economics” — i.e., that branch of the subject which explicitly concerns itself with the appropriate design of economic systems in order to promote the well-being or welfare of individual participants.

The following few reflections summarize some of my current thinking on these matters — thinking which I would like to think that many of my economist colleagues share, though I am well aware that by no means all do so. Each topic has been explored at some length in technical journal articles which a number of colleagues and I have published over the years.

1. *Ethics* seems to be a peculiarly difficult branch of philosophy. On the whole it is easy to understand why most economists would prefer to stay well clear of it. Yet ethics is important to welfare economics because

there is no way of avoiding it if we are to give our recommendations any ethical force or content. Without making ethical value judgements, at least implicitly, there is obviously no way of giving ethical significance to evaluations of economic systems and policies, or to recommendations for improvements. Without ethics, welfare economics is reduced to, at most, propositions about how to give people more of what they seem to want, without any presumption that this would actually be ethically desirable. For example, this leaves the economist unable to say that it would be wrong to provide what drug-addicts or alcoholics appear to want.

Even more important, without ethics one cannot decide such important policy questions as the following. Suppose that a specific improvement in public health service or some other welfare program is being contemplated, where it is understood that the extra costs will be met by a general increase in rates of income taxation. Typically the rich will lose more from higher income taxes than they will gain from better public health services, whereas the poor will gain more from the improvements in those services than they will lose from having to pay a little more income tax. In the absence of ethical value judgements, there is no way to weigh the gains of the poor against the losses of the rich in order to decide which are more important and so whether such a policy change is desirable or not.

2. *Economic welfarism* is a particular and very special ethical value judgement. It judges economic systems

solely on the basis of what goods and services individuals are able to enjoy, and of what labour services and resources they are required to supply. Indeed, it assumes that: (a) in the end, it is only the allocation of goods, services, and tasks to individual consumers and workers which is ethically relevant; (b) individuals behave in a way which maximizes their own welfare — in the sense that they choose what it is right for them to have, provided that nobody else is unduly deprived as a result.

Notice how (a) the above definition specifically excludes any consideration of whether individuals' rights to choose are respected. It also pays no attention whatsoever to any feelings which individuals may have that they would rather earn what they get instead of having it be provided directly through some welfare program of public assistance or through charity. Part (b) of the above definition of economic welfarism involves what is often called “consumer sovereignty” — it is assumed that consumers behave in a way that reveals their preferences, and also that they prefer what is better for them. Denying part (b) is a form of paternalism, of course. Yet who is to say that no kind of paternalism can ever have an ethical justification?

This particular value judgement of economic welfarism has become standard in welfare economics and in most discussions of economic policy. What is being left out are many ethical considerations which may be important even in economics, such as the understandable desire of most people to be free of tax gatherers, customs officers, (potentially) corrupt bureaucrats, and tax

systems which are far too complicated for even most intelligent and well trained people to be able to understand fully. Of course, part of this desire surely arises because people believe that they would be paying less to the governments of the world, and would be better off as a result, if there were fewer tax gatherers, customs officers, bureaucrats, and unnecessarily complicated regulations. If this were all that lay behind such desires, however, there would be no very good reason for economists to go beyond the ethics of economic welfarism. Yet it seems that, in addition, many individuals really would value freedom for its own sake, even if policies which added to their freedom would also make the allocation of resources no better, or even somewhat worse. Despite this fact, I am still willing to accept provisionally the ethics of economic welfarism on the grounds that there are so many other pressing issues worth discussing which may be more important. Also, economists obviously have a much greater claim to expertise about the effects of policy changes upon economic welfare than their effects upon any more general ethical values.

3. *Interpersonal comparisons of well-being* are another kind of ethical value judgement, to be used in conjunction with economic welfarism as discussed under item 2 above. They concern not just comparisons of who is better or worse off, but also comparisons of the gains and losses of different individuals which result from a policy change. As already mentioned under item 1 above, the latter kind of comparison seems inevitable if

one is ever going to discuss the merits of such economic reforms as increased income taxes being used to finance a better public health service which will clearly benefit some individuals at the expense of others. Otherwise, without such comparisons, there is absolutely no procedure for weighing the gains of some individuals against the losses of others.

Much welfare economics has impoverished itself by seeking to avoid interpersonal comparisons altogether. As a result it has been limited to identifying those (all too rare) “Pareto” improvements in which everybody gains. Economists are probably right in remaining reluctant to consider how gains and losses should be compared, since the ethics involved does lie rather beyond their usual field of competence. Nevertheless, it is not clear whether it lies within anybody else’s usual field of competence either. So if economists are not willing to discuss this important question, who else is going to? In the meantime, until some more generally agreed procedure for comparing different individuals’ gains and losses has emerged, economists should at least tell the world who is likely to gain and who is likely to lose from any suggested policy change. And also how large different individuals’ gains and losses are likely to be. Then everybody, including any interested non-economists, can make their own comparisons and form their own opinions based on much better information than is usually the case at present.

4. *Total wealth maximization* is a rather commonly used criterion for making the interpersonal comparisons

which are usually required in order to be able to compare different economic policies. The criterion involves simply adding up different individuals' indices of real wealth, or some alternative monetary measures of well-being. Then that policy is recommended which would make total wealth as large as possible. In this way different individuals' gains and losses are simply reduced to monetary values, and then get added up in order to determine the total net gain, which must be equal to the (net) increase in total wealth. No attempt at all is made to see how gains and losses are distributed between rich and poor, or between individuals who are less or more deserving. This procedure therefore amounts to "one dollar, one vote" instead of "one person, one vote." It is a very particular way of making interpersonal comparisons on the basis of wealth alone. It equates the extra money which a rich man wants to spend a superior bottle of wine to the same sum of money which a poor mother needs in order to buy medicine which will save the life of her child. For this reason, most people would dearly find it ethically unacceptable. You may notice that I have carefully avoided calling it "ethical" criterion. Yet too many economists in the past have become accustomed to making interpersonal comparisons in this way. Indeed it is precisely this kind of value judgement which lies behind the usual comparisons of economic performance simply on the basis of GNP or national income statistics.

Of course, some economists do claim that, if more total wealth becomes available to a community, then



some of that increase can be relied upon to “trickle down” or otherwise be redistributed so that all do benefit in the end. “A rising tide raises all boats,” is an expression I have often seen and heard in recent years. But we should be concerned to see that some such redistribution actually occurs as an essential part of any change which we recommend. Otherwise, when the tide rises, some boats which may have become irretrievably stuck in the mud when the tide was low will not be able to rise, but will sink and even drown any occupants they may have who are unable to escape. We should not simply presume that, even if the economy is left to itself, compensating redistribution will automatically occur later on.

It is also becoming generally accepted that we now live in a world economy which exhibits gross distributive injustice. This being so, there is no good ethical reason I can see why we should consider only those changes that happen to do no harm to anybody, including those people now fortunate enough to be relatively rich. Instead, one should be no less willing to consider policies that benefit the many poor, even if the rich are thereby forced to make some sacrifices which they can probably well afford. Obviously, the rich are more able to afford sacrifices than the poor, and it is certainly right to bear this in mind when considering what kind of policy changes are worth careful examination.

5. *The perfect market systems* of standard textbooks in economic theory would have to overcome numerous practical difficulties before their supposed benefits

could actually be achieved in full. All problems concerning pollution and other abuses of the environment would have to be resolved by means of suitable payment schemes. In effect, resources like clean air and water in each locality would have to cease being treated as if they were public goods, for which it is unfortunately typical that nobody in particular feels responsible. Instead, they would have to be converted into some kind of private good owned by a clearly identified individual or institution. Moreover, that owner would have to be given the right to charge for using (or abusing) that resource, as well as some method of collecting the appropriate payments. In a similar way, traffic congestion would have to be properly controlled by charging drivers, pedestrians, and others for the use they make of the road network. In other words, if I may use the standard economists' jargon, all external effects should be internalized by creating markets which control the activities that produce these effects.

In addition, a perfect market economy requires in effect that all consumers should draw up complete lifetime plans for their patterns of expenditure at all future dates and in all possible different circumstances. Then they would be expected to invest in appropriate financial securities which can make these lifetime expenditure plans viable for sure, without any risk that their plans could not be carried out later on because of some unforeseen event or some unanticipated changes in prices or rates of interest. All firms would have to make similar plans for the whole of their lifetimes, after allowing for

any changes of management which there may be in the future. In fact, the practical difficulties which this requirement creates are obviously so great that the theoretical ideal remains completely unattainable.

Of course, such difficulties are likely to be an intrinsic part of any economic system, be it market oriented, centrally planned, or of some other form. What should be clearly understood, however, is that all systems have their inevitable imperfections, and that we should be looking for that system whose imperfections are the least intolerable. This could well turn out to be some kind of market system, but to date I am aware of no satisfactory demonstration that a pure market system really is superior to a suitably designed mixed economy. Indeed, much of the recent work I am aware of seems to suggest precisely the opposite.

A rather deeper criticism of even the most perfect market systems can be made, however. Although they would certainly allocate resources efficiently, there need not be much distributive justice in the outcomes which result. Indeed, a perfect market system by itself would be totally incapable of remedying even gross distributive injustice. Such a system is entirely compatible with having all wealth concentrated in very few hands. Actually, to take an extreme case, even dictatorship is “efficient”, in the usual sense in which economists use that term, provided that the dictator is made as well off as possible by using all the economy’s resources in order to maximize his personal benefit. To take another but less extreme case, a perfect market system does not even guar-

antee the survival of the economically weakest unless they happen to have sufficient labour power or other resources to contribute to the economy. Otherwise, if they had too little, their failure to survive would actually be efficient in the sense that is generally accepted by economists. This is because they could not afford to go on living without some other people who are more fortunate having to make some sacrifices.

6. *Equity and efficiency* could nevertheless be considered separately, as they have been in most economics textbooks, if wealth could somehow be costlessly redistributed from those who already have plenty to those most in need. One could then arrange that the economic system always produces some efficient allocation of resources between consumers and producers, and then use redistributive transfers to alleviate any remaining distributive injustice which is ethically unacceptable. This, however, overlooks the inevitable difficulties which arise because any such wealth redistribution is bound in practice to affect incentives to work, save, buy insurance, acquire skills, run profitable enterprises, take reasonable precautions against personal accident or misfortune, etc.

7. *Incentives* are virtually always damaged by redistribution, in fact. The truly needy, who have become poor through absolutely no fault of their own (or of their families), are almost impossible to tell apart from those relatively few undeserving individuals who may have brought (apparent) poverty upon themselves in order to

exploit whatever program of public assistance which the economic system may make available. Schemes to assist the needy therefore risk blunting the incentives for individuals to remain able to support themselves. On the other hand, the taxation schemes which are needed to finance such welfare programs must also reduce the incentives to earn extra income because there must be at least some points in the income scale where those whose extra efforts make them a bit richer find themselves liable to pay more taxes. That is, there must be some points in the income scale where a transition occurs between being a poor person who receives public support, and a person rich enough to pay taxes which go, at least in part, in order to provide such support. Of course, taxes are generally arranged so that they rise steadily with income over a large range of income levels.

In fact, since true skills and needs are not publicly observable, any economic system can only care for the truly needy by providing benefit programs which are inevitably vulnerable to exploitation by some dishonest people who do not really need them. An economic system can also use only those labour services which it provides strong enough incentives for individuals to supply.

8. *Economic efficiency* has traditionally been defined, following Vilfredo Pareto, as meaning that no feasible reallocation of resources could make all individuals in the economy better off — or at least that no such reallocation could possibly make some individuals better off without making some others worse off. This was the

sense which I myself was using in discussing items 5 and 6 above. It has nearly always been interpreted in a way which ignores the fact that redistribution is almost sure to blunt incentives. A truly efficient economic system is actually one which makes efficient use of all the economy's scarce resources, including the (generally very limited) information upon which suitable redistribution schemes can be based. This limited information imposes "incentive constraints" upon what is truly feasible, of the kind mentioned under item 7 above.

It is accordingly imperative, in my view, that economists change completely their understanding of what "efficiency" should actually mean, especially when they consider allocations of goods and services to individual consumers. Among such allocations, most of those which lie on the "efficiency frontier" of the standard textbooks take account only of physical constraints. These concern what individuals are able to supply, and what can be produced with those supplies. They also include the inevitable "resource balance" constraints which reflect the obvious need to meet consumption demand out of what producers can supply, and to have workers provide whatever labour services producers need. In fact, most points of this standard "physically constrained" efficiency frontier cannot be reached at all without using the theoretically ideal costless transfers mentioned in paragraph 6 above.

Yet such transfers neglect the limited information upon which they can be based and the corresponding need to provide appropriate incentives to workers,

managers, capitalists, etc. Accordingly, most allocations which are alleged to lie on this “full information” efficiency frontier of the standard theory could never be reached in actual practice, and so are in truth not feasible. For this reason, a more appropriate efficiency concept would seem to be that of “incentive constrained efficiency” — i.e., efficiency taking account not only physical constraints on possible allocations of goods and services to individuals, but also those incentive constraints on redistribution and on the financing of public goods which arise because limited information makes it necessary to provide suitable incentives for individuals to participate properly in the economic system.

9. *Incentive constrained efficient allocations* are therefore the ones which, I claim, economists should really be considering. Usually such allocations cannot be achieved by means of even the most perfect market system. The only exceptions are those probably very unjust allocations which would emerge in a perfected and purified *laissez faire* market system, without any redistribution of real income or provision of any public goods. In such a *laissez faire* system, the incentive constraints limiting the redistribution of real income obviously do not matter. Also, because no public goods or services are being provided, there is no need to worry about those incentive constraints which limit the ways in which taxes can be raised in order to finance the provision of such goods.

10. *Distortions to the market system* are an almost inevitable part of any economic system which seeks to remedy *even* the grossest distributive injustice, or even to provide certain desirable public goods and services at the most rudimentary level. The only truly possible schemes of public finance require so-called “distortionary” taxes and subsidies, which may nevertheless be part of an incentive constrained efficient economic system. Examples of such distortions include income taxes, value added taxes, agricultural subsidies, as well as State provision or funding of those goods like medical services, education, and pensions which could be arranged privately and voluntarily, but which the governments of most developed countries provide either entirely free or else with substantial subsidies to a significant fraction of their citizens. Only land redistribution comes close to the theoretical ideal of non-distortionary interference in the market. But even this creates problems if existing landholders come to believe that it could be repeated at some future date, since then they will be given an obvious incentive to neglect the long-term potential of the land which they fear may be confiscated in the near future. Indeed, distortionary intervention in the market system is virtually certain to be needed if any kind of ethically acceptable distribution of resources between people is to be achieved. Paradoxically, most truly incentive preserving schemes of taxation and subsidy involve market distortions and so depart from the usual economists’ theoretical ideal.



11. *Market forces* have generally been regarded by economists in the past as always helping to allocate resources efficiently. Yet market forces may actually undermine desirable and even (incentive constrained) efficient distortions to makers, as when individuals seek to evade appropriately imposed taxes, to transact in the hidden economy, to deal in illegal drugs, or to become “economic migrants” in a country where their personal opportunities are greater but their contribution to the world economy is less. That is, market forces may actually make things worse by imposing extra constraints on the efficiency of those truly feasible allocations which realistic economic policies could actually be used to put into effect. Market forces make it necessary for modern economic systems to have tax inspectors, fraud squads, customs officers, drug enforcement agencies, etc. The only alternative would be completely unregulated markets which, as we have seen, by no means always produce desirable allocations. They also make it harder to achieve incentive constrained efficient allocations. The additional constraints which market forces themselves create might nevertheless become weakened if only economists could bring themselves first to admit and then to teach that, even in economics and business, greed is sometimes a sin.

12. *Production efficiency* is a much weaker concept than (full) economic efficiency. It simply requires that no more output of any good can be produced unless more inputs are made available, or unless less of some other output is produced. Alternatively, no less input of any

good or service can be used without either substituting more of some other input, or making do with less of some output. Nothing at all is said, however, about whether those goods which do get produced are actually desired by consumers, nor about whether those goods get distributed efficiently or not. Distortions to the price system for producers are incompatible with production efficiency. Common examples of such distortions include tariffs and quotas which discriminate between domestic and foreign producers, as well as taxes on intermediate goods — i.e., those goods which are sold by one producer to another. Such distortions should be clearly distinguished from those like consumption or value added taxes, since the latter only distort the price system for consumers relative to producers. This they do by driving wedges between the prices for each good or service faced by consumers and the corresponding prices faced by producers.

This partial criterion of production efficiency is more likely to be ethically acceptable on its own than the overall criterion that production and distribution together should be (Pareto) efficient in the classical full information sense. Indeed, we saw that there can be very good reasons for “distorting” the distribution of goods and services to consumers in order to promote distributive justice by redistributing real wealth, or in order to finance the provision of desirable public goods. Nevertheless, there are far fewer reasons to organize the world’s production inefficiently. In fact, there is a “second best” case for production efficiency on its own. It

relies on being able to justify efficiency enhancing policy reforms on the supply side of the world economy, such as freeing international trade, or abolishing unproductive enterprises in order to release resources needed by new ones which are more productive. In principle, the case for even production efficiency on its own generally requires that compensating arrangements be made for any deserving individuals who are unfortunate enough to lose their livelihoods when currently unproductive businesses cease to operate. It also involves ensuring that the former customers of a business that has closed can still receive adequate supplies from elsewhere.

Nevertheless, moves towards increased efficiency in production are far from being automatically desirable. This is especially true as there may be no easy way of arranging compensation, without destroying important incentives, for any deserving individuals who have lost their jobs or businesses. Without such compensation being guaranteed, however; the argument for increased production efficiency suffers from the same inadequacies as the “trickle down” argument for wealth maximization which was criticized under item 4 above.

*Conclusion.* The perfectly competitive market system described in most “Western” economics textbooks almost certainly needs to be considerably distorted if one is to achieve anything like an ethically acceptable level of distributive justice. There is, in fact, a clear sense in which, left to themselves, markets are much better at satisfying the wants of the rich than they are at meeting

the needs of poor. This is quite apart from other market failures which have become more widely understood by economists, such as those due to incomplete markets, monopoly power, or concerns about the environment and other externalities. It is hard, but perhaps not quite totally impossible, to separate concerns for distributive justice from those of efficiency in production alone. It is virtually impossible, however, to separate equity from the overall efficiency of an economic allocation to both consumers and producers. Indeed, I claim that economists should even be using an entirely different notion of “incentive constrained” efficiency, allowing for the fact that there is only limited information which can serve as the basis for redistributive policies. Once this is generally understood, economists can give up the futile search for ways of making markets work “perfectly”. Instead they can settle down to the more useful task of finding out how to organize a well-functioning mixed economy, even recognizing that some markets may hinder rather than help in this process.

If I had to summarize in just one (rather long) sentence what was needed in order to create an ethically acceptable economic system, this might be it:

Organize production reasonably efficiently by measures such as encouraging fair competition and using market forces on the supply side of the world economy, but be sure to intervene judiciously on the demand side of markets in order to ensure that the resulting goods, services, and job opportunities are distributed as justly as possible, while bearing in mind the crucial need

to preserve incentives in order that individuals, firms, and other organizations should all be encouraged to create desirable outputs and to acquire and deploy useful skills.



## The Ethics of Markets and Prices

*Prof. Hendrik S. Houthakker*

The market, in which each good has its price and individuals are reasonably free to buy and sell as much as they see fit, is one of mankind's most ancient institutions. From the oldest documents available to us, including the Bible, it is clear that markets existed even though they may not be specifically mentioned.<sup>1</sup> Markets developed naturally because they proved to be capable of promoting the earthly aspirations of individuals in an orderly and peaceful manner. The universal task of bringing supply and demand in line with each other is usually performed more smoothly by the market than by other mechanisms, such as queuing ("first come, first served") or allocation by some official authority.

The emergence of markets reflected — and in turn facilitated — another basic social phenomenon, the division of labor, which leads individuals and firms to

<sup>1</sup> Some endorsement of ordinary economic behavior is implicit, for instance, in the parable of the talents (*Matthew* 25). Although it should no doubt be interpreted in a spiritual sense, the parable would lose its force if the revenue-maximizing action of the two good servants were reprehensible in itself, or if the failure of the wicked servant to profit from market opportunities were somehow meritorious.

specialize in those activities where they can earn the highest income or profit while at the same time contributing more to the welfare of others. The division of labor is socially useful because, as *Rerum Novarum* emphasizes, *individuals* differ in their productive abilities. It is the realization of this mutual advantage that provides the main ethical justification of the market as an institution. Even though they are pursuing their own interest, the participants in a competitive market act in accordance with the common good.

In primitive societies many households are self-sufficient at a low level of subsistence, so the exchange of goods through the market is of limited scope. In the course of economic development, however, reliance on the market mechanism becomes more and more essential. In countries where market forces are allowed to operate, consumers enjoy a much higher standard of living than in otherwise comparable countries where market forces are suppressed by government controls. Thus the Soviet Union is quite similar to the United States and Canada combined in population, climate and resource endowment, but its per capita consumption is only a fraction of what it is in those countries.<sup>2</sup> And it can hardly be said that the Soviet Union's failures in the

<sup>2</sup> After the introduction of perestroika — which has so far not included the freeing up of markets and prices — the Soviet Union has been increasingly unable to make its products available to the people at large, and is now reduced to asking other countries for food aid despite a plentiful harvest.



economic sphere are offset by accomplishments in the spiritual and cultural domain; the opposite is the case.

The superior performance of the market system is due in part to the relatively low cost of the system itself. It does not require individuals and firms to spend much of their time hunting for such supplies as may exist, nor does it call for a vast bureaucracy to administer a system of government allocation. This does not mean that the market system is costless; thus a rather elaborate legal system is necessary for market forces to operate without creating undue fractions. The development of this legal system, the influence of which goes well beyond the market, is itself one of the great accomplishments of mankind.

To some extent, markets are compatible with different forms of economic organization. They existed under feudalism and fascism, and the idea of “market socialism” was at one time advocated (particularly by the Polish economist Oskar Lange) as a remedy for the obvious defects of comprehensive government control of the economy. Experience suggests, however, that markets cannot flourish in the absence of considerable economic freedom, including the protection of private property. Moreover, the prosperity created by greater economic freedom is likely to bring demands for political freedom; economic and political liberty go hand in hand.<sup>3</sup>

<sup>3</sup> During the 1980s the Chinese Communists permitted freer markets without relaxing their political control; the resulting tensions led to the

The specific function of prices in a market economy is to convey information about the cost of producing commodities and about the scarcity of the underlying resources (including human resources). The market mechanism therefore serves as a messenger. The messages it transmits, however, are not always popular. In poor countries, for instance, many people complain about high food prices, so governments are under pressure to keep them artificially low. In more affluent countries the situation is usually the opposite: farmers complain that the prices they receive for their products are inadequate, and governments are induced to keep food prices artificially high. These two types of direct interference by the government in the market will sooner or later create more trouble than they are worth.

More generally the price mechanism, if left to itself, will bring about a distribution of income that may not agree with the political preferences of the population. In a democracy those who consider their incomes to be unduly low are likely to outnumber those who are satisfied with their (usually high) incomes. The distribution can be modified by a system of progressive taxation and subsidies; the latter may take the form of children's allowances, old-age pensions, free health care and the like. Such a system can be arranged without seriously un-

massacre in Tianamen Square to a marked reduction in economic growth. Under Gorbachev, by contrast, the Soviet Union allowed some liberalization in the political sphere but not in the economy; the result has been chaos in both spheres.

dermining the benefits of the market mechanism. Thanks to these corrective mechanisms, the distribution of income in a democracy is not only in reasonable accord with the desires of the electorate, but it also tends to express the “preferential option for the poor” postulated by many social thinkers.

It is incorrect to say, therefore, that reliance on the market necessarily reduces the influence of moral considerations. The concepts of rationality and competition on which economic theory is based themselves embody moral considerations of a high order. Economic rationality, especially as it applies to consumers, is not confined to “material” aspects of existence; it is broad enough to encompass responsibility towards one’s family, benevolence towards others and concern for religious and other spiritual values. The Pareto optimum that a competitive economy seeks to attain is an essentially moral goal in that one individual’s well-being is not attained at the expense of another’s well-being. The concept of a Pareto optimum, in fact, is a more precise definition of the traditional concept of the common good.

It is also incorrect to say that a competitive market economy fails to foster co-operation among the individuals and firms that are its components. On the contrary, such an economy leads to as much cooperation as is socially justified, but it has no room for socially undesirable forms of co-operation like cartels. It is fair to say that economists from Adam Smith on have been sceptical about cooperation among producers, and expect bet-

ter results from competition.<sup>4</sup> One of the main tasks of the government in a free economy is to preserve adequate competition.

A liberal policy towards foreign trade — as opposed to a short-sighted protectionism — will help accomplish this task, and it will also help reduce income differences among nations.

As is true of most ideas, appreciation of the benefits of a market economy can be pushed to excess. The so-called Austrian school, for instance, represents an extreme form of free-market Winking that rejects nearly all government intervention and comes close to anarchism. In a democracy there is a threefold role for the government: (a) to supply services not readily provided by the market (such as law and order, national security, environmental protection, and certain types of infrastructure and information); (b) to provide adequate standards of living and medical care to those unable to attain these standards by their own efforts; (c) to promote vigorous competition in the private sector, and to enforce regulation where such competition is not viable.

These factors also determine the role of government in the transition from a centrally planned to a market economy. Priority in the transition agenda should go to

<sup>4</sup> The case of labor unions is somewhat special. Historically, and more recently Poland, unions have served to correct the biases against workers that may be implicit laws enacted in an insufficiently democratic society. Unions will not interfere with competition if they are open to all, and if no one is forced to join a union.

the establishment of a legal framework conducive to a market economy, including (a) strict definition of the powers of intervention by central authorities and rescission of all laws incompatible with a reasonably free economy; (b) recognition of the individual's right to choose and change employment, and of the firm's (not necessarily unlimited) right to hire and fire workers; (c) safeguards for private property and corporations. It is also urgent to make progress in (d) monetary reform aimed at overall price stability and convertibility; (e) tax reform with a view to creating appropriate incentives and adequate funding for the government's remaining functions; (f) privatization of government enterprises, possibly after reducing them to a more efficient size; and (g) rules for international trade and investment that will promote openness and competition.

The measures just enumerated, however, do not suffice for a full transformation of stagnant centrally-planned economies. The breakdown of Marxism in practice is not a case of good intentions poorly implemented; instead it reflects a total failure of analysis. The dichotomy of society into workers and capitalists may have had some superficial plausibility in the 19<sup>th</sup> century, but it has no bearing on modern industrial societies. The central concept of capital no longer means just physical capital (machinery, buildings, etc.), as it did in Marx's day. The expansion of education has created a new concept, human capital, which corresponds to the productive skills of individuals. According to some economists, human capital is now more important than physical cap-

ital. Since human capital is embodied in people, it is no longer true — if indeed it ever was — that workers do not own the means of production.<sup>5</sup>

Marxism has also been wrong in predicting a high concentration of economic power in private business. Far from being dominated by a few monopolies, economic power under democratic capitalism is highly dispersed. In the United States, for instance, no single firm accounts for as much as one per cent of national income. Not only are there literally millions of active corporations, but unincorporated businesses (mostly family-owned), in the aggregate, control as much of the national wealth as do corporations.

It is not surprising, therefore, that two of the central dogmas of Marxism — the progressive immiserization of the masses and the breakdown of capitalism from its own contradictions — are patently false. It is not capitalism but communism that has collapsed from its internal contradictions. The “dictatorship of the proletariat”, the remedy envisaged by Marx, has in reality been an excuse for centralization of power in the hands of a small self-appointed clique, totally out of touch with the true economic and spiritual aspirations of the people.

There would be no need for this devastating comparison of communism and capitalism if there were not many people, including some in the Church, who con-

<sup>5</sup> In addition, more and more workers are indirect owners of physical capital through their claims on pension funds and life insurance companies.

tinue to be attracted by the facile social analysis of the Marxists. Liberation theology, opposed by the Holy Father but still strong in certain parts of the world, is one of the manifestations of this attraction. Perhaps this vulnerability of those who should know better to specious socio-political doctrines is the result of insufficient instruction in economics in the educational program preparing for the priesthood.

Despite its clear superiority over communism, democratic capitalism is not perfect. As is true of other social institutions, it can benefit from the moral guidance of the Church. Such guidance is more likely to be effective if it is based on an understanding of the principles that any economic system has to satisfy. In the past, Catholic social thought has often sought a third way between socialism and capitalism, but there appears to be no third way, certainly not the corporatism that was at one time advocated by the fascists and found some response in the Church. If the Church intends to preserve its beneficial influence on modern society, its teachings on secular matters will have to reflect the lessons provided by contemporary economic history.





## **Ethics, Economic Policy and the Understanding of Economic Development**

*Prof. Robert E. Lucas, Jr.*

### QUESTION 1

My conception of economics does not permit me to offer very useful answers to these questions. Economics does not have or imply a view of the nature of man. Economics is a method for understanding human behavior that works through the construction of artificial, fictional people — robots, one might say — and the study of the workings of artificial economic systems made up of such agents. The idea is that by studying the behavior of highly simplified theoretical systems we can gain understanding of the way actual societies respond to changes in their situation.

An “economic man”, which is to say a constituent robot in an artificial economic system, is typically so constructed as to be perfectly rational (and hence perfectly understandable) in a way that actual people never are. Economic man has proved to be an extremely flexible and useful abstraction, but it is certainly not a complete view of what human nature is, or ought to be.

It is typical in an economic model — an artificial economic system — that the outcome that arises when each agent acts in his own interests, as he defines them,

is inferior according to the preferences of all parties involved to some other outcome that could be achieved if each agent were to act in some other way. Yet there is no action that any agent could take on his own that would bring about this superior outcome. There is a sense in which each agent is acting rationally and also a sense in which all of them, viewed collectively, are acting irrationally. If one believes that this situation, which regularly arises in theory, has no counterpart in actual society, one can view this as a deficiency of the theory. In this case, one would be motivated to try to remove the paradox by adopting some other notion of individual rationality. But if one believes — as I do — that such situations are common in actual society, then the fact that they can be clearly exhibited in artificial, theoretical societies is a theoretical advantage.

A line of theoretical research that is attracting many economists today involves the design of modes of interaction which can resolve such paradoxes by reconciling individual rationality with collectively rational behavior. One searches for new “rules of the game” under which self-interested behavior produces socially desirable outcomes, taking agents as they are but viewing their environment as improvable. I believe this research on what are called “mechanism design” problems has tremendous potential for improving social policy.

Is there a sense in which the approach taken by economic theory can be said to “undermine moral imagination”? If there is, I think it has less to do with economists’ view of rationality than with our often used

hypothesis of atomistic behavior: the assumption that an individual's choices affect his own well-being but are too insignificant to affect society as a whole. The litter I throw on the street makes an insignificant contribution to the total, so why bother to use a trash can? What I give to the poor has no appreciable effect on the total amount of poverty in the world, so why give anything? My vote will not affect the outcome of the election, so why waste time standing in line to vote? This view is seductive because it has so much truth to it. Yet a society in which everyone believes this way on every issue would be unliveable. We need to view ourselves as a part of a larger whole, and I think most of us do, but this important aspect of life does not really have a place in economic theory.

One can discuss whether economic theory undermines moral imagination, but I do not see what it means to say that capitalism as an economic system does so. People are free to imagine whatever they like, under capitalism or under any other system. In any case, "capitalism" is, I think, best viewed as a loose descriptive term that allows great scope for differing roles of the State in economic affairs. I do not think this term defines a specific economic system, and it certainly does not define a complete social philosophy.

## QUESTION 2

Two theoretical developments of the past 40 years have all but erased what once seemed to be a sharp dis-

inction between issues of efficiency and distributional questions. The first is the reinterpretation of what was formerly viewed as static general equilibrium theory as a model that encompasses both the passage of time and uncertainty about the future. On this reinterpretation, one can speak of efficiency for any given *initial* distribution of endowments, but as the system evolves from its initial position the evolution of the distribution of wealth is thereafter dictated by efficiency considerations. One cannot redistribute each year, say, without sacrificing efficiency.

The second development involves theories that take into account the fact that much relevant information about endowments is privately held, so that any redistribution scheme must induce the well-endowed to reveal their situation voluntarily. These theories have, to take one important example, explained why lump-sum taxation, an ideal policy under full information about individual endowments, is so little used to actual societies. These considerations tie issues of distribution and Incentives, and hence efficiency, hopelessly together.

A by-product of these two developments in theory is that many policy issues that were once viewed as distributional questions are now viewed as efficiency questions. Instead of rationalizing grants to unemployed people as a redistribution from rich to poor, one rationalizes them as payments in a social insurance plan, in which the State promotes efficiency by filling in where private market arrangements are inadequate. (Of course, in this regard economic analysis is simply catching up to

the arguments advanced by the original designers of such programs!) Rather than conflicting with economic efficiency, then, many programs that were once viewed as redistributive are now seen as *required* by efficiency considerations.

A second consequence of these developments is that few economists now view economic efficiency as applying only to the long run outcome of a change in policy. A modern, dynamic economic model describes the process by which an economic system moves from one situation to another, different one following a change in circumstances. The criterion of efficiency applies to the entire process, not only the end result of the process. One asks whether all of the consequences of a change — transitional as well as ultimate — improve efficiency.

I agree with the observation, presupposed in the question, that market organizations are not universally superior to other organizations. I think it is an advantage of a capitalist system that people are free to form other organizations — like business firms — and to withdraw a certain set of allocative decisions from market control. People in a market economy can have whatever degree of non-market decision making they prefer (provided they can find others who wish to join them). Historically, in the U.S., there has been an enormous amount of experimenting with different organizational forms, from utopian communities organized along religious or ideological lines to modern firms experimenting with Japanese-style personnel policies. Since we have very little theoretical understanding of

the factors that determine which decisions should be left to the market and which should be set inside non-market organizations, I think this kind of organizational competition is much to be preferred over any kind of centralized decision as to what is the one right kind of organization.

### QUESTION 3

I do not think we have anything like a full understanding of why it is that some countries develop rapidly while others do not. The success stories of the last few decades are all largely market economies, but many of the failures are market economies as well.

A striking characteristic of the Asian successes has been the rapid growth of their exports of manufacturing goods to the advanced countries. I think it must be the case that such trade, and the interchange of ideas associated with it, fosters the growth of technical expertise — technology transfer — that seems to be essential for rapid economic growth.

Whether the growth in exports in these countries can be attributed to reduced State intervention is harder to say. Certainly Japan and Korea have pursued active industrial planning and mercantilist commercial policies. I think it is likely that these policies have retarded growth and reduced welfare in these countries, and have never seen convincing argument to the contrary, but it would be hard to settle this question very definitively.

I think it is obvious that direct aid at anything like the levels offered by the wealthy economies or the international agencies has only a negligible role to play in the economic development of the poor countries. Such programs are best viewed as (possibly useful) systems of political bribery to bureaucratic elites, not as having any real connection with the present or future living standards of masses of people.

#### QUESTION 4

I am not familiar with the evidence that associates deterioration in living standards with spontaneous transitions. The U.S. conversion from a wartime to a peacetime economy in the 1940s occurred very rapidly, with an almost continuous improvement in living standards throughout an entirely unplanned transition. The post-war German and Japanese experience was even more striking.

The apparently widely held view that central economic planning is inadequate during fairly normal times but is needed during periods of rapid transition seems to me almost the opposite of the truth. Is there anything in the record of Eastern European planning authorities that would lead one to believe that they are competent to work out the details of a transition to capitalism?

It is also not generally the case that lengthy transitions are less painful than speedy ones. A land redistribution, such as the Japanese underwent after the war, has almost no social costs if carried out quickly. But the

*announcement* of a land redistribution that will be carried out some time in the future, or carried out gradually over an extended time period, will have disastrous consequences: Those who now own land have no reason to maintain it while those who will come to acquire it do not have the ability to do so. I think it is clear that such perverse announcement effects are having serious consequences in the Soviet Union today.

In a period of economic transition, the State does have an important role to play in maintaining living standards for the economic casualties, not by preserving jobs producing goods of little value but by providing some kind of income floor for those who lose jobs. The Eastern European governments are in an excellent position to do this, if they wish, since they now own such a large fraction of their societies' resources. As they sell off land and capital, they can channel the proceeds to those most in need of them without distorting resource allocation.

#### QUESTION 5

Environmental issues arise when private and social costs differ. A motorist counts the car and the gasoline he buys as costs, but not the contribution they make to lower air quality. Since the problem is by definition one in which market incentives are the wrong ones, it does not have a purely market solution. But taxes can be used to bring private (market) and social costs into line.



My impression is that most of the environmental policies pursued in the U.S. in recent years use outright prohibitions in place of tax penalties: We do not tax leaded gasoline differentially; we ban it altogether. Insofar as the right tax would reduce leaded gasoline use to zero anyway, the two policies are equivalent.

Improved air quality is not captured in national product estimates (though the extra cost of producing engines that can accommodate unleaded fuel is), so there may be a statistical conflict between environmental improvements and economic growth. This is just one of many ways in which changes in measured product fail to capture changes in living standards. I don't see any reason why environmental improvements should conflict with growth in living standards as we would like to measure them.

Just looking around my own city, Chicago, it is striking that so many of the public goods we enjoy today — parks and boulevards, museums, libraries — were built during the years of most rapid economic growth. Cities like Taipei or Sao Paulo today that are undergoing rapid growth in private goods while investing very little in public goods are, I think, just making a mistake. They would sacrifice very little private sector growth and gain in the growth of living standards more reasonably defined by pursuing a better balance in private-public sector investment. Doing so would obviously involve State action, but would not in any way be inconsistent with the maintenance of market economy.

## *Addendum*

### REACTIONS TO THE 5 NOVEMBER CONFERENCE

At the 5 November Conference, many stimulating ideas were advanced on a very wide range of issues. In my memory, Jeffrey Sachs's remarks on economic development in Eastern Europe and Latin America stand out as worth special emphasis and elaboration.

While I believe it is true, as I said in my answer to Question 4, that our understanding of the details of the process of economic development is very limited, it is certainly a fact that those countries that have succeeded in raising living standards close to European or North American levels have done so in a sense by joining the West. They have adopted largely Western economic and political institutions and Western technology, and they have extensive economic interaction with the West. There is only one advanced, world economy and undergoing economic growth means joining this economy. No one has discovered any other way.

As a practical matter, joining the advanced world means trading with it — the more the better. Any steps toward openness on the part of a poor economy are steps toward higher living standards. I think the central element is the exchange of ideas, but by ideas I do not mean the kind of high-falutin talk that goes on in conferences of elderly academicians. I mean the kind of interchange that is needed if uneducated Hong Kong

workers are to make sweaters that women in Chicago want to wear. For this to happen, people need to spend hours arguing together over details of color, stitching, and a dozen other dimensions, and to motivate such an exchange, all parties have to see some potential gain in it. I think this kind of interchange has been central to every post-war developmental success, and it only occurs through Trade.

What is central to recognize, I think, is that economic openness need not entail either loss of autonomy or the uncritical adoption of everything Western. Neither capitalism nor Free trade is an all-or-nothing ideology. It is obviously possible to pursue an economic policy oriented toward trade and at the same time keep domestic rice prices at many times the world level (as Japan does) or sugar prices (as the U.S. does). In my opinion, the Japanese would lose nothing of their essential character if they ate the better cheaper rice that Americans eat, but the point is that this is a Japanese decision, not an American one, and if this particular deviation from Free trade is a mistake, it is a minor mistake.

I agree with Hirofumi Uzawa's insistence that by thinking of Japan as a "model" we must not deny the existence of very real Japanese social problems. Certainly the same can be said about my own country, with our widening gap between the economically successful and those my colleague William Wilson calls the "truly disadvantaged". A poor country choosing to pursue policies of economic openness need not adopt every aspect of wealthy societies as something to emulate.

The sense in which Japan is a model, I believe, is in demonstrating that openness and adoption of aspects of Western technology and tradition does not place a society in a permanently imitative or subordinate role. The Tokyo String Quartet is not an imitation of European or American quartets — it is just the best. Most of the music they play was written by Europeans, but this does not make it the property of Europeans. Like any other aspect of Western civilization, it is the property of anyone with the interest and the talent to master it and contribute to its future development.

## On the Social Doctrine of the Church

*Prof. Edmond Malinvaud*

The purpose of this note is to contribute effectively to the reflection undertaken in preparation for the centenary of the encyclical *Rerum Novarum*. Unfortunately, its scope risks being somewhat limited because of my hesitancy about some of the more delicate topics.

My point of view — and this is precisely what is desired — is that of someone specialized in economics as an organized discipline, of someone who has also long been active in the field of economic and social observation. What I have to say obviously bears the mark of my personal opinions, although I have tried to exclude them when, in my judgement, they are not widely shared by my fellow economists.

My reference points are not only the questionnaire that served as a basis for the meeting of 5 November (Q 90) and the note that I submitted in answer to it (R 90), as well as the notes of the other participants, but also the encyclicals<sup>1</sup> *Rerum Novarum* (RN), *Quadragesimo Anno*

<sup>1</sup> For RN and QA, the references follow the numbering of the paragraphs found in the 1971 editions of the Tipografia Poliglotta Vaticana. For MM, the English edition of the Tipografia Poliglotta Vaticana,

(QA) and *Mater et Magistra* (MM). I have made a conscious effort to avoid repeating what I said in my November note but will refer to it in the appropriate places (see p. 90).

## THE SCIENCE OF ECONOMICS

In several places, *Quadragesimo Anno* takes position about the science of economics, reproached for often being individualistic and mistaken (§ 37) and for being “alien to the true moral law” (§ 53). A similar attitude underlies the first questions of Q 90. Analogous criticisms have often been expressed in other terms by those belonging to dissenting tendencies within the discipline itself.

A clear distinction must be made between two questions: that of a certain lack of realism in the theories and that of a systematic bias in the conclusions drawn from these theories. *To assume that* economic agents are purely individualistic is a simplification which, like all other such simplifications, *does not correspond to reality*. However, the modifications that must be made in the theory by taking altruism into account have been sufficiently studied to indicate that the resulting implications are only slightly different (an answer given by several of the participants in November).

1961 (unofficial translation) has been used; my references are to sections and pages.

There is a natural division of roles between those who are responsible for deepening the understanding of the realities and those who are concerned with their ethical aspects. The former fulfil their role poorly when they want at all costs to read into the facts the confirmation of their moral preferences. This is a reproach which can frequently be addressed to economists. Many examples can be cited of cases where proposals for action have been inspired by good sentiments, justified by a slipshod reference to so-called facts, applied, and then later recognized to be disastrous. (For examples of this, it suffices to consider the history of certain Third World countries.)

The true problems that religious authorities face in taking any definitive positions — and the same holds true for all of our contemporaries in their decisions — stems neither from economic research efforts having been poorly oriented nor from badly chosen hypotheses,<sup>2</sup> *but from their resulting in so few certitudes*. This is the point that I wanted to make at the very outset in R 90. Basically, the time lag in the development of the science of economics when compared with that of the natural and life sciences is due both to the complexity of economic phenomena and to the impossibility of carrying out valid experiments in their regard.

<sup>2</sup> In other circumstances and when addressing my fellow economists, I do call into question certain orientations and hypotheses. But in this note, I obviously must take some distance as regards the internal working of the discipline.

## THE DESIRABLE AND THE POSSIBLE

Any attempt to look ahead at the coming decades and the 21<sup>st</sup> century, during which the youth being formed today will live, cannot avoid raising questions about the possibilities open to humanity in relation to the resources of the planet. The questions asked in Part 5 of Q 90 concern the environment. In the same way, the encyclical *MM*, in its third section, also addressed the question of an eventual imbalance between population and the means of sustenance (p. 41–4). Major unknowns exist in both areas, and scholars are therefore able to reject neither pessimism nor optimism. Since I have difficulty in believing that the Christian faith can dispense anyone from the need for critical thinking, I consider it a duty to integrate the pessimistic possibilities into the following reflections.

In 1987, the “Brundtland Report” of the World Commission on the Environment and Development studied the relation between the global phenomena of the environment (greenhouse effect, ozone layer depletion, acid rain, etc...) and economic development. This report has often been deliberately interpreted in an optimistic way: despite concern about the environment, economic development will be “sustainable”. Everything depends, of course, on what this adjective is understood to mean, but the context shows that it does not entail calling into question the present standard of living of the richer peoples nor the growth targets of the others. Present-day scientific knowledge, as I interpret it, unfortunately does not give any guarantee in this re-



gard. I had wanted to express this doubt at the end of my answer to question 5 in R 90, but I did so in a manner which was too indirect.

I have similar doubts when I re-read the text of *Mater et Magistra* which evokes the “inexhaustible resources” of nature and affirms that “the true solution (to the demographic problem) is found only in the economic development and in the social progress” (p. 42). Today, we understand the conditions of economic development better than thirty years ago and we know that it has often been compromised by a lack of will or by the blunders of the ruling classes. But it is difficult to maintain with any certitude that this development can suffice to reabsorb all imbalance between population and the means of sustenance. May I allow myself to go beyond my competence as an economist and express my opinion that the real solution could well be found in another passage of MM, the one where we are reminded that “the Christian concept of life... requires a spirit of moderation and of sacrifice, so contrasting with the current prevailing hedonistic conception” (Part IV, p. 50).

#### THE CHOICE OF AN ECONOMIC REGIME: INITIAL CONSIDERATIONS

In 1991, it is particularly delicate to attempt to delineate a doctrine concerning an economic regime, above all when this doctrine is destined to inspire ideas and lines of action for several decades to come. While too great a sensitivity to the present acceleration of history must be

avoided, at the same time, care must be taken to use terms that are acceptable at the present time.

There has always been a gap between effective and ideal regimes on which economists focus their theoretical reflections in an effort to analyze the respective advantages and inconveniences of various modes of organization of economic activities. Moreover, the comparing of effective regimes does not always result in clear conclusions, because history is the product of multiple influences among which it is difficult to isolate the effect of a given economic regime. That is why economists would do well to be rather prudent in giving their opinion on the subject.

I wonder if, a fortiori, the social teaching of the Church should not maintain a certain distance from the debate about what constitutes a good economic regime and so be able to express a message which is valid for rather different regimes. When I re-read *Quadragesimo Anno*, I get the feeling that the text is sometimes too committed to certain positions (in favour of corporative organizations § 36, against free competition § 37). The search for distributive justice and for social order can take place within rather varied institutional frameworks.

Today, our societies are abandoning regimes that had been set up as a rejection of the market system. This evolution can be considered in line with the social teaching of the Church which has always been opposed to a centralizing socialism and which has always promoted individual initiative and private property as constitutive elements of social order. Poverty, however, has

not disappeared, even in the richest countries, and the limitless appetite for gain, denounced in the encyclicals, has been significantly evident in recent times. As a result, it is clear that no economic regime is perfect and that, still more, the choice of an economic regime does not of itself assure social order; *individual behaviours must also respect ethical norms*, the cement of that reciprocal trust which is indispensable in human relations, as K. Arrow reminded us in November. I think that public opinion is now ready to listen with some interest to what the Church has to teach about this ethics.

#### THE EFFICIENCY OF MARKET ECONOMIES

Since the market system plays, and will continue to play, the principal role in the organization of economic activities, attention should be focused on examining its various modalities. The entire first page of Q 90 can be interpreted as related to such an examination in my answers, I expressed the idea that the choice of modalities to be retained should be considered a *pragmatic compromise*, because every solution has its defects. The spirit and the letter of the written and oral commentaries of most of my colleagues went along these same lines.

The classic distinction between the problems of efficiency and the problems of distribution can serve as a convenient basis for considering this point. R. Lucas rightly insisted, in his answer, on the strict interdependencies between these two groups of problems. But J. Drèze reminded us that, more often than not, to ignore

the distinction between the two had led to serious difficulties.

The efficiency of the market in allocating resources has been abundantly studied by economic theory, which has made considerable progress in this regard over the past last fifty years, in particular in analyzing the varying sources of “market deficiencies”. The notes of my colleagues give many indications on this topic, notably that of P. Hammond. Even strictly from the point of view of efficiency, where the market system has enormous advantages, *place remains for the intervention of public authorities*: to be responsible for assuring collective services, to assure competition in the market, to regulate certain activities or the use of certain goods, to encourage an intelligent development strategy.

Unfortunately, we *are well aware of the “deficiencies of the State”*. Their origin falls into two categories. At times, public authorities lack *the necessary information* to give proper direction to their intervention. At other times, the power that these authorities hold is used for *ends other than the pursuit of the common good*; it rather serves the interests of certain individuals or certain groups that are primarily concerned with assuring certain specific advantages for themselves (“rent seeking activities”).

Before these two categories of deficiencies of the State, what attitude the Church should take seems rather evident. In the first place, it must insist on the exacting duties of all those who hold power, duties that are most easily fostered through democratic institutions. Secondly, it would be important to stress the “principle of sub-

sidiarity”, first introduced by QA (§ 35), and repeated in Part II of MM (pp. 13–4) and widely accepted today, at least as a point of reference.

## DISTRIBUTIVE JUSTICE IN MARKET ECONOMIES

*Rerum Novarum* had stated that the first duty of those who governed was to observe strictly the principles of distributive justice (§ 35). At least in Europe, this preoccupation actually often dominated all other considerations during the course of the last century. “Catholic principles of sociology gradually became part of the intellectual heritage of the whole human race” (QA 7). The century ended, however, with the feeling of having more or less failed, even in Western Europe. If the idea of social security found concrete expression in our countries, poverty was not eliminated as a result.

This sentiment came in part from problems which were the result of the *far too numerous cases in which decisions* that were *motivated by a sense of justice ignored the resulting losses of efficiency*, losses that actually compromised the improvement in the living conditions of those whom they intended to help. Experience has taught us *how difficult* it is to act in a way that respects the individual liberties of all while seeking to *protect the weaker members of society*. Aware of this difficulty, many people are tempted today to abandon the objectives of distributive justice.

To avoid regressing and to give better direction to social policies, it seems to me that the *time has come to try to redefine the objectives of distributive justice*. Public opinion

and our political parties have all too often interpreted them in an egalitarian fashion and have therefore somewhat deformed them. To establish an equality between the greatest number possible has now taken priority over seeking to eliminate the most serious cases of distress. I consider that this priority and rather illusive pursuit<sup>3</sup> are at the origin of the reversal of ideas that I perceive. In my opinion, the objectives now need to be refocused on a *system of social insurance* and on a policy of *struggle against poverty*. Several of my colleagues seem to share this opinion (Atkinson, Dasgupta, Daze, Sen...). This would actually be a return to the sources of *Rerum Novarum* that had been motivated by the poverty of the working class in the 19<sup>th</sup> century.

There also seems to be an increasing agreement among us that the availability of public services, readily accessible to the poorest and available in case of emergencies (famines), is the *best* way to fight poverty. This leads us back to one of the recommendations in the third part of *Mater et Magistra*, concerning the “provision of essential services” in rural or under-developed regions (p. 29, 32, 34). In the same way, the existence of intermediary bodies, be they cooperatives or other types, often offers an effective protection against the risk of poverty (RN 47, MM p. 33).

<sup>3</sup> See RN 16.

## RIGHT TO WORK

The establishment of a right to work was doubtlessly one of the greatest achievements that followed upon *Rerum Novarum*. As the first part of *Mater et Magistra* reminds us (p. 6), the first principle advanced by the encyclical of 1891 was that labour ought “to be treated not just as a commodity but as an expression of the human person”. This principle is now generally accepted, even though it would be well to reaffirm it today.

The encyclical is perhaps most dated when it addresses the question of how to determine wages in the industrial countries, because the purchasing power of wages has changed over the last century. *Quadragesimo Anno* made a point of specifying three factors to be taken into consideration in determining wages: the needs of the worker, the state of the business, the overall economic welfare (Nos. 31-34). But the way the question is summarized in the second part of *Mater et Magistra* is perhaps not particularly felicitous: “The remuneration of work, just as it cannot be left entirely to the laws of the market, so neither can it be fixed arbitrarily; it must rather be determined according to justice and equity” (p. 17). More importantly, at a time when an egalitarian concept of justice prevailed, this sentence was understood in such a way that some were able to propose a wage policy that was in contradiction with the pursuit of economic efficiency.

In fact, two pages later the same encyclical asks that “a just share only of the fruits of production be permitted to accumulate in the hands of the wealthy” (p. 18).

Looking back today, it would be difficult to state that the share of goods going to workers in 1961 was inequitable: since the residual was for the most part re-invested as corporate saving, that is for the growth of the means of production and an increase in the standard of living, the real yield on financial capital was weak. Be that as it may, the proportion of goods going to workers increased in Western Europe in the 1970s, following what I consider to have been an exaggerated increase in wages, because I hold it partially responsible for the increase in unemployment. It seems to me that *Quadragesimo Anno* chose a better formula when it states that “a level of wages too low, no less than a level excessively high, causes unemployment” (§ 34).<sup>4</sup> In my answer (R 90, p. 92, point 4), I had flagged the wage policy of the 1970s as an example of the errors of arbitrage committed in the management of our economies.

In short, I believe that it would be better to develop the following ideas: remuneration for work generally obeys the laws of the market; but labour regulations must assure the protection of the worker, and government policy must see that the needs of the economy in general prevail and also guarantee a just remuneration for all (for example by determining a minimum wage, which however could cause a certain degree of unem-

<sup>4</sup> This phrase is preceded by the clause “All are aware”, which makes me smile when I think of the scepticism that I have met among some of my fellow economists concerning the idea of a wage level that would maximize employment.



ployment if it is brought too close to the level of average wages).

## PROFIT, WEALTH AND DEBTS

The laws of the market and private property can lead in certain cases to excesses that are ethically wrong: exorbitant gains, high speculative profits, abnormally strong yield on financial capital (as is the case over the last ten years), great inequalities in the distribution of wealth. Since these excesses cannot be eliminated in advance without calling into question the right to property and the institutions of the market economy, they must be corrected after the fact. The *fiscal system should play this redistributive role*. This idea, despite its being very simple and natural, has recently lost credibility; in my opinion, it should be unambiguously supported in a new encyclical which I am sure, moreover, will reiterate the particular duties that those favoured by nature, inheritance or luck have as regards solidarity and sobriety.<sup>5</sup>

One of the most crucial problems of the past decade and of the present moment lies in the abnormal burden that debts are placing on the debtors, and correlatively the abnormally high return on loans. The sources of the

<sup>5</sup> The passage of *Quadragesimo Anno* consecrated to the dire consequences of instability of the market remains very timely (§ 53). Unfortunately, a certain degree of instability seems inevitable. It will be suggested that financial authorities do their very best to reduce it to the minimum.

wrong seem to me to lie partially in an excessively high level of real interest rates, in turn due to insufficient savings and to an abuse of incitements to spend and to go into debt, and, on the other hand, in the fact that this excessively high level was abruptly established ten years ago, taking debtors by surprise and bringing an unexpected windfall to creditors.

In order to deal respectively with both aspects of this problem, on the one hand, emergency measures to lessen the burden of the heaviest debts must be adopted. The timeliness of these latter measures, about which J. Sachs spoke orally in November, has been widely recognized; but very little has been done concretely up until now. Behaviour modification presupposes returning to a spirit of saving and the development of a commercial and banking ethic that bans the abuse of credit.

## THE PLACE OF PUBLIC PROPERTY

The passages of the encyclicals on the right to property have proved to be far-seeing, even from the sole point of view of economics. Notable in this regard is the failure of the countries of Central Europe that tried to institute a “market socialism”, in which the majority of enterprises belonged to the State and where the market was to regulate the operations of these enterprises, while the bureaucratic forms of managing these same enterprises survived, actually preventing the establishment of a true market economy. This latter presupposes

that the vast majority of enterprises be run primarily in response to stimuli generated by private property.

But must all public ownership of enterprises be excluded? Some people would maintain so. I believe that this opinion is simply fashionable at present. It is very possible to conceive of an *application of the principle of subsidiarity* that would lead to entrusting public bodies with the direct responsibility for certain activities in the field of production, transportation, insurance or credit. In certain well identified cases of market deficiencies, the choice between private property and public property is one of those pragmatic compromises that I mentioned *which I do not believe the social doctrine of the Church has to deal with.*

#### TRANSITION TOWARDS A MARKET ECONOMY

During the November meeting, we spoke of the problems presented by the transition from centrally planned economies to a market regime, a new problem not considered by earlier encyclicals. This has not made me want to change what I had written on this subject in R 90. I have well understood that the Church is above all *concerned that the human cost of this transition be minimized.* This concern was not absent from my replies. Perhaps I should have added, however, that this is a problem where the duty of solidarity is strikingly clear; since international solidarity has only limited power, what is needed most here is solidarity among the inhabitants of the country in question who have the major

role to play, *notably by rapidly setting up* systems of social insurance comparable to those in Western Europe.

When I consider what is said and written today about how best to organize this transition, I have the feeling that the role attributed to the *privatization* of major enterprises is more often than not *exaggerated*. Such privatization obviously does *not suffice* to create a market economy which presupposes, in the first place, the existence of a legislative and regulatory framework that guarantees an equitable competition and lucidly allows private economic initiatives to work. Experience has shown that the private sector develops very dynamically from the ground up *as soon as its legitimacy is recognized*. Likewise, much can be expected from the opening up of international commerce, provided that the economies in transition have the wisdom to accept the competitive exchange rates (therefore unfavourable in the short term as regards standards of living). Freedom of private transactions and of trade with the Western world will rapidly give rise to a system of adequate prices, which is a precondition for the success of any program of privatization.

## INTERNATIONAL ECONOMIC COOPERATION

Knowing that other participants in the November meeting were more qualified than I am to speak about under-development, I did not answer the corresponding questions of Q 90. I believe that my colleagues did, in fact, give information sufficient for the preparation of a

new encyclical. But I cannot end this note without acknowledging the prime importance of the problem of under-development.

I shall simply say that *Mater et Magistra* seems to have expressed the message well in its third part (pages 36-41), and particularly when it states that “the scientific, technical and economic cooperation between the economically developed political communities and those just beginning or on the way to development needs to be increased beyond the present level” (p. 38).

Let me add that I found the oral intervention of J. Sachs in November more than adequate. He pointed out the failure of utopic approaches to the problem of development and the fact that it is unanimously recognized today that it would be in the interest of the poor countries to take their inspiration from the example of the developed mixed economies. He made the following recommendations for the policies of the countries in question: to avoid engaging in risky experiments; to set as their goal integration into the developed world; to trust private stimuli; to orient their policy of redistribution towards the needs of the poorest.

I shall end by expressing an intuitive idea that I have long held. In order to make the most of what the modern world has to offer, the *poor countries should*, on the one hand, try to set up central and local administrations that are intelligent, disinterested and dedicated, and, on the other hand, give *priority to education and training*. Does this intuition not correspond to what a large number of missionaries of the Church believe?

## *Appendix*

### REACTIONS TO THE QUESTIONNAIRE R 90

#### PRELIMINARIES

1. The science of economics is not much advanced: it has no objective explanations for a number of economic facts; it has no answers to a number of questions raised by the concern for a satisfactory conduct of economic affairs. When realizing it, many people believe they can find elsewhere easy explanations or easy answers; but clearly this is a delusion; when reliable explanations or answers exist, economists know them. The danger of this delusion is serious because the so-called explanations presented by some may look attractive when they claim to identify the social group or the institution responsible for the evil; similarly, supposed answers may please people moved by good moral sentiments.

2. *Economics studies existing economic systems. It shows that none of them is perfect.* Thus, economics has no *a priori* bias against economic reform. But many people have a bias For such or such a reform whose consequences have not been seriously studied. Not surprisingly, history shows that, when reforms were hastily tried, they often brought more bads than goods.

## QUESTIONS 1 AND 2

1. The word *capitalism* usually means more than simply an economic system and also refers to a *wide range of systems*. It is used more often by historians than by economists.

2. If everybody could agree on ethical norms and if public policies could be decided by a benevolent and perfectly knowledgeable State, ethics would in principle be all the better served as this State would have more power; but the hypotheses are wrong in several respects. Theory and observation show that *market economies have a good efficiency for production and for the satisfaction of many human wants, but that this efficiency is not perfect and may conflict with requirements of distributional justice. The choice of an economic system must then be viewed as a pragmatic compromise*. Similarly, the choice of the organization within large modern corporations may be seen as a pragmatic compromise.

3. A correct assessment of the trade-offs between conflicting objectives is required not only for a wise choice among economic systems, but also for all public decisions. When some deficiencies in the socioeconomic system or in the existing process of policy formation are perceived, one naturally looks for remedies; but *one then often forgets to consider the potential negative side effects of contemplated measures. Economists must always aim at estimating the full set of effects and so at assessing what are the real options. This is certainly also a concern for moral and religious au-*

*thorities, as soon as they judge actions and do not limit themselves to speaking about the weights to be given to various human values.*

4. Assuming that easy access for all to employment is more important than 5 per cent more or less on real consumption of those employed, assuming that the health of a society is very dependent on how well its youth feel in it, witnessing what happened in Western countries during the past decades, *I believe that our economic policies were not well managed and that the economic profession as a whole was not as helpful as it should have been. I fear moreover that present wants may be overvalued with respect to future ones and that the long term trade-offs may not be considered seriously enough; in this last respect I have no confidence in the spontaneous operation of the market system.*

5. *The role of economic incentives appears to be strong in private decisions.* Positive economic theory focused its attention on the consequences of these incentives. The rationality hypotheses made in classical theory may be criticized as somewhat unrealistic, but this is a secondary issue in the present discussion. In particular introducing more altruism is possible and seldom makes a substantial difference for the implications of the theory.

#### QUESTION 4

1. Understanding how a complex modern economy operates under stable conditions remains a challenge. Clearly, it is a much bigger challenge still to try to understand how Eastern European economies will operate



during the transition to a market or mixed economy, and this under alternative hypotheses concerning the *pattern and speed* of institutional reforms. Thus, one cannot speak with much confidence about the strategy that would *minimize the social costs of the transition*.

2. One may doubt whether there is a real trade-off between the length of the transition and its total cost. *A fast transition may very well be less costly than a slow one. If the new rules of the game are really workable and clear to everybody, simultaneous adaptation to them by all may bring much better results than a long phase of successive small steps, leaving room for all kinds of unproductive individual strategies.* A Western European may remember that reforms were fairly easily made in the immediate post-war, when changes could be implemented quickly. Thus, the length of the transition may be imposed by socio-political and administrative factors, rather than chosen on the basis of economic considerations.

3. The outcome and even the ease of the transition are likely to be all the more favorable as the Eastern European economies will be more competitive abroad. It seems to me that the *real trade-off for the people of these countries is between the level of the present real wage in international money and their future prosperity.* As I see it, *any attempt at raising the real wage during the initial period will have a huge cost later on.*

## QUESTION 5

1. Degradation of the environment is due *much more* to industrialization, to urbanization and to demographic growth *than to market forces*. Actually, industrialization has been more destructive of the environment in the planned economies Of Eastern Europe than in the mixed economies of Western Europe, where a long experience exists on how to control the external effects induced by market operations. Pragmatic solutions, with a mixture of regulations and economic incentives, have been found appropriate for dealing with the kinds of externalities that have been identified long site. Similar pragmatic solutions will emerge for some of the new environmental concerns.

2. The global character of other concerns (acid rains, global warming...) creates new types of problems. It is global in the sense of being international and of being also much *more intergenerational* than with traditional pollutions. *The problems raised by the international aspect are not economic but political*. Several countries must agree on a regulation, or on a system of economic incentives; moreover the solution can hardly be neutral on their respective well-being or competitiveness. The intergenerational character means that a distant future is involved. *This creates an additional reason for lacking confidence in spontaneous market operations* (see above). It also explains why uncertainties concerning the physical and biological phenomena are often tremendous.

3. Some of the proposals intended to cope with environmental issues would also have, if accepted, *huge costs*. The economists must insist on the *estimation of these costs*, because *others tend to neglect them*. They are for instance neglected by those who at the same time assert that growth will be sustainable and present very pessimistic views on the physical phenomena involved in the degradation of the environment. In most cases it would be premature today, on the basis of existing physical and biological knowledge, to take the decision to assume these costs. But if and when major decisions of conservation or adaptation have to be taken, economists will contribute to the definition of a wise solution; *they will then avoid dogmatism*.



## **Transition from a Planned Economy to a Market Economy**

*Prof. Jeffrey D. Sachs*

The political leaders of last year's democratic revolutions have wisely described their basic goal as "the return to Europe". This "return" has two senses: first, the adoption of the fundamental political and economic institutions of Western Europe (parliamentary democracy and a market economy based on private ownership); and second, the reintegration of Eastern Europe into the mainstream of European life, by re-establishing the rich and deep linkages of culture and economic interchange that were sundered by the Cold War.

There is enormous merit in posing the economic task as the "*return to Europe*". The overwhelming historical experience within Europe, and in the world economy more generally, shows that poorer countries (such as in Eastern Europe today) can best catch up with their wealthier counterparts *by encouraging extensive trading relations with the wealthier nations, and by adopting the basic economic institutions of those nations*. Eastern Europe's best hopes for escape from its economic predicament therefore lies in close and deep economic links with Western Europe. Both experience and economic theory suggest that the deeper these links are, the more rapid will be

the convergence in living standards between East and West.

This perspective helps to answer key questions regarding the economic transition from central planning to a market economy. First, the targets of institutional change are made clear: Eastern Europe should strive to adopt the economic institutions of Western Europe with an aim at eventual membership in the European Community. Poland's Finance Minister Leszek Balcerowicz has wisely said many times,

We will adopt the *proven* institutions of the West, rather than experiment with new economic institutions. Let the rich countries experiment. Poland is too poor for that.

Second, the basic method of reform is also made clear: *Eastern Europe should eliminate economic barriers* to the free flow of goods, individuals, and technologies between East and West. At the same time, the governments of Western Europe must keep the Western economies open to the growing exports from Eastern Europe.

Mr. I. Angelov (quoted in Question 4) is correct that we lack the precise historical experience of how to move from central planning to a market. At the same time, however, we have a rich historical knowledge of how a country can pursue economic policies in order to reintegrate with its wealthier neighbors. As one example, Eastern Europe's task resembles the task that has been carried out by Spain since the earlier 1960s, during which time Spain emerged from decades of stagnation caused by an autarkic and authoritarian regime, to be-

come a rapidly growing country closely linked with the rest of Europe.

Experiences of Spain and many other countries help us to *identify the specific technical path that Eastern Europe should pursue*. In particular, economic reform in Eastern Europe should begin, as much as possible, with a rapid and extensive opening of the economy to the outside world. This means an *elimination of most trade barriers*, the establishment of a *convertible* currency to support free trade, and the creation of a *stable macroeconomic environment* so businesses can take advantage of the newly opened economy. In Eastern Europe, it also means the *renewed protection of private property* rights, and the *transfer of ownership and control of State enterprises* back to the hands of private citizens, because only the private sector will be able to act with flexibility to take advantage of the new economic environment. Note that this is a *comprehensive package* of measures, known as a *program of stabilization, liberalization, and privatization*. It is precisely the kind of package of measures that was adopted by Poland at the beginning of 1990.

The measures of liberalization and privatization are also justified, on moral and political grounds, as providing for increased human freedoms in Eastern Europe and protecting against the tyranny of an all-powerful State. Perhaps those motivations are even more important than the purely economic dimension of promoting a rise in living standards. Thus, in the case of economic reform in Eastern Europe there is a happy

confluence of economic, moral, and political reasons for the package of needed measures.

One of the most critical choices in the economic strategy is the *time dimension of the policies*. Should the reforms be introduced rapidly or gradually? Again, history offers many important lessons. *Rapid reforms are much more likely to succeed than gradual reforms, for at least three reasons*. First, with rapid reforms, individuals and businesses can react quickly and with confidence to the new economic environment. With gradual reforms, on the other hand, there is a *long period of intense uncertainty* about the future path of the economy, so that individuals and firms do not know how to react. Second, gradual reforms are likely to leave the system in a state of internal contradiction — without central planning, but also without markets. This kind of “non-system” produces calamities of the sort that visited Poland in the late 1980s, and that is now inflicting economic collapse in the Soviet Union. Third, with gradual reforms, powerful special interests in the society are given time to become politically mobilized in order to block economic changes that are good for the society as a whole but harmful to special interests.

For this reason, most of the countries of Eastern Europe are now tending to follow Poland’s lead, in introducing a policy package of *comprehensive and rapid reforms*. It must be stressed, however, that even with rapid reforms, the real improvements in the economy will require many years to achieve. Thus, the introduction of reforms is not enough. *The public must also be patient* in



order to give time for the reforms to achieve their results. *Political leaders must recognize the importance of maintaining a steady course.* The necessary reforms will not work if there is constant improvisation and rapid shifts of direction. As an example, we should remember that the German economic miracle of the post-war owes its success in part to the fact that Chancellor Adenauer and Finance Minister Erhard were in office for 15 years pursuing a consistent set of policies.

There is no doubt that the people of Eastern Europe will live through *major dislocations* in coming years. *These dislocations will be minimized, not increased, if the reforms are rapid.* At the same time, we should recognize a tendency to overstate the harmful effects of the reforms, and to understate the benefits, especially in the initial years. It is often claimed, for example, that living standards have fallen sharply in Poland during 1990, but much of this alleged fall is simply a statistical illusion. Living standards had already fallen sharply under the old regime, even before this year's reforms, but the official data used until this year seriously distorted the accurate measurement of living standards. Thus, before this year's reforms, the prices of many goods were set at artificially low levels, but the goods were simply not available in the shops (or were available only after long queuing, or only with a payment of bribes or black market prices). Now the market prices are at higher, realistic levels, but the goods are widely available in the shops. In a similar way, much of the measured fall in industrial

production and the measured rise in unemployment reflects a statistical overstatement of the actual situation.

The governments of Eastern Europe will have a major responsibility to *ensure that the costs of the economic reforms are shared widely in the society*, and that the weakest members of the society are protected from serious harm. Thus, the Eastern European economies must make a *special effort* (as is now underway in Poland) to *support the poorest and weakest members* of the society through social welfare payments, unemployment insurance, job retraining and other forms of social expenditure. In the final analysis, however, the peoples of Eastern Europe can be sustained economically *only through a revival* of the economies, rather than through social expenditures alone.

The economic transition in Eastern Europe — the return to Europe — will require help from the West alongside the decisive reforms and patience in the East. Western Europe must help the newly emerging market economies in three ways. First, the West must *keep its borders open* to economic and cultural exchange with Eastern Europe. Eventually, this openness should include welcoming the countries of Eastern Europe into full membership in the European Community. Second, the West should provide *financial assistance* to Eastern Europe, tailored to the needs of the individual countries. For Poland, as an example, there is an urgent need for a permanent reduction of Poland's debt burden. Third, the Western governments should play a major

role in providing technical assistance to help in the rebuilding of market institutions in Eastern Europe.



## Some Contemporary Economic and Social Issues\*

*Prof. Amartya Sen*

### 1. POVERTY

We were asked, in the questionnaire sent to us, whether poverty can be adequately described as “privation of something”. I think that *format* is broad enough, but it is an empty box unless we specify what that “something” is. The really material question is privation of *what?*

If one accepts that development is a process of expansion of human capabilities to live in ways we have reason to value, then deprivation cannot be seen simply in terms of the lowness of incomes. The real problems in developing countries are reduced lives, rather than low income as such, even though the latter contributes to the former. Some countries have been much more successful in using income well in enhancing living standards by expanding elementary education, by efficient epidemiological control, by medical insurance and health care, by eliminating endemic undernourishment

\* These observations develop the background notes prepared for discussion at the Vatican on Monday, 5 November 1990, and incorporate reactions to the deliberations that occurred.

through public intervention, and so on, than have been others.

It is not quite correct to say that growth has not been high in countries receiving IMF-WB funds. Some have had quite high growth rates of GNP. In regional terms during 1980-89, while the annual rate of growth of gross domestic product was 3.0 per cent in the industrial countries, it was 2.9 per cent in the Middle East and North Africa, and decisively higher in Asia: 8.4 per cent in East Asia (including China) and 5.5 per cent in South Asia (including India). It is important to note the gathering momentum of economic expansion in such economies as Thailand and Indonesia, and the belated but significant expansion of growth rates in the two most populous countries in the world, viz. China and India.

Sub-Saharan Africa does have a problem with economic growth, and this does need attention. But more commonly the real problem is that often growth of GNP does not lead to a corresponding expansion of quality of life. In fact, while China expanded life expectancy at birth from being close to 40 years to the high 60s between the revolution and 1979 with only a moderate overall growth of real incomes and very little growth of food and agriculture, in the period since the economic reforms, while the growth rates of GNP and of food output have gone up dramatically, life expectancy has faltered and may even have fallen somewhat since 1979. This has something to do with the decline of communal medicine and the cut-back in public support for medical insurance, previously provided through

communal agriculture in the rural areas. The main focus in China has shifted from issues of providing basic services to all to that of growth of personal incomes, and this has been particularly detrimental to communal health care.

It is also worth mentioning in this context that high-growth countries vary greatly in their experiences. Some (like South Korea) have used the increase in their income levels to provide better health care, education and social insurance across the population, whereas others (like Brazil) have done little with it other than seeing it as expansion of personal incomes, often of the relatively better off.

In my joint book with Jean Drèze (*Hunger and Public Action*, OUP, 1989), we have tried to contrast the divergent experiences and successes of different countries and disparate policies, and have discussed the advantages and limitations of both the market mechanism and State planning. The scores are mixed, contrary to what is often claimed these days. It also emerges that there is need to consider in this context the importance of popular participation and democracy in shaping the development of a nation.

## 2. THE LIMITS OF THE PRICE SYSTEM

That the market mechanism can lead to iniquitous results — given the inequalities in ownership patterns — is easier to see than the fact that it can also lead to inefficient outcomes and insufficient promotion of individ-

ual freedoms. What goes wrong with market calculations in dealing with such subjects as public health care, basic education, prevention of crimes and environmental protection? Part of the answer lies in the fact that these ingredients of good living do not consist entirely of personal commodities which can be smartly allocated among different persons with the help of the price mechanism. They consist partly in what economists call “public goods”, for which one person’s consumption of the good does not preclude that of another.

In the case of a “private good”, e.g., a toothbrush or a bicycle or an apple, either you can use it or I can, but not both — our uses compete. This is not so with “public goods” like a good environment or the absence of epidemics. Both of us may benefit from breathing fresh air, living in an epidemic-free environment, or not being exposed to urban crime. When uses of commodities are non-competitive, as in the case of public goods, the rationale of the market mechanism does not operate very well.

The market system works by putting a price on a commodity and the allocation between consumers is done by the respective willingness to buy it at the prevailing price. When “equilibrium prices” emerge, they equate demand with supply for each commodity. In contrast, in the case of public goods, the uses are — largely or entirely — non-competitive, and the system of giving a good to the highest bidder does not have much merit, since one person’s consumption does not exclude that of another. Instead, our joint benefits have



to be compared with costs of production, and here the market mechanism functions badly.

A related problem concerns the allocation of private goods that have strong “externalities”, with interpersonal interdependences working outside the markets. If the smoke from a factory makes a neighbour’s home dirty and unpleasant, without the neighbour being able to charge the factory owner for the loss she suffers, then that is an “external” relation. The market does not help in this case, since it is not there to allocate the effects — good or bad — that work outside the market.

Public goods and externalities are related phenomena, and they are both quite common in such fields as public health care, basic education, environmental protection, and so on. One person’s contagious illness can spread to another (an “externality”), and both the persons would have benefited from living instead in a contagion-free atmosphere (a “public good”). In all these cases, there is a breakdown of the simple rationale of allocating goods according to the willingness of the purchaser to pay for them, and this undermines the market logic.

Other problems for the market mechanism arise from certain types of uncertainties, and of course from the market’s lack of concern for distributional equity. Sometimes these problems interact and reinforce each other. For example, in medical care uninsurable uncertainties may relate partly to the difficulty of devising appropriate market arrangements to deal with each eventuality and also to the interest of private insurance

companies to leave out (or discriminate against) those who are more prone to illnesses, and the results can be both inefficient and iniquitous.<sup>1</sup>

Another problem relates to the necessity of competition for markets to use the price mechanism effectively. Extensive competition is often difficult to achieve when technical economies of large scale make it inefficient to have many competitors producing the same good. In these cases, the firm may be inevitably monopolistic, and here the discipline of the market may well be totally inadequate.

It is not surprising that in the experience of privatization vigorously pursued in Great Britain, more problems have arisen and have remained unresolved in the case of those enterprises which are close to being “natural monopolies”. There are less problems in the privatization of competitive firms, such as Jaguar, Rolls Royce, British Petroleum, Trustees Savings Bank, British Airways, etc. than in operating privatized British Telecommunication, British Gas, and the regional water companies.<sup>2</sup> The latter category of cases tends to yield monopolies or near monopolies in the provision of the particular good or service in question (at least at the local level).

<sup>1</sup> A classic treatment of the major difficulties of dealing with medical care through the private market system was provided by Kenneth J. Arrow, “Uncertainty and the Welfare Economics of Health Care”, *American Economic Review*, 53 (1963).

<sup>2</sup> For an insightful analysis of the differences between diverse categories of privatization, see John Vickers and George Yarrow, *Privatization: An Economic Analysis* (Cambridge, MA: MIT Press, 1988).

For example, it is not technically cost effective for many telephone companies to have their own respective networks, and even when there is competition at some level (e.g., between British Telecommunication and Mercury in providing local telephone services), there is need for collusion at other levels (e.g., in arranging the sharing of joint facilities). In the latter category of cases, it is hard to put the privatized firms under the strict discipline of fully competitive markets.

When the possibility of efficient market allocation through competitive use of the price mechanism breaks down (because of the importance of public goods, externalities, uncertainties or economies of large scale), there is need to seek some other method of dealing with the challenge. There are various alternative possibilities, including replacing the private firms by public enterprises, or alternatively, subjecting the private firms to strict regulations and public scrutiny. It may not be easy to determine which alternative would do better. Often, it may not even be clear that either alternative would be superior to continuing with private firms despite the diagnosed problems. There is also the question — a big one — as to what principles or rules should be followed in making public decisions. If the comparative economic experiences in different parts of the world establish anything, they show the pitfalls in generalizing about “best rules”, and they underline the need for pragmatic decisions in each case based on the exact nature of the problems faced.

There is a very impressive theoretical literature on the allocation rules for public goods, externalities, etc. But the distance between that literature and practical rules that can be readily used in running public firms is quite considerable. They are more helpful in giving us good insights into the nature of the problems faced than in yielding immediately usable formulae to be adopted and enforced. The insights capture the reasons of the failure for the standard price mechanism and the directions in which remedial arrangements would have to be sought. As was discussed in the last section, the public sector has a good record of actual achievement in particular fields like health care in many different economies (as can be illustrated with examples from countries as diverse as Canada, Costa Rica, Jamaica, Singapore, China or Cuba), and economic theory helps us to understand why this need not be entirely surprising.<sup>3</sup>

## B. RATIONALITY

A different — but not unrelated — issue that was raised in the questionnaire sent to us related to the nature of “rationality” presupposed in economic theory. There are many different characterizations of rationality in standard economics. In one view, rationality is seen as no more than internal consistency. It is possible to

<sup>3</sup> This question and related analytical and empirical issues have been discussed in my joint book with Jean Drèze, *Hunger and Public Action* (Oxford: Clarendon Press, 1989).

argue that the idea of purely internal consistency of choice is bizarre, and what counts as internal consistency of choice must turn on the form and content of the objectives being pursued.<sup>4</sup> But no matter what the problems are in formulating internal consistency, the formulation of rationality as internal consistency does not in itself preclude the influence of moral considerations and cooperative motivation.

The alternative characterization of rationality used in standard economics, viz. that in terms of the pursuit of self-interest, does, however, have that reducing role. How much of a barrier this is must depend on how narrowly self-interest is defined. If a view of self-interest is as broad as what Adam Smith called “prudence” (taking into account what we may call “enlightened self-interest”), then some of the moral and cooperative considerations would have been already included within the notion of self-interest. It would still be inadequate to capture adequately all the rational “moral sentiments”, but it would not be as narrow as the objective functions presented in much of contemporary economics.

In addition to the nature of the objective function, there is also the question as to how moral considerations may affect the relation between choice and objectives (no matter how moral). In moral philosophy, those emphasizing deontological demands have tended to ar-

<sup>4</sup> On this see my *Choice, Welfare and Measurement* (Oxford: Blackwell, and Cambridge, MA: MIT Press, 1982) and *On Ethics and Economics* (Oxford: Blackwell, 1987).

gue that the use of objectives must be restrained by moral constraints on behavior (e.g., not doing certain bad things even if the consequences are good). There is a distinction to be drawn here, but standardly it should be possible to include the moral considerations that govern the constraints into a suitably discriminating formulation of the objective function itself. It is possible to get truly complex cases that help to question the possibility of doing this, but in general I do not see the reach of the additional implement of deontological constraints as substantially greater than what can be done through suitably discriminating objective functions.

There is a different issue that concerns the need for taking the instruments of choice as a combination of strategies of different people, since it can demonstrably achieve more than what can be achieved through atomistic instrumental choices. Hobbes and Rousseau knew this well, and Smith and Kant made this a central aspect of their ethical analyses.

There is an impressive recent literature that tries to make atomistic instrumental choice achieve what can be done through cooperative instrumental selection, by using such devices as finitely repeated games. But this does not necessarily work. Nor is it clear that these devices adequately capture the reasoning behind moral and cooperative behavior. In matters of social behavior, Kantian reasoning remains morally relevant and descriptively important despite the room opened up by prudential coordinations in finitely repeated games.

As far as capitalism is concerned, to some extent the system does undermine “moral imagination”, as suggested. But no less important is the often-ignored fact that capitalism also needs particular types of moral imagination for it to be successful and flourishing. It is not just profit maximization that capitalism needs (as Weber and Tawney knew well). The relevant moral imagination is closer to Adam Smith’s notion of “prudence” than anything that can be captured in terms of the usual formulations of self-interest in the standard economic literature. (I say standard economic literature, rather than “neo-classical economics”, since that limited characterization is shared by anti-neoclassical schools as well, including neo-Ricardians, neo-Marxians, and neo-Keynesians.) While the standard assumptions explain market relations tolerably adequately, they fail rather badly in explaining such matters as the sense of responsibility to other workers or loyalty to the firm, and these can be very important for the success of capitalism. For example, the contrast between productivity performances of, say, Japan and Britain may relate to this type of issue, and the corrections have been explored, in rather different ways, by Michio Morishima and Ronald Dore, among others.

The fact that capitalism needs ethics for its success does not, of course, suggest that capitalist ethics would be adequate to deal with problems that are not of central concern to capitalism. Problems raised by distributive justice, demands of equality, removal of poverty, enhancement of communal health, maintenance of ur-

ban quality of life, the preservation of environment and such other matters raise challenges with which traditional capitalist ethics has not been deeply concerned. The moral lacuna of capitalism, thus, does remain, but it does not arise from the absence of a capitalist ethic, but rather from its limited nature.



## **Incentives, Efficiency and Equity in a Market Economy**

*Prof. Horst Siebert*

Imagine an economist who has to develop an economy anew from the drawing board. What are the main aspects that he would take into consideration? Which are some of the principles that he would apply? Individual liberty, rationality, or in economic jargon, efficiency, and equity are the guiding concepts that come to mind.

### INDIVIDUAL LIBERTY

In Western societies, it is accepted as a starting point for our problem of designing an economic system that each individual is the best judge of his affairs and that he or she decides according to his or her preferences. The economic system of Western market economies thus reflects a specific concept of man: the sovereign individual, capable of choosing among alternatives freely and in a rational way. Individual freedom is respected in most constitutions, and the sovereignty of the individual is the basis for economic decisions with respect to the areas of consumption, saving, work, leisure, housing, location, and migration, among others. Sovereignty of the individual with respect to economic

matters is the companion of political liberty guaranteeing the freedom of expressing opinions. Individual liberty is to be restrained if the rights of others are negatively affected.

## RATIONALITY OR EFFICIENCY

The principle of rationality or economic efficiency requires that a goal be achieved with the use of a minimum amount of resources. The concept of opportunity costs is the compass for deciding on activities. There are competing uses for resources and goods, there is a choice among opportunities or alternatives, and economics is the discipline of choice. For each activity, the benefit of the activity must outweigh its opportunity cost; this means that the benefit of an activity must be larger than undertaking any other activity involving the same consumption of resources. For instance, using a resource in a specific production activity should bring a larger benefit than using it elsewhere. Spending income on consuming a specific good should bring a higher benefit than spending it for another good. Using time for labor should be more beneficial than using it for leisure. Opportunity costs are the cost of an opportunity foregone.

In determining the benefit of an activity, the goal does not have to be a narrow economic objective such as profit maximization. Ethical values can very well be an element of the utility function of individuals and of the objective function of economic organizations

(firms). Rationality in the above sense (instrumental rationality, “Zweckrationalität” according to Max Weber) is to be distinguished from value rationality (“Wertrationalität”), which implies a value judgement on the goal by someone who is not necessarily the actual decision maker. It seems to be a safe position for a scientist that he or she cannot establish value judgements on a scientific ground, but can only introduce values in a hypothetical way or as a matter of personal judgement.<sup>1</sup> It is a serious misunderstanding to interpret the economist’s view of man as a normative concept.

#### INCENTIVES AND WIRTSCHAFTSORDNUNG (ECONOMIC ORDER)

The issue is whether individual rationality leads to an acceptable result for society (in the sense of value rationality). Is Adam Smith<sup>2</sup> right: “As every individual, therefore, endeavours as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to render the annual revenue of the society as great as he

<sup>1</sup> It should be acknowledged, however, that the scientific approach itself is not “wertfrei” (free of value). On the one hand, it is based on a common system of methodological positions like empirical verification, experiment, objectivity, etc., on the other hand, science constantly promotes change and development in the real world so that it refers not only to the “is” but also to the “ought”.

<sup>2</sup> Wealth of Nations, p. 423.

can.”? “By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.”

Accordingly, it is the economist’s role to point out how an institutional arrangement can steer the decisions of individuals — households and firms — so that their decisions eventually end up in contributing to the target of society as a whole. This is an issue of setting the right incentives.

In the jargon of the economist, drawing up the institutional arrangement for an economy is a super-principal-agent problem. In a typical principal-agent problem, the principal sets an institutional arrangement, for instance a contract so that the agent behaves according to the target of the principal while maximizing his own targets. An example is a resource country granting resource rights to an international firm. The rules should be such that the maximizing behaviour of the agent leads to optimal results for him — within the restraint — and simultaneously reaches optimal results for the principal. In drawing up an institutional arrangement for a society, the economist drafting a constitution must set incentives in such a way that Adam Smith’s statement becomes true.

The concept of letting incentives do their job implies a decentralization of decisions, thus respecting individual autonomy. This is an issue of motivation, responsibility and informational efficiency. It is an application of the subsidiary principle. Property rights defining how goods and resources can be used by decentralized units

are an important vehicle of decentralizing an economy. Thus, property rights basically define the incentive system of a market economy. They attribute the benefits and the opportunity costs to a specific decision.

## MARKETS AND COMPETITION

In a decentralized economy, individual economic action is coordinated by markets. On the demand side, the individual can vote with his or her purse and feet. By giving up income and by spending money on a specific product and not on alternative products, the individual clearly signals his or her opportunity costs and the marginal willingness to pay. By choosing one place to live and not another one, he or she indicates the willingness to pay for a specific location. When these individual evaluations are summed up by the market, the value of a good from the point of view of the demand side is specified.

On the supply side, markets allow a decentralized autonomy of decisions on production and investment; they signal the incentives to produce. Individuals feel the opportunity costs of leisure in terms of income lost, and so they decide how many hours to work and not to work. By expressing opportunity costs, i.e. the costs of an opportunity foregone, the market economy prevents inefficiency. Firms making a loss have to exit because their opportunity costs are too high: the resources could be used better elsewhere.

The efficient interaction of demand and supply requires transparency of the market. Information on economic and technical conditions, however, is not ubiquitous in an economy but distributed asymmetrically among the subsystems. Fortunately, the decentralized market system itself promotes the dissemination of knowledge because it offers profit opportunities for the utilization of comparative advantages in the generation and processing of information; it is an incentive to collect and reveal information. Moreover, prices convey information, for instance by signalling relative scarcities.

The competitive order not only works towards an efficient allocation at one point in time (static efficiency), it also provides incentives to expand production possibilities over a lapse of time (dynamic efficiency). Firms search for new technical knowledge and look for new possibilities for investments. Thus, markets are not only a mechanism to disseminate a given set of information; they are an exploratory device in the sense of Hayek (1968) generating new knowledge.

Competition is another necessary condition for an effective decentralization, but the spontaneity of the market may be endangered endogenously by the behaviour of firms. Profit-maximizing firms can improve their position by reducing competition. They can form cartels and engage in other forms of cooperation in order to reduce competition; they can strive for a monopoly position by internal growth or can attain a monopolistic position by mergers. An important framework of the institutional arrangement of a social market economy is

therefore competition policy. Its role is to guarantee that competition is not eroded endogenously principally by ruling out cartels, by controlling mergers and by surveilling the abuse of a monopolistic position.

Recently, economic theory has widened the concept of competition policy. The concentration has shifted from controlling firms already present in the market by anti-trust policy to guaranteeing access of new competitors and forcing exit of uncompetitive old ones. This is the issue of contestability. Markets can only do their job if they are contestable, if there is a permanent threat of competition from outside. Then newcomers will have a chance to prove cheaper production methods, introduce new technologies (competition as a cost reducer), and develop new or better products.

International trade and open markets enhance the degree of contestability. Competition from abroad serves as a device against strategic positions that national firms might acquire without it. Openness can also prevent resources from being wasted by inefficient production and protects consumers against firms charging too high a price. Therefore, markets must be open. Of course, those who are established in the market — the insider, the grandfather — want to exclude those who want to enter — the outsider, the newcomer. Governmental regulation is frequently abused to achieve this result. Regulation very often defines entry and exit conditions, either explicitly or implicitly. It becomes more and more profitable for sclerotic firms to devote resources to lobbying for regulation and insider protec-

tion. The entrepreneur then gives up his classical function as a Schumpeterian innovator who introduces new combinations of productive factors. Instead, he operates on the political market to secure a protective level of regulation for his firm. As a side product, the resulting confusion of private and public interest erodes people's belief in justice and fairness. The higher the level of regulation is, the more rent-seeking is induced so that a vicious circle begins. Thus, one way to reduce rent-seeking is to reduce the level of regulation in an economy. Incidentally, the insider-outsider issue also arises in the labour market when trade unions specialize on improving the conditions of those employed and forget those that are outside.

We have pointed out earlier that markets depend on property rights that in turn define power or "Macht". To avoid a scenario in which firms engage in rent-seeking as described above, it is essential to recognize the linkage between property rights and market entry conditions when designing an institutional order. One way to reduce power is to reduce the level of regulation.

A market may "disappear" in a hierarchy (firm). This fact neither automatically destroys the efficiency property of markets nor does it support the notion of the superiority of central planning. A hierarchy is more efficient than the market if it can reduce transaction costs. Empirically, we observe growing transaction costs associated with increasing sizes of organizations. Hence, the size of an efficient hierarchy is limited by market competition.



## INTERNALIZING EXTERNALITIES

When the incentives are set through the definition of property rights and individual agents are free to operate on competitive markets, the issue whether Adam Smith is right boils down to the question to what extent individual behaviour takes into account externalities on others in a broad interpretation. Economics has pointed out that technological repercussions on others are not taken into account if the individual or a firm can behave strategically. This is possible when the decentralized units can behave as a free rider, i.e. if public goods (“must be consumed in equal amounts by all”) are supplied, when technological externalities prevail (environmental problems), or when an individual organization has market power.

Public goods do not allow for a complete decentralization. The dike in Holland is such a public good; it is used in equal amounts by all, and everyone contributes to its construction (or financing). The concept of a public good rests on indivisibilities in a technological sense. When smaller scale public goods can be defined, decentralization becomes possible, for instance in a federal structure of government, in privatizing public goods and financing them by user charges and interpreting them as club goods.

The decentralization of the supply of public goods leads to institutional competition. This means that different regional (local, national) institutional arrangements can exist simultaneously in one market. Then, competition for the mobile factors of production oc-

curs, and the emerging institutional setting is the result of an open-ended process. To let this happen, markets have to be open to allow a constant flow of ideas, people, capital, goods and services. The strategy reflects a liberal philosophy and therefore contrasts sharply with a more planning-oriented approach. It mirrors the conviction that there is not only a necessity to control private accumulations of power but also to control the State.

## PROPERTY RIGHTS AND INCENTIVES

Under a set of conditions, an efficient allocation can be achieved by alternative institutional arrangements of property rights. The Coase Theorem (1960) is a strong proposition: Irrespective of the initial allocation of property rights, an efficient allocation will result. Thus, according to this theorem, the allocation of rights does not matter for efficiency. The theorem only states the uncoupling of the allocation of property rights and efficiency; alternative institutional arrangements of property rights do have different distributional effects.

However, the Coase Theorem only holds under rather simplified assumptions. Institutional arrangements, including property rights, define incentives in many ways, and incentives have an impact on production (and other variables such as employment), and consequently influence allocation. One important aspect is that incentives or property rights influence behaviour in an inter-

temporal sense. Examples are property rights for land<sup>3</sup> (and their impact on agricultural production including soil quality and the upkeep of machinery and buildings), property rights for firms<sup>4</sup> (and their impact on capital accumulation and viability of the firm), patents (and their role to stimulate inventions and innovations) and labour market regulations (having an impact on the supply and demand for labour, i.e. employment). Therefore the Coase Theorem cannot be generalized. Institutions define incentives and incentives influence production.

## ENVIRONMENT AND NATURE

The environment issue is a prime example of the role of property rights and incentives. With the environment having two competing uses (public good of consumption, receptacle of wastes), the political process has to define environmental quality (the public good); moreover property rights have to be established for the use of the environment as a receptacle of wastes. Such an institutional arrangement will internalize social costs by attributing the opportunity costs of economic decisions to the organizational units which experience the benefits

<sup>3</sup> The Mexican *egido*-arrangement whereby governmental land is not inherited and falls back to the State is an incentive not to take into account opportunity costs for the future.

<sup>4</sup> The Yugoslav labour-managed firm is an example for not accumulating capital.

of a decision. Then, not only the individual benefits will have to outweigh individual costs, but the cost-benefit comparison will show an increment of welfare for the whole of the economy, too. Of course, the reckoning will have to include the sequels for future generations. In doing so, the uncoupling of economic growth and environmental degradation can be managed (Siebert 1991).

The environmental issue is an interesting case for the question to what extent human (economic) behaviour can be steered by ethical values (norms) or by economic incentives. It seems that the environmental problem is so complex that ethical norms alone (as in the case of the Aborigines in Australia or the Navajo Indians) are not sufficient to prevent environmental degradation and must be substituted in part by an institutional arrangement of economic incentives. In modern societies, institutional arrangements such as pricing environmental use have substituted ethical norms.

## EQUITY

We have so far established our view that in a world where individuals pursue their self-interest, where the risk of endogenous erosion of competition exists, and where firms and individuals are inclined to free-ride on the environment, an institutional order can be set so as to promote the efficient use of resources. Here, the term efficiency refers to the Paretian interpretation, i.e. an allocation is said to be efficient if no individual can

be made better off unless someone else is made worse off. Obviously, an efficient allocation in the above sense need not coincide with a distribution of income that — according to common values — is acceptable for society.

In evaluating the trade-off between efficiency and equity, it should be recognized that equity and efficiency show a high interdependence in a dynamic economic process. If, for example, children from disadvantaged families are denied access to knowledge and education, the formation of human capital slows down and human resources are wasted. Then the principle of dynamic efficiency is violated. On the other hand, equity measures affect efficiency. The social order (including distribution policies) has an impact on production.

Take as an example the communist system which starts from the equity target and severely affects production. In contrast, a market economy based on a large middle class and many small firms is much more successful in reaching both the efficiency and the equity target. There is a broad range of problems where the basic principles of personal liberty, the competitive order and equity are in harmony. Thus, the competitive order is instrumental in allowing personal freedom and in contributing towards a solution to the social question. But there are problems where the basic principles are in conflict and where a balance has to be found. This problem of finding a balance is a continuous process, and the opportunity costs of solutions will become apparent only over time. Specifically, there is a wide choice

of policy instruments affecting efficiency and equity differently, such as direct price control (with a severe impact on production, see agricultural overproduction with price floors in Western Europe and underproduction with price ceilings in Eastern Europe) or a transfer policy (voucher systems) not affecting prices directly. Thus, the interdependence between the social order and production can be influenced by the type of policy instruments used.

When equity considerations are applied to economic activity, very often their long-run impact is not taken into account. Rent control seems fair at first sight; in a more detailed analysis, rent control will reduce incentives to build houses, will imply higher rents in the free market and will deteriorate the situation that one intended to improve. Lay off restraints for workers will protect those who are actually employed. But it will introduce an incentive not to hire workers because the constraint will be anticipated. Thus, the insiders are protected; the outsiders will find fewer jobs. The malfunctioning of the labour-market seems to be enhanced by a bargaining game of employers and trade unions who form an insider cartel and burden the public with the outsiders.

Equity consideration may lead to the conclusion that you protect a given sector, but over time, the sector will become less competitive, more subsidies are needed, and resources are wasted, eventually making everybody in the economy worse off. The economist is required to study the impact of equity measures, including all the

ramifications and changes in incentives, that is in a general equilibrium context. It is a fascinating question whether this proposition applies to ethical norms as well. Are ethical norms evaluated from a *prima vista* point of view or are they judged in a general equilibrium including all ramifications in a social system?

### THE SOCIAL MARKET ECONOMY – A PRAGMATIC MODEL

Developing an economic system from the drawing board should take into account the practical experience of economic systems so far. Whereas the economies in Western Europe and North America have done pretty well, the communist central planning approach has failed completely. In the “social market economy” of the German type an attempt has been made to strike a balance between the targets of equity and efficiency.

In the system’s core, the market process coordinates decentralized decisions, so that resources are guided to their most efficient uses. It is not discrete interventionism that secures the functioning of the market, but a permanent economic order including competition policy preventing an endogenous erosion of competition, a monetary system maintaining price level stability and a contract law that — to some extent — protects the potentially weaker bargaining partner. The underlying principles include a relatively far-reaching belief in self-regulation within restraints and stress the need for system conformity of policy measures when employed by

the State. Furthermore, only a strong government remains immune from specific group interests. The distribution of income that emerges as a result of the market mechanism is subject to correction by progressive taxation of the efficient and successful on the one hand and transfers to those members of society who are disadvantaged by capacity or fortune on the other hand. In the sense of the subsidiary principle, social regulation intervenes whenever an individual cannot secure a decent living by his or her own means.

#### DEVELOPING COUNTRIES AND TRANSITION TO A MARKET ECONOMY

The possibility of voting with one's feet, i.e. the possibility of free exit, is an important mechanism of controlling power. If people can move away from a given institutional setting, institutional competition will result. This consideration views the national systems of regulation and economic and social orders as country-specific, immobile factors of production that compete for complementary, internationally mobile factors like well-trained manpower and capital resources. With the rapidly growing process of diffusion of information, mutual penetration of countries via the media and decreasing costs of relocation, locational arbitrage becomes a matter of concern for national governments that now have to take into account the opportunity costs of their actions in terms of the emigration factor. It seems to be fair to conclude that institutional competition was



among the driving forces that led to the collapse of central planning in Eastern Europe. In the future, developing countries and the reform countries in the East will enter in competition with each other by redesigning their systems in a fashion that attracts the greatest share of capital inflow and new technology from the West.

The transition to a market economy is characterized by three major areas of reform: creating the institutional infrastructure, monetary stabilization and real economic adjustment on the microlevel (in the firms). Economic adjustment will imply a severe reduction in output and employment. The ex-GDR, where the institutional infrastructure and monetary stability were created instantaneously, is a case in point. Industrial production fell to one third after monetary and economic union. This was paralleled by a surge of unemployment, short-time working, commuting to the West and early retirement. With respect to sequencing, the institutional infrastructure should be established first. Monetary reform and real adjustment should not be separated too much in time; monetary stabilization can precede real adjustments, it should not follow it. I do not see options of lengthening the transition process except that some sectors may be handed over to the market at a later stage (the existing housing stock, some aspects of transportation like railroad: Siebert 1991c).

Africa, Asia and Latin America have had different experiences in their economic development. Comparing the Asian and the Latin American experience, we can draw the conclusion that the Prebisch concept of im-

port substitution and protection of infant industries has failed. Integrating a developing country into the international economy by exposing it to international competition (outward orientation) has been extremely successful.

Additionally, other conditions have to be satisfied (reducing budget deficits, not financing budget deficits with the printing press, privatizing government firms). An important condition is that industrialized countries do not close their markets nor hinder the flow of knowledge. Beyond the static gain of efficiency and consumer satisfaction due to opening up a market, countries that try to compete on the foreign market import new skills and attitudes, refine their knowledge and catch up with the more advanced and developed countries.

The developed countries can support both the developing countries and the Eastern European countries best by opening up their own markets. The damage caused by protectionism, especially in those fields where a comparative advantage for reforming and developing countries can be expected (agriculture, textiles), seems to exceed the annual amount of development aid by far. For this reason, the enforcement of liberal and multilateral trade rules in the GATT must be advocated.

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## **From a Centralized Command Economy to a Market Economy**

*Prof. Witold Trzeciakowski*

1.1. Scientists find themselves confronted in a way with questions of objectives, norms and values. The concept of rationality used in standard economics is based on a different set of objectives, norms and values than the set of values based on moral conditions and/or cooperative motivations. Economic growth (which is a value) is often (at least partially) incompatible with such other values as social justice or preservation of the national environment. The priority ranking depends upon the choice of values. In this sense economic rationality reduces the influence of moral conditions on economic behaviour.

1.2. The leaders of every country repeatedly announce the goals of economic growth, elimination of poverty, improved social services, and so on. The translation of these national goals into more operational terms, however, is far more difficult.

With these goals on the horizon, a set of policies must be pursued in order to attain more specific objectives.

In an ideal decision-making process these aims will be formulated in terms of an objective function.

We define an objective function as a rule by which to compare the values of varying degrees of the qualities of desired objectives. Its existence is necessary to choose rationally between states of the economy with a different combination of goods.

The market is a mechanism by which to aggregate the preferences of lower-level centres, and therefore the value assigned to the goods would be based upon the market prices of the goods.

However, no society is prepared to accept market preferences as sufficient. At the minimum, there is an insistence that there be considerations concerning the distribution of income among individuals. Beyond this, there are usually significant political judgements about regional distribution and specific “goods” such as education. If there is a political judgement in regard to these issues, then market price information will be an insufficient guide.

Market operations are imperfect and do not reflect the value of the resources when they are used in other ways. Therefore supplementary constraints should be imposed by the government.

1.3. Economic theory tells us about the properties of the optimal solution (in a perfect competitive market). As follows from 1.1 and 1.2, the functioning of the real market is far from the ideal model; hence the criteria of purely economic optimization (criteria of economic rationality) are often deficient. In these cases they should be supplemented with moral (ethical) criteria resulting

from a different set of values, chosen within parliamentary democratic procedures.

The choice of a specific type of the market economy system should be confirmed by the Parliament. This decision may determine the order of priority among value systems. As long as improvement of economic well-being is the preference function, the capitalist market economy seems to be the best option. However, after reaching some adequate standard of living, societies, like individual human beings, may want “to be” more than “to have”. In this sense the ethos of Solidarity may have chances of becoming superior to the criteria of economic rationality.

2.1. Each socio-economic system is operating in reality in conditions in which decisions on the production of wealth are inseparably linked with decisions on the distribution of wealth. In practice this means that the preference function maximizing production (or profit) has to be constrained by considerations of social justice determining some imposed limit on the socially admissible distribution of wealth (e.g. in the form of a system of taxation).

2.3. Assuming the predominance of an ethical point of view, the achievement of efficient results should not be reached by morally unacceptable ways, as is sometimes done. The use of such morally unacceptable ways may be forbidden by legal constraints or excluded by democratic parliamentary rules.

2.4. The existence of a free competitive market does not exclude that some of the competing firms be centrally managed. Equally, it cannot always be assumed that large centrally managed firms are superior to small enterprises. In many cases small enterprises prove to be more flexible and more efficient than the large giants (“Small is beautiful”). Internal decentralization of decisions favours human creativity and this may lead to a better economic performance than the rigid system of centralized decision-making constraining the involvement of the staff.

In order to improve the efficiency and flexibility, some large firms switched to a form of internal decentralized decision-making by partitioning the firm into smaller internal units co-operating like independent enterprises and applying the rules of “staff participation”.

3.1. Yes, if “privatization of something” is understood in a broader sense, that is not only lack of things and means, but also lack of possibilities and options (lack of things being the result of lack of possibilities).

In a developed economy the concept of poverty is strongly related to the existence of very large discrepancies in wealth in a given society, regardless of the absolute level of consumption (above the subsistence level).

Whereas in the Third World, poverty may be connected with a standard of living which is below the subsistence level.



3.2. The enormous diversity of experience of industrialization may be explained by different factors of an economic, political and cultural nature.

First — the diversity of economic management systems: from highly centralized-command systems to decentralized market-oriented economies.

Second — from privately-owned capitalist forms of ownership to State-owned forms of ownership.

Third — from totalitarian-communist political systems through autocratic forms of government to free democracies.

Fourth — the existence of profound social, cultural, religious and historical differences, traditions and ethical attitudes characterizing different nations.

Hence, the incentive-based approach alone cannot explain this diversity of experiences.

3.3. The growth prospects of the majority of indebted developing countries will remain grim as long as there is no willingness on the part of creditor countries to reduce the excessive burden of debt servicing. It is correct to support the market-oriented reforms that “get prices right” and use a strong incentive-based approach, provided a system of a social safety net is guaranteed through State intervention. All these internal measures presuppose the implementation of a tight stabilization program and a painful restructuring program, which require the patience of the society to bear hard sacrifices. All this can be assumed when the government can count upon the political support of the society.

However, all these internal measures may not suffice; what is needed is the readiness of developed countries to open the access to their internal markets for exports from developing countries. In this sense it is fair to say that we need a new international economic order to cope with the problems of the LDCs.

4. Shifting the centralized-command economy into a market economy requires:

— a tight monetary stabilization policy aimed at constraining inflation and at regaining macro-equilibrium. Here the rules of stabilization policy are similar to those applied in the West (liberalization of prices, convertibility, liquidation of subsidies, positive interest rates, etc.);

— implementing a complete restructuring of economy aimed at:

- demonopolization of production — distribution — transport in industry, agriculture and services;
- opening the domestic market to foreign competition through imports;
- adapting the ownership structure or the management system to the requirement of the market (through massive privatization and commercialization);
- creating the complex infrastructure indispensable for the smooth functioning of the market: a telecommunication network, a banking system, a functioning capital market with its institutions.

The implementation of the stabilization policy necessarily results in *immediate painful adjustments* (fall of unprofitable production, rising unemployment, cuts in incomes of the population). In principle, the speed of the process of transformation and adjustment depends upon the readiness of the society to bear the negative consequences of a temporary decrease in the standard of living or upon the existence of financial reserves (internal or external) that can amortize the shock. The case of East Germany demonstrates the last case (the existence of huge reserves).

In a situation where reserves do not exist, the society must regulate the speed of bankruptcies and the magnitude of unemployment by lengthening the transition process to admissible limits.

The restructuring process is connected with the building of new institutions that were non-existent at the start of the reform. Creating new producers or new distributors takes time. Implementing new institutions (e.g. stock exchange) requires training new specialists and also takes time. Privatization is costly and requires time in order to constrain the share of State-owned enterprises.

The above mentioned arguments prove that a “big bang” scenario is feasible *only in cases where huge capital means are at the disposal of the government*. In all other cases a complex approach should encompass:

- the reduction of the burden of servicing foreign debts;

- the inflow of credits from international organizations (IMF, WB, EBRiD, etc.);
- the promotion of foreign investment;
- perseverance in implementing a tight monetary policy and of a stabilization program;
- free access to foreign markets for exports from the indebted countries;
- the political *support* of the society for the government implementing the stabilization and restructuring program;
- the construction of a *social safety net*, capable of dealing with high unemployment.

The simultaneous fulfilment of so many tasks shows the scale of the problem.

5. Economic development in both industrialized and developing countries relies crucially on natural resources and on the productivity of natural life-supporting environmental systems. At the same time, economic growth often is accompanied by increasing pressure on natural systems and adverse effects on environmental quality. The central issue, then, is to conduct development activities in a fashion that preserves the long-term productivity of natural systems for sustained development and minimizes deterioration of natural environment.

Economic growth and environmental quality are not alternatives. Deterioration in environmental quality should not be viewed as a necessary cost of rapid economic growth. For example, deforestation and the resulting soil erosion undermine the agricultural base of

an economy and reduce long-term growth prospects (actually, deforestation which has attained very dangerous proportions, especially in Latin America — extinction of tropical forest — contributes significantly to the problem of global warming and to the consequent possibility of climatic changes). Water pollution affects human health with resultant direct losses of well-being to individuals (this probably is worth stressing — the deterioration of human health as a consequence of environmental degradation — the moral dimensions of environmental degradation). For all these reasons, the effects of development projects and programs on natural environmental systems must always be carefully analyzed.

The first paragraph of (5) puts the three following questions into a good context. But it is not so that *only* “market has unleashed powerful forces” that have acted to degrade the environment. The environmental degradation in the USSR (e.g. the death of the Aral Sea), the environmental problems of Poland (e.g. Silesia; 97% of surface water contaminated bacteriologically — this is on the scale of the whole country), Czechoslovakia, and the former GDR, all indicate that environmental degradation should *not* be attributed to the markets alone. It happened in the centrally planned economies as well. In fact, environmental degradation in these countries is one of the best proofs of the inhuman character of the political and economic systems which were dominant in the USSR and in Central and Eastern Europe after the 2<sup>nd</sup> World War. To summarize, the market as such is not

the entire source of evil. At the same time, however, there is a general agreement that market forces alone cannot take care of the environmental issue (the externalities — one of the main causes). Economic incentives, albeit very important (e.g. the polluter pays principle — the so-called PPP principle), must always be strengthened by regulation (e.g. environmental quality standards), legislation, and adequate institutional arrangements.

a) How can economic incentives be used to provide the kind of signal what will make sustainable development possible?

- Create financial preferences for enterprises stimulating their activities aiming at the protection of the environment, especially by appropriate credit policies, tax reliefs, and State subsidies.
- Create economic incentives for the establishment of enterprises specializing in the protection of the environment (planning, designing, industry manufacturing equipment for pollution control, specialized investment agencies, etc.).
- Introduce a system of payments (charges) for the use of environment (e.g. water pricing), favouring explicitly the application of those technological solutions which are efficient from the point of view of energy, water, and raw materials use (energy efficiency is a big issue in this context — refer to Poland, where more than 50 % of our environmental problems can be attributed to the use of coal: salinization of surface water by saline water from

mine dewatering operations — 7000 tons per day of pure salt is discharged into the Odra and Vistula rivers; air pollution by sulphur emissions — we are burning highly sulphurized coal — good grades are being exported).

- Improve the system of fines (penalties) for the excessive use of environmental resources. The penalty should be high enough so as to discourage environmental pollution (this is very much related to the issue of environmental standards).
- Try the systems of marketable permits (the “bubble” concept). This is an innovative idea, tested to some extent in the US, to set up a market (regionally) for pollution permits.

b) Since the power of economic incentives is certainly not inevitably channelled towards the achievement of sustainable growth, which kind of control could be suggested to achieve environmental growth?

- Good regulations and adequate institutional arrangements for their enforcement are of the utmost importance.
- Institutional build-up: the need for institutions capable of reacting quickly to changes in the economic and social situation; the need of adaptive management of environmental resources.
- Importance of environmental education: social awareness of the problem is generally low, especially in the less developed economies.
- Environmental concerns should be properly built into foreign aid packages (à propos, the World

Bank has done it in the case of the Structural Adjustment Program for Poland).

c) Which other approaches, apart from the economic incentive approach, has the economist's community to offer the policy maker to cope with the environmental issue?

- The basic premise is that a collection of already existing analytical approaches and techniques, including benefit-cost analysis, can be used to incorporate environmental quality concerns into the economic analysis of projects, programs, and development strategies. Until now, these techniques have not been used widely for economic/environmental analysis. Although there have been rapid advances in environmental and natural-resource economics and in environmental management techniques, the two strands have evolved separately. The time has come to pull the strands together and show how these techniques can assist in incorporating the dimensions of environmental quality into development planning and management.



# **Institutions, Development, Environment**

*Prof. Hirofumi Uzawa*

## I. INTRODUCTION

In his historic 1891 Encyclical *Rerum Novarum*, Pope Leo XIII addressed himself to the most pressing problems of the times — the abuses of capitalism and the illusions of socialism. He called the attention of the world to the “misery and wretchedness pressing so unjustly on the majority of the working class”, and condemned the abuses of liberal capitalism, particularly the greed of the capitalist class. At the same time, he vigorously criticized the illusions of socialism, chiefly on the ground that private property is a natural right indispensable for the pursuit of individual freedom. Exactly one hundred years after *Rerum Novarum*, the problems which plague the world are the abuses of socialism and the illusions of capitalism.

Contrary to the classic Marxist scenario of the transition of capitalism to socialism, the world is now faced with the entirely different problem of how to transform smoothly a socialist economy into a capitalist economy. In order for such a transformation to result in a stable, well-balanced society, we have to be explicitly aware of the shortcomings of the decentralized market system as

well as the deficiencies of the centralized planned economy.

The centralized planned economy has been plagued by the enormous power which has been exclusively possessed by the State and which has been arbitrarily exercised. The degree of freedom bestowed upon the average citizen has been held at the minimum, while human dignity and professional ethics have not been properly respected. The experiences of socialist countries during the last several decades have clearly shown that the economic plans, both centralized and decentralized, which have been conceived by the government bureaucracy, have been inevitably found untenable either because of technological deficiencies or in terms of incentive incompatibility. The living standard of the average person has fallen far short of the expectations, and the dreams and aspirations of the majority of the people have been left unfulfilled.

On the other hand, the decentralized market economy has suffered from the perpetual tendency toward an unequal income distribution, unless significant remedial measures are taken, and from the volatile fluctuations in price and demand conditions, under which the maintenance of productive ethics has been found to be extremely difficult. Profit motives often outrun moral, social, and natural constraints, while speculative motives tend to dominate productive motives, unless proper regulatory measures are administered.

We may now have to search for an economic system in which stable, harmonious processes of economic de-

velopment may be realized with the maximum degree of individual freedom and due respect to human dignity and professional ethics. I may term such an economic system *institutionalism*, to emphasize that it is not defined in terms of a certain unified principle, but rather that the structural characteristics of an institutionalist economy are determined by the interplay of moral, social, cultural, and natural conditions inherent in the society, and that they change as the process of economic development evolves and social consciousness correspondingly transforms itself. It explicitly denies the Marxist doctrine that the social relations of production and labour determine the basic tenure of the moral, social, and cultural conditions of the society in question. Adam Smith emphasized several times in his *Wealth of Nations* that the design of an economic system conceived of purely in terms of logical consistency inevitably is in contradiction with the diverse, basic nature of human being, and instead he chose to advocate the merits of an economic system evolved through the democratic processes of social and political development. It is in this Smithian sense that I should like to address myself to the problems of the restoration of market economies in Eastern and Central European socialist countries and their possible integration into a Greater Europe.

## 2. INSTITUTIONALISM AND SOCIAL OVERHEAD CAPITAL

Institutionalism is characterized by the concept of social overhead capital and by the nature of social insti-

tutions which manage various social overhead capital facilities.

In an institutionalist economy, all the scarce resources which are limitational in the processes of production and consumption are classified into two categories — social overhead capital and private capital. Social overhead capital comprises those scarce resources that are not privately appropriated, but held as common property resources, to be managed by social institutions of various kinds. Private capital, on the other hand, consists of privately owned or managed scarce resources, of which the ownership rights are transacted in the market. The criteria by which scarce resources are classified into these two categories are not necessarily technological, but rather social and cultural, depending upon the nature of the functions they perform in relation to the fulfilment of the minimum standard of living for the average citizen.

Natural environments such as atmosphere, soil, water, forests, rivers and oceans are important constituents of social overhead capital; so are social infrastructures such as roads, bridges, public transportation systems, communication systems, medical, educational and cultural institutions, and administrative systems.

Scarce resources are classified as social overhead capital when the social consensus is attained that the services derived from them play a crucial role in order for the average citizen to be able to enjoy the minimum, but still human, properly dignified, life. Each type of social overhead capital is to be managed by an autono-

mous institution, which is subject to professional codes of ethics in deciding how to maintain the social overhead capital in charge and how to distribute the services derived from it. This does not necessarily mean that services derived from social overhead capital are freely distributed to the members of the society, nor does it imply that each autonomous institution in charge of social overhead capital is in financial equilibrium. Indeed, the aggregate of the current expenditures of all these institutions is nothing but the current government expenditures, while the aggregate of investments expenditures is the governmental capital formation.

It should be emphasized that the way in which the management of social overhead capital is entrusted to each autonomous institution is fiduciary. If social overhead capital is efficiently and equitably managed, the level of the minimum income which would be required for the average person to maintain the minimum, but still dignified, standard of living will be the lowest possible, thus implying the intrinsic stability of the distribution of real income.

In an institutionalist economy, every citizen is accorded a maximum degree of freedom, constrained only by the moral and ethical codes of behaviour, while the power bestowed upon the government is held to the minimum, largely consisting of the fiduciary functions for the management of social overhead capital.

The processes by which scarce resources are designated as social overhead capital to be fiduciarily managed by autonomous social institutions are necessarily

political. However, the economist has to play a pivotal role in the assessment of the functions of various scarce resources in terms of their effect upon the stability, equity, and efficiency of the allocative mechanism.

It may be noted that private capital and produced outputs are in principle to be transacted in the perfectly competitive market. On each product is levied an excise tax corresponding to the extent of the marginal social costs incurred by its production and use. The network of social overhead capital serves as the environment in which all the social and private activities of the members of the society are conducted. The economic activities are centered around the market system, and the stability, equity, and efficiency of the market mechanism crucially hinge upon the structure of social overhead capital and the way in which services from social overhead capital are distributed among the members of the society. Thus if a group of countries having diverse social overhead capital structures are united to form a common market, a distortion may occur in the processes of resource allocation even in the perfectly competitive situation.

I should like to emphasize that the role of the State is not to control and govern the people, but rather to maintain and put order into the management of social overhead capital, which is fiducially entrusted by the people.

### 3. ECONOMIC GROWTH AND ENVIRONMENTAL DEGRADATION

Economic growth is typically defined as a sustained growth in real national product or in related aggregative statistical indices. However, for example, growth in the per capita level of real national income does not necessarily mean that the level of the standard of living or the degree of satisfaction the average individual enjoys is improving at the same rate as the rate of increase in per capita national income. This is particularly the case when a disruption of natural environments accompanies the process of economic growth, as has been the case with the processes of post-war economic development in many countries, both capitalist and socialist.

Natural environments constitute an important part of social overhead capital. The real level of the standard of living or the degree of satisfaction is influenced by the quality and quantity of social overhead capital, as well as by the per capita level of real national income. Indeed, those scarce resources that play an indispensable role in producing the services required in maintaining the minimum, but still human, standard of living are likely to be designated as social overhead capital, and accordingly the elasticities of the real level of the standard of living with respect to various social overhead capitals are high. This is particularly the case with natural environments, and, if the process of economic growth involves the degradation of natural environments, the rate of increase in the real level of the standard of living would be significantly lower than the rate at which the per capita

level of real national income is increasing. Depletion of social overhead capital, particularly degradation of natural environments, implies not only a worsening of the welfare of the current generation, but it also affects the welfare of all the future generations. In order to ensure the pattern of economic growth which is optimal from a social point of view, it is necessary to obtain the optimum balance between the increase in per capita national income and the resulting degradation of social overhead capital, particularly of natural environments.

The optimum balance between economic growth, as defined in terms of the increase in per capita real national income, and the degree of degradation of social overhead capital, particularly of natural environments, may be obtained by applying the concept of imputed price associated with social overhead capital. The imputed price of a particular type of social overhead capital measures the extent to which the marginal decrease in the stock of social overhead capital is conducive to the decrease in the real level of the standard of living for the entire future. The concept of imputed price also takes into account the equity aspect of the allocative mechanism, not only between current and future generations, but also between the individuals or countries involved.

Within the framework of an institutionalist economy, when each economic activity is levied, by the autonomous social institutions in charge of social overhead capital, for the amounts evaluated at the imputed prices of social overhead capital which are degraded by such



an activity, then the economy will be able to sustain the path of the optimum balance between economic growth measured in the narrow sense and the degradation of social overhead capital, particularly of natural environments.

In the actual calculation of imputed prices for various social overhead capital projects where the equity aspect of the resulting pattern of resource allocation is explicitly taken into consideration, however, one would have to be satisfied with obtaining approximated values. I should like to refer to an illustrative example with regard to the problem resulting from the anthropogenic concentration of radiative forcing agents in the atmosphere, as reported in a recent paper of mine, "Global Warming Initiatives: The Pacific Rim", in *Global Warming: The Problem and Economic Policy Responses*, edited by R. Dornbusch and J. Poterba (MIT Press, 1991).

The atmospheric concentration of radiative forcing agents, in particular carbon dioxide, methane, nitrous oxide, and chlorofluorocarbons (CFCs), has significantly increased since the times of the Industrial Revolution, resulting in a drastic increase in the global average surface air temperature. It is estimated that if the current trend were to continue, the global average surface air temperature would be increased by 2°C from the pre-industrial level within fifty years. The increase in the global average surface air temperature the earth has experienced in the period of 18,000 years, since the last ice age to the times of the Industrial Revolution, was about 1°C.

The phenomenon of global warming is largely of anthropogenic origin, particularly due to the combustion of fossil fuels and the depletion of terrestrial forests, particularly of tropical rain forests. The magnitudes of imputed prices of carbon dioxide and terrestrial forests make the values quite different from those obtained within the traditional theory of imputation where only the efficiency aspect of the allocative mechanism is taken into consideration. The estimates I have obtained in the paper referred to above are based upon the method of imputation where the ratios of the imputed prices of carbon dioxide and terrestrial forests over the per capita level of national income are identical between the countries involved. Thus the imputed price of carbon dioxide in the United States and Japan both is \$ 30 per metric ton of the carbon content, while it is \$ 1.00 for the Philippines and \$ 3.00 for Brazil. As for terrestrial forests, the imputed price in the United States and Japan both is \$ 3,000 per hectare, while it is \$ 300 For the Philippines and \$ 900 for Brazil.

The optimum pattern of the allocation of scarce resources, including social overhead capital, will ensue when each economic activity is levied for the amounts evaluated at the imputed prices for the degradation of social overhead capital, while privately owned or managed scarce resources are transacted in the perfectly competitive market.

#### 4. RATIONALITY, ETHICS, AND SOCIAL COOPERATION

The concept of rationality is the corner-stone upon which the construct of standard, neoclassical economic theory has been made possible. Rationality is defined firstly by the fact that each economic individual possesses a certain value judgement, typically seen in terms of a preference ordering over the set of all conceivable patterns of final consumption, in itself independent of the economic behaviour of other members of the same society where the individual concerned resides. Secondly, it means that each individual chooses an economic behaviour, among all feasible choices, which will result in that State with the maximum degree of satisfaction in terms of his or her value judgement.

The concept of rationality thus defined is based upon the implicit assumption that the degree of satisfaction each economic individual obtains is solely determined by the outcome of his or her economic behaviour, to be represented by the pattern of final consumption he or she would enjoy, independently of the moral, social, cultural, or natural implications the choice of such an economic behaviour would yield. One could argue that a proper modification of the standard theory of value would take into account such moral, social, cultural, or natural implications. Namely, when preference orderings or utility functions may be so modified as to include as the basic variables the magnitude of the psychological and moral impacts each individual receives in connection with the outcome of his or her economic behaviour. However, such modifications would alter the

basic theoretical framework to such an extent that an important portion of value theory and welfare economics would no longer remain valid. Particularly, propositions concerning the welfare implications of the allocative mechanism through the market apparatus need to be substantially altered and the social assessment of the economic institutions such as market economy may have to take into account explicitly the moral, social, cultural, and natural implications of the economic behaviour chosen by individual members of the society.

The above observation suggests that we may have to seek a substantial change in the basic premises of the standard theory of value. The value judgement now has to be defined not only with reference to the pattern of final consumption available to each individual, but also with explicit reference to the choice of economic behaviour and the moral, social, cultural, and natural implications a particular choice of economic behaviour yields. The patterns of the allocation of scarce resources are then assessed in terms of the balance between the resulting outputs of various commodities for final consumption and the moral, social, cultural, and natural impediments in the productive and distributive processes.

In a decentralized market economy, each economic unit seeks the maximum degree of personal satisfaction or the maximum profits among feasible choices. In particular, each business firm tries to allocate factors of production under its control in such a manner that the resulting profits are maximized, within the boundary constrained by legal, ethical, and habitual codes of be-

haviour. Workers employed by business firms are then presumed to allocate their labour according to the patterns dictated by management, where the moral considerations and cultural propensities are not duly respected in the normal circumstances.

In order to illustrate the theme I am pronouncing, I should like to cite an episode which I myself experienced in the 60s when I used to teach at the University of Chicago where the new conservatism was burgeoning. It was just a week or two before the 1965 devaluation of the British pound. Everyone knew that the devaluation was imminent, except for the exact rate of devaluation. One day, an eminent colleague of mine came in, visibly upset by an incident he had just experienced. He told us that he went to the Continental Bank of Illinois, then the largest bank in the State of Illinois, and asked the international desk to sell the British pounds short in a substantial amount. The desk replied to him saying that “No. We don’t do that, because we are gentlemen”. The professor was almost indignant because he believed that, in a capitalistic society, the definition of a gentleman was one who seeks for a profit whenever it is available. The Continental Bank was one of the finest banks in the United States, strictly obeying monetary discipline and prudently avoiding being involved in undertakings of a speculative, unethical nature. However, the bank was apparently heavily engaged in speculative selling of the dollar in the Tokyo foreign exchange market in August 1971, when other foreign exchange markets were all closed down after the an-

nouncement of the New Economic Policy by President Nixon. The bank then began rapidly to expand its speculative operations, until, in May 1984, it was virtually bankrupt because of the spectacular failure in its speculative transactions.

Banking institutions are business enterprises operating under the rules of a decentralized market economy, and, as such, sufficient profits have to be generated in order for them to remain solvent financial entities. Yet, not only are they subject to legal, cultural, and habitual constraints, but also ethical considerations and social concerns have to play an important role in the choice of economic behaviour. Such ethical and social considerations, to a significant extent, take the form of professional codes of ethics, either explicitly or implicitly formulated. Thus banking institutions are subject to monetary discipline, while medical institutions have to obey strictly professional codes of behaviour, written or unwritten, if I cite a notable example.

Some economists argue that, if an economic institution were to violate professional codes of ethics, it would, in the long run, be punished by the market, as indicated by the example cited above. I disagree with this observation on the ground that the reprimand by the market may not work out as expected and, even if it works out, the disturbances experienced during the transient period may be substantial.

## 5. POVERTY AMID “ECONOMIC PROSPERITY”

Poverty in a developed country may be defined as follows: We first define the minimum income as the minimum expenditure required for the average individual to maintain the minimum level of a standard of living. The minimum level of a standard of living is the level below which it is difficult for a person (including those whose livelihood he or she is supporting) to maintain life with human dignity. Poverty is the state when one's income is below the level of the minimum income thus defined.

This definition may sound strange, but, in a country like Japan which apparently seems to be enjoying economic prosperity, poverty in this sense prevails. The level of the minimum income in Japan is extremely high, since a substantial portion of essential goods and services, natural environments, and social amenities are either almost impossible to obtain or they are priced at extravagant levels. At the same time, governmental policies in the last three decades have resulted in the serious degradation of both natural and social environments, following upon the extreme degree of inequality in the distribution of real income, as analyzed in a number of recently published studies. (I may just quote a study of mine, *Poverty amid “Economic Prosperity”*, Tokyo: Iwanami Shoten, 1990.)

## 6. INSTITUTIONALISM AND MARKET ECONOMY

The processes of resource allocation in a market system are closely related to the institutional arrangements within which it works. A particularly important role is played by the structure of social overhead capital and by the way the services derived from social overhead capital are distributed among the members of the society.

As indicated in Section 2 above, public transportation systems, communication systems, educational, medical, and cultural institutions, monetary and financial institutions, as well as administrative systems, constitute important components of social overhead capital, and they are crucial determinants for the stability of the market mechanism and the optimality of the resulting resource allocation. One of the economic criteria by which scarce resources are classified as social overhead capital is that the elasticities, with respect to the minimum level of a standard of living, are close to zero, and if the scarcity of this social overhead capital, relative to the endowment of private capital, is increased, the prices of those goods and services that are indispensable for the maintenance of the minimum standard of living will become higher, resulting in an increase in the level of the *minimum income*. The distribution of real income then becomes more unstable and the percentage of those who are not able to earn enough income to sustain the minimum level of a standard of living will be increased.

In order for the existing stock of social overhead capital to be efficiently utilized, the price corresponding to the marginal social cost has to be charged for the use of



each type of social overhead capital. Each society then has to maintain the stock of social overhead capital in such a manner that the magnitude of marginal social costs remains below a certain critical level, thus ensuring the stability of the market mechanism and the dynamic optimality of resource allocation.

The introduction of a market system in a socialist country may now be discussed within the theoretical framework of institutionalism. A purely centralized socialist country may be regarded as an extreme form of an institutional economy where all scarce resources are classified as social overhead capital and the allocation of scarce resources, including labour, is dictated by the State authorities. Most of the Eastern and Central Socialist Countries naturally have not been purely centralized socialist countries. However, the major implications of the introduction of a market system may be discussed within the context of such a purely socialist economy. On the other hand, the performance of capitalist countries has been crucially dependent upon the nature of social overhead capital. The relatively excellent performance of West Germany and Japan during the 1980s may be attributed to the well-balanced structure of social overhead capital these two countries have succeeded in maintaining, while the poor performance of the United States seems to me to be due to the degradation of the social overhead capital structure, particularly since the end of the 1960s.

Thus, the introduction of a market system in a socialist country has to be done in such a manner that the

structure of social overhead capital ensures the stability of the market mechanism and the dynamic optimality of resource allocation in the institutionalist economy evolved.

Among the most important constituents of social overhead capital necessary to ensure the proper working of the market mechanism are public transportation systems, communication systems, educational, medical, and cultural institutions, as well as fiscal and monetary institutions. The proper maintenance of these social infrastructures is indispensable in order for the allocative mechanism in any market economy to yield a dynamically efficient pattern of resource allocation and a stable distribution of real income. The prices to be charged for the services of these infrastructures are evaluated at the marginal social costs incurred by the use of such services. The revenues of the social institutions in charge of these infrastructures do not necessarily match the costs, both current and capital, they incur with respect to the maintenance of these infrastructures and the rendering of the services derived from them. In general, the larger the social evaluation of the services rendered by each type of social infrastructure, the larger will be the deficit incurred by the social institution in charge.

There is another category of social overhead capital which plays a crucial role in the stable maintenance of the allocative mechanism. It is related to the production and distribution of basic foodstuffs. In the productive activities in the agricultural sector of the society, some of the factors of production, such as land cultivation

and husbandry techniques, distribution systems, and natural environments are better classified as social overhead capital to be fiducially managed by autonomous institutions in order to ensure adequate and stable provision of basic foodstuffs. This does not mean that the modes of production in the agricultural sector are either nationalized or collective organizations, nor does it imply that those who are engaged in the agricultural sector are coerced to do their work. The financial and institutional arrangements have to be devised in such a manner that the productive and distributive organizations are so set up that they are compatible with private incentives and, at the same time, that the adequate and stable supply of basic foodstuffs is maintained.

When a group of countries having diverse structures of social overhead capital get together to form a common market, it should be emphasized that proper policy measures have to be adopted to counter inefficient price fluctuations and volatile changes in the production of basic foodstuffs which occur as the result of differences in the structure of social overhead capital between the countries involved. At the same time, investment in social overhead capital in each country is so arranged that differences in the structure of social overhead capital among countries would gradually disappear. The efficiency function of the market system then would be fully realized, without having an undesirable effect upon the distribution of real income.

It should be noted, however, that the transactions based largely upon speculative motives should be cur-

tailed as effectively as feasible. The experiences China had during the process of introducing the market system into the otherwise centralized society, at the beginning of the 1980s, have taught us that, if speculative motives dominate the choice of economic activities, the allocative function of the market system will not work properly, occasionally with disastrous implications for the processes of resource allocation and income distribution for the society as a whole. In the absence of efficient distribution and transportation systems, the speculative hoarding of basic foodstuffs had been increased and the price movement became volatile, with an extremely unstable pattern of real income distribution and the spread of political unrest in the cities. The disruption of economic activities and the political unrest resulting from it finally threatened the legitimacy of the central power structure, with the tragic end of the brief period of the democratization in China.

The Chinese experiences during the same period also teach us another lesson on the privatization of land tenure. The gigantic structure of the peoples' communes was abruptly dismantled to be replaced by the system of bidding on land tenure, with, however, the political control by the Party apparatus kept intact. The members of the Communist Party, or those associated with them, came to have exclusive possession of the land tenure which had previously been controlled by the peoples' communes or similar organizations, and the majority of rural people had to become hired labourers, with extremely low wages. On the other hand, the introduction

of the market mechanism in the land ownership in a previously socialist country would involve processes which would seem to be unsurmountable; namely, the processes of dividing between the people the land ownership or tenure which previously had been collectively controlled. At the same time, the system of allocating land ownership or tenure through the market mechanism would involve a significant degree of disturbance due to the speculative motives. It would be more desirable, both from the view points of the efficiency and equity of the allocative mechanism, to classify land as social overhead capital and to set up autonomous institutions to which the management and allocation of land tenure would be fiducially entrusted.

I should like to conclude my paper with a brief remark on the role of the central banking system. The central banking system provides each country with the institutional framework within which not only the efficient and stable working of the monetary and financial systems is ensured, but also all the economic, social, and cultural activities of the society are smoothly organized. Thus the central banking system may be regarded as an important component of social overhead capital in each country, and the management of the central banking system has to be discretely and prudently organized so that the stability of the whole society is not disturbed. It involves a political process in the genuine sense of the word and seems to be primarily dedicated to preserving the economic and social welfare of the country concerned, with due respect to the interests of all the coun-

tries involved. The concept of a unified, common central banking system for a group of countries would work well only if the countries involved have similar social overhead capital structures or appropriate measures are adopted to nullify the disturbances which would arise out of differences in the structures of social overhead capital between the countries involved.

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