11. Markets and Justice: An Economist's Perspective

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INTRODUCTION
The interaction between moral philosophy and economics has a long history; many have worked in both fields and welfare economics is to a large extent an applied branch of moral philosophy. For a number of years this interaction lay dormant as economists unselfconsciously accepted Pareto optimality in their rigorous work (with a nod in the direction of a social welfare function) and relied on a rough-and-ready version of utilitarianism (cost-benefit analysis) in their applied work. Historically, the primary reason for this reliance on Pareto optimality was that it appeared to be the residual ethical assumption available to those economists who wished to keep their roots in utilitarianism but also had accepted the program of the positivists with its insistence that cardinal utility and interpersonal comparisons be outlawed.1

With the revival of a strong public and policy interest in issues of poverty and redistribution in the 1960s, economists began to search for theoretical frameworks in which to discuss them. The work of Mirlees and Rawls further spurred the interest of economists in issues of justice: Mirlees’s seminal paper explored the optimal income tax in hopes of defending progressive taxation even while taking incentive questions explicitly into account;2 Rawls’s book A Theory of Justice used categories and modes of analysis that economists found congenial. Also, the renewed
interest of philosophers in public policy issues has brought an increase in their conversation with economists. These days we see a new journal, *Economics and Philosophy*, alongside *Philosophy and Public Affairs*. The economics profession has certainly rewarded those who have done substantive work on justice and markets, as is shown by the awarding of Nobel Prizes to Samuelson, Arrow, Hayek, Friedman and Buchanan. ⁴

Most of the discussion in economics continues to draw on the two classic theorems of welfare economics. First, what is now regarded as the Adam Smith theorem, that a perfectly competitive equilibrium is Pareto optimal (sometimes called Pareto efficient); and second, that any Pareto-optimal outcome can be achieved by lump-sum taxes and transfers (that is, their payment or receipt does not depend on the individual's behavior) and the use of markets to achieve a competitive equilibrium.

The applicability of the first theorem has been the subject of much debate. Discussion has centered on those conditions when a competitive equilibrium fails to develop (for example, economies of scale) or when a competitive equilibrium might still not be Pareto optimal (possibly, because of externalities). While the first theorem guarantees that competitive markets will lead to an efficient outcome, this outcome need not be a just one. Many economists would argue that it depends on the ownership of the initial endowments: If the initial distribution of inputs is fair, then the results of the market are fair. ⁴

It is the second theorem that has formed much of the basis of the discussion of distributive justice and markets. A just allocation that maximizes a Bergson-Samuelson individualistic social welfare function can be achieved by the use of lump-sum taxes and transfers, then relying on the market to reach a competitive equilibrium. This theorem has provided a justification for separating distributional and efficiency issues as well as the theoretical justification for market socialism. While its purpose is to convince economists, this is hardly the sort of result that will lead anyone to the barricades.

Recently, work on incentives and information has dominated economic theory. This work has had important implications on how we view the possibility of using markets to achieve justice and so we shall devote a good part of this chapter to its analysis.

Even though the interest of economists in discussions of jus-
tice is growing, I believe that Baumol is correct when he argues that most economists do not want to get involved in this matter because they are uncomfortable with having uniquely to define justice, are afraid of imposing their own values, and have had difficulty finding an appropriate analytical mechanism. This has become less true. Economists were able to avoid these issues earlier partly because they eschewed discussions of distributional issues. In the 1960s and 1970s, when questions of income distribution became paramount in both policy and academic discussion, it became clear that answering many of the important questions of income distribution and taxation required some criteria of justice.

It is difficult even to summarize the vast amount of work that has been done in this field. It has yielded important new insights and added a new subtlety to the debate. I make no claim for comprehensiveness; the issues discussed are those that I am interested in and that I believe may not be well known to legal and political philosophers—in particular, I have omitted any substantive discussion of the works of Hayek and Buchanan.

The first section of the chapter will review the standard work on the two theorems of welfare economics and then look at the optimal tax literature's exploration of the difficulties of implementation raised by incentive, informational, and strategic issues (especially the differential information available to the government and its citizens). We then examine some alternative criteria (versions of fairness as a lack of envy) that do not rely on interpersonal utility comparisons but often do utilize markets for their implementation: This will highlight some of the profound difficulties in implementing utopian theories of justice.

The last sections focus on some issues that have arisen in the 1980s (in fact, most of them were raised in articles that I read for other purposes while preparing this review) that are important to any consideration of justice, be it utopian or realistic. I first look at some of the empirical data on incentives. Here, the data are certainly more encouraging to those who would minimize the relevance of disincentive effects than conventional wisdom had it at the beginning of the 1980s. We also look at revisionist views of inheritance and savings that should inform a theory of justice. The last section on the internal economy
considers questions of aid, trade, and immigration that raise many disturbing problems for radical advocates of justice as well as for defenders of free markets.

**The Welfare Theorems**

Much of the debate on the relation of markets to justice revolves around a defense, attack, or modification of the fundamental theorems of welfare economics. It might first be useful to sketch the standard welfare theorems. The more widely known result, taught in all economic theory courses, is that markets are efficient because a perfectly competitive equilibrium is Pareto optimal (that is, that no person can be made better off without making someone else worse off). A second theorem, less well known, but one, as we shall see, central to the analysis of the relation of markets to justice, states that any Pareto-optimal allocation can be reached by a competitive market equilibrium after appropriate lump-sum taxes and transfers.

The assumptions required to prove these theorems are well known and their validity is controversial. The assumptions required for the first are usually viewed as minimal: a competitive equilibrium (fixed prices, supply equal to demand in all markets, and maximization of profits and utility), a full set of markets, and perfect information. Behind these assumptions lies some additional structure. The assumption of a full set of markets requires a market for property rights (the lack of which creates externalities). Also, to incorporate intertemporal choice and uncertainty there needs to be a competitive market for each commodity in each time period and for each outcome of the world, so that bread this year and next year is distinguished, and bread next year if the Republicans win is distinguished from bread next year if the Democrats win. The second theorem has similar requirements for its validity, but also requires additional assumptions about the concavity of preferences and production sets.

The argument between critics and defenders of the usefulness of the first theorem can best be described as a series of ritualized thrusts and counterthrusts. A standard argument is that the presence of government, externalities (without property rights), the absence of the necessary markets, and noncom-
petitive influences would greatly limit the applicability of the result. When these conditions obtain, second-best theory is used. Now the goal is to achieve an optimum given an additional constraint—so, for example, where there are governmental as well as private participants the government can choose the optimal level of expenditures to produce public goods and then raise taxes in the least distortionary manner.

A competitive equilibrium assumes that all markets clear. Where is macroeconomics with its inflation and depressions? Once again some recent theories try to demonstrate the optimality of cycles with theories about the voluntary nature of unemployment—so, for example, unemployment is higher in depressions because workers choose to work less when their wages are lower than in good times. The persistence of high unemployment rates in Europe as well as the recent crash in the stock market has raised serious questions about theories that assume market clearance.

Another objection, the focus of much recent work, is the possibility of asymmetric and incomplete information that leads to the problems of moral hazard and adverse selection. As will appear, these issues become even more important in any implementation of the second theorem, since that requires lump-sum taxes and transfers that differ among people.

The first theorem says nothing about end-state notions of fairness or justice of the competitive equilibrium—it simply gives us the minimal result that no further gains can be exploited by production or trade. The second theorem that any Pareto-optimal outcome can be achieved by the use of markets and lump-sum taxes and transfers is important to our understanding of justice and markets. Assume that the goals of justice can be expressed as maximizing a function that depends on each individual’s utility, as would be the case with utilitarianism, (with each individual's utility function depending only on the goods received). At the maximum it must be Pareto optimal, for otherwise we could increase the value of the function by making someone better off without making someone else worse off. We know from the second theorem that with appropriate lump-sum transfers and competitive markets we can achieve this Pareto-optimal point and so maximize the function.7

These results have given comfort to economists from a variety
of schools. Conservative economists can argue for the separation of efficiency and equity considerations: We can rely on the market to make the correct efficiency judgements, while in principle allowing someone else to make the distributional ones. In addition, they contend that the assumptions of the competitive model are approximated well enough in the real world so that we can rely on the market.

This theorem has also been used to justify a form of market socialism where the state distributes lump-sum amounts and also sets the market prices. To do this the state has to know each person's preferences and initial endowment as well as the production sets. Advocates of a command economy can also build on this result, and ask why, given that all of this information is available to it, the state does not bypass the market and just redistribute the final optimal equilibrium quantities of goods to each consumer.

Although much of the discussion of these theorems is highly abstract with assumptions that are unlikely to be met, it has served as the basis for many of the later developments to which we now turn.

INCENTIVES, INFORMATIONAL AND STRATEGIC ISSUES

We have already mentioned strategic behavior as a problem in achieving social goals, but in recent years in economic theory it has moved from being a caveat to general results to being analyzed as a primary force in economic behavior. Much of the discussion was foreshadowed by J. de V. Graff thirty years ago: “It is clear that truly lump-sum measures are extraordinarily hard to devise. A poll-tax, of course, meets all the requirements; but it is not very helpful in securing desired redistributions unless we tax different men differently. But on what criteria should we discriminate between different men? . . . If we tax able men more than dunderheads, we open the door to all forms of falsification: we make stupidity seem profitable—and any able man can make himself seem stupid.” The trouble is that the state does not have all of the information that it needs to achieve its goals. In this section we will show that the disincentive to reveal relevant information can lead to differential information on the part of the state and its citizens and can then have a profound effect on the rules that we choose.
Although these issues have dominated all branches of economic theory as of late, it seems best to illustrate them in the context of redistributive taxation, since the problems of implementation here are akin to those of most end-state theories of justice. A perusal of the literature shows that the seminal paper is by Mirlees, who moved us away from just making comments on the need to worry about the impact of redistribution on incentives to creating a rigorous model.

To highlight these issues they are examined in the context of utilitarianism. We know that the assumptions of identical utility functions with decreasing marginal utility, a fixed quantity of goods to be distributed, and maximizing the sum of interpersonal utility yield an outcome that requires equality. Also well known is that when the total amount to be distributed depends on the amount of work done, then this result must be modified to take incentives into the account. More recent work highlights even more subtle issues when there is differential information.

Some of the issues can be illustrated in a fairly simple model with two workers whose diminishing marginal utility functions are identical and are positive functions of consumption and leisure, and who differ only in their productivity. While the state knows the common utility function, in each of these examples it has differing amounts of information about the worker's ability, ranging from knowing each person's ability, to only knowing the underlying distribution of abilities. Here it is important to include leisure (which cannot be traded), since its taxation has been the major source of problems in analyzing optimal taxation.

If each individual maximized her own utility, then the more productive would have a higher utility. If the government has complete information as to who is in which group and can tax and subsidize them in a way such that their labor supply does not affect the tax paid (that is, a lump-sum tax), then the outcome using the utilitarian criterion radically diverges from that based on the individualistic criterion. The more productive workers now get a lower level of utility than the less productive; they work harder to subsidize the less able.

Once we make the realistic assumption that before imposing the tax-transfer scheme the government does not know which of the workers is more productive and has only information on their income, then it can't tell if the low-income workers are less
productive or are high-productivity workers who choose more leisure. Now the state cannot use differential lump-sum taxes based on ability, and the issues of self-selection and incentive compatibility also enter; high-productivity workers will have an incentive to become low-productivity workers to raise their utility. The goal then becomes to design schemes so that at the end both high- and low-productivity workers work appropriately hard. Now the results change and higher-productivity workers have a higher utility level than when the government had complete information, though lower, because they are subsidizing low-productivity workers, than before any government intervention.

If the government can monitor income and hours (giving it a measure of revealed skill), then the optimal solution changes again and becomes one of equal utility.

The analysis also alters if we allow for somewhat different models. For example, if we recognize that those on whom the tax is initially levied need not bear its full impact if pretax wages change, we can get the even more surprising result that the marginal tax on the highest-ability group (in this case, skilled labor) should be negative. The optimal tax also changes if in addition to assuming that workers have different productivities in working in the market we recognize that people may differ in their ability to generate utility when combining consumption goods with time not spent at market work (for example, listening to records). If those who are more productive at market work are also the more productive in their use of nonmarket time, then the utilitarian framework requires that they should be given more of the consumption good.

The optimal tax also changes if we allow for a different type of tax system—say, that we allow for random taxation. For example, if high-productivity workers are risk-averse then the random taxation of low-productivity workers will reduce the temptation for high-productivity workers to appear as low-productivity workers, since they then could fall quite far.

The conclusions that we are forced to draw from this analysis are highly pessimistic about the possibilities of developing rules for end-state theories of justice. We see that even if we are willing to accept an ethical goal, which might seem the most problematical part, the rules we choose will not only be a func-
tion of the model of the economy but will also be highly dependent on the amount of information and tools that the government has available.

Still another set of problems is typically ignored by utopian theorists as merely technical issues to be left to bureaucrats, yet their solution can in fact have radically different effects on the functioning of the system. Thus, whether we consider the welfare of the individual or the family, or a lifetime versus a single year of welfare, can make a great difference. People's behavior may well depend on the definition of welfare. Effort will go into activities that are more favored. So, for example, once a distinction is made between ordinary income and capital gains with the latter taxed at lower rates, then we find that much of the tax code is devoted to defining this distinction as lawyers and accountants try to convert ordinary income to capital gains. An even more striking outcome results when families split or unite depending on the detailed provisions of the tax and welfare system.

In general, it would make most sense to build our theories on the assumption that information that can be hidden will be hidden. Even if we begin with a society with a high sense of compliance to truth, one “chiseler,” unless deterred by Draconian means, often leads others to do likewise. In this respect, one need only notice the erosion of compliance with the U.S. income tax as people began to expect others to behave in a similar manner.

Of course, we can continue to get more and more information about people, but not only does this use up resources, it might lead to the “Machlup result.” Machlup used to play a game called exchange control with graduate students in his international trade seminar. One half of the class were businessmen who wished to get their money out of a country with exchange controls, while the other half were the government which tried to prevent it. The game always ended the same way—with a totalitarian state.

**Envy, Equity, and Fairness**

One of the most interesting attempts by economists to deal with these issues stems from the work on envy and fairness.\(^{11}\) It lies
in the mainstream of traditional economics: interpersonal utility comparisons are avoided and competitive markets continue to play a major role in finding the desired solutions. It has now become apparent that many of the goals of this research program are not likely to be achieved, but by appraising it we can see the kinds of difficulties that economists face when they analyze questions of justice.

Conceptually, the use of fairness comes from the classical solution of the problem of the fair division of a cake between two people—one person cuts and the other chooses. This notion was then generalized so that a lack of envy means that A did not prefer B's bundle of commodities (in this case, his slice of cake) to her own. Note that no interpersonal utility comparisons are made since each person compares her valuation of her bundle to the other's bundle, and not the other's utility. Although terminology has varied widely, absence of envy will be called an equitable outcome. When a fixed bundle of goods is to be divided the simplest equitable solution is an equal distribution of each of the goods, but when tastes differ the division might not be Pareto optimal. Much of the work in this area has been a search for outcomes that are fair, that is, both equitable and Pareto optimal.

A simple way to find fair outcomes might appear at first to start with an equal distribution and then let people trade. This process need not achieve fairness. For example, if there are three people (A, B, and C) and two (A and B) have the same tastes and only one (A) can trade with (C), then the other (B) will envy (A).

How can we achieve fair outcomes? Once again, the competitive market and the first theorem of welfare economics come to the rescue. If we distribute the commodities equally and then have a competitive equilibrium, we know that the result will be Pareto optimal; we also know that there cannot be envy since each individual had the same initial amounts of every good and faced the same prices, so each person could have chosen the final bundle of any other. Of course, many other fair outcomes are possible, but this particular one of the initial equality and trade to a competitive equilibrium has been the focus of much of the attention. Thomson and Varian argue that not only are these outcomes fair but they have many other positive attri-
butes, including minimal information requirements, which suggests its centrality for appraisals of economic justice.\textsuperscript{13}

Just as with the development of optimal taxation, serious problems arose with implementing this concept when economies were analyzed that have production as well as exchange. The difficulty appears in many guises in the literature. It is due to people having differing productive abilities and differing tastes for leisure and commodities: then where there is only leisure (or work) and commodities, efficiency may require the more productive person to work harder and have more commodities, but if she has a preference for leisure and the less productive person has a preference for work and more commodities, the outcome may not be fair.\textsuperscript{14}

To deal with this unwelcome prospect, a number of alternative criteria have been suggested that attempt to capture other notions of equity, within a framework that treats all of the participants symmetrically. After reviewing some of these criteria, including the work of Varian, Thomson and Varian somewhat sadly have recently concluded, “So as of this date there does not seem to be an entirely satisfactory concept of equity in the case of a production economy. Perhaps this reflects an inherent difficulty with notions of justice based on symmetry. They seem to work well when everyone is similar, but if there are too many things that differ across individuals the demands of equity and efficiency become difficult to reconcile.”\textsuperscript{15}

**Incentives and the Supply of Labor and Capital**

To this point the arguments we have examined arise in the context of various theories with differing assumptions. Many of the assumptions are of an ethical or parable nature and therefore not easily verified. Now I wish to take up some of the empirical data, in particular changing beliefs as to the importance of incentives. If incentive effects are small, then redistributive policies introduced to achieve some goals of a just society would have relatively little effect on total output and growth.\textsuperscript{16}

Much of the opposition to large-scale redistributions of income is partially justified by pointing to the possible negative incentive effects on both those who are taxed as well as those who receive transfers. Until the 1970s economists were in fairly
wide agreement that the effects of taxes on labor supply and on savings behavior were minimal. Then a great deal of new research found large incentive effects. This provided the intellectual basis for many policy decisions of the Reagan administration and has become the new conventional wisdom. Being of the older generation, I have always been skeptical of this work and while writing this, a group of papers appeared that are also increasingly skeptical of this new research. This is not the place to rehearse the whole debate, but I would like to focus on some of the revisionist thinking that I believe makes it easier to implement a more equitable income distribution.

I turn first to the labor supply. Contrary to the current conventional wisdom, for many years it was believed that labor supply was quite unresponsive (or even negatively related) to changes in the wage rate. (Almost all of these analyses assumed that the worker is concerned only with the after-tax wage rate, so that lowering wages and raising taxes would have similar results.) It was pointed out that over a fairly long time period, as wages have risen, the work week has fallen, vacations have lengthened, and retirement is earlier. Some also question the discretion that workers have in controlling hours actually worked. In addition, the results from the standard theory of labor supply were not conclusive: an income effect from higher taxes (workers were now poorer) implied that they wanted less leisure and more market work; and a substitution effect (leisure was now relatively cheaper) that had them wish to work less. The two effects went in opposite directions and so the quantitative size of these two effects was needed to get a qualitative result for the effect of taxes on labor supply. It should be noted that this is in contrast to the theory of demand for a commodity where, as long as more of it is desired with a higher income, we can be sure that taxing it will reduce demand.

This view began to be challenged in the 1970s and 1980s: the negative income tax experiments showed fairly large labor-supply effects in the poverty populations, especially among youths and women; there were estimates of significant earnings falls from transfers to the poor; it was argued that social security and disability insurance encouraged early retirement; the welfare loss of taxes was found to be large as a proportion of the revenue gained; and a theoretical argument that only substitu-
tion effects of tax changes mattered (which implied that disincentive effects were likely) because the increased government transfers to others or the government expenditure on goods that taxpayers wanted would eliminate the income effect.

Burtless and Haveman examine these arguments and conclude, “our assessment of the recent literature on tax and transfer distortions leads us to be skeptical of the claim that these distortions have led to massive reductions in work effort.” They cite the overall growth in labor-force participation rates in recent years, with women entrants compensating for retired men.

They and others are especially concerned with relying on the econometric studies that found large incentive effects (that is, large labor-supply elasticities) because of the variability of the estimates. Two of the leading scholars of female labor supply, Killingsworth and Heckman, have surveyed the field and point out that while the female labor supply elasticities are large when compared with males, they do vary greatly and range from −.30 or less to +14.00 or more. They also compared this survey to an earlier one: “Six years ago [we and Thomas E. Macurdy] commented that elasticity estimates obtained using recently developed econometric techniques had increased the mean of what might be called the ‘reasonable guesstimate’ of the wage-elasticity of female labor supply. Work since then seems to have reduced the mean and substantially increased the variance of this guesstimate.” Pencavel, after surveying studies of the labor supply of men, argues that the studies of the past twenty years show a small elasticity of the effect of wages on hours of work, but he finds that the model is contradicted in enough instances to warrant skepticism about its applicability.

A similar outcome occurred in the study of savings. For many years we had no econometric evidence that changes in the return to capital influenced the savings rate; once again the theory only provided income and substitution effects that moved in opposite directions. Then along came Boskin’s major paper, which began to change the profession’s view of the matter and greatly influenced Reagan’s early tax proposals. This view has recently undergone an empirical test. During the early 1980s real after-tax rates of return to savers increased both because of rise in real interest rates (nominal interest rates did not fall as
fast as the rate of inflation) and because marginal tax rates were cut, and yet savings rates decreased. This increasing skepticism about the strong effects of changing incentives on labor supply and savings behavior should encourage those who believe in the possibility of a more just distribution of income without greatly decreasing the potential for growth.

**Inheritance**

The role of inherited wealth has always been central to reflections on economic justice. Recently, Haslett has argued for its abolition, while Stiglitz has made the point that on utilitarian grounds it's a “twofer,” since it provides utility to both the giver and the receiver. It is also very important in designing the tax system: For example, recently there has been a strong argument made to move away from an annual income tax toward a consumption tax system, but the equity of the tax crucially depends on the treatment of gifts and bequests. While we continue the debate, in my view one’s reaction to the institution of inheritance should be based on a sense of its empirical importance.

To noneconomists, it seems self-evident that all of the wealth is passed on by inheritance. Economists, however, have tended to downplay the importance of a bequest motive for explaining the level of wealth in society. The dominant theory of savings in economics has been the life-cycle hypothesis, which argues that most saving is an attempt to even out consumption over a lifetime. In its simplest version, with no bequest motive, people save during their working years and then dissave in retirement. During his lifetime each person consumes all of his wealth. The major determinants, then, of the growth of wealth is the growing number of workers or their growing productivity so that their accumulation is greater than the dissaving of the retired. Modigliani (whose Nobel Prize came largely from this work) did not question that a bequest motive existed, but claimed that it was small and could account for only about 15 to 20 percent of total wealth in the U.S. It should be made clear that not all inheritance is included; we are measuring intergenerational transfers, so that an estate left to a spouse would not be included in the measure of the transfer.
This view has recently been challenged by Kotlikoff and Summers.\textsuperscript{27} They estimate the proportion of savings that derives from the need to even out life-cycle consumption and identify the residual as intergenerational transfers. These transfers are large and depending on definitions constitute between 46 and 80 percent of wealth, with 80 percent as their preferred value. They contend that we cannot reconcile the observed data on savings with the consumption behavior of workers and retirees required by the life-cycle hypothesis. The reason is that very little saving is done by the below-45 age group and so this large group can contribute relatively little to life-cycle saving.

Do not be misled by the specificity of these percentages. These estimates are subject to great controversy because they are derived from calculations that make use of very indirect methods; these are not values found in probate records.

At this stage the reasons for the differences between the estimates of Modigliani, and Kotlikoff and Summers have become clear enough so that we can choose between them in thinking about justice. Modigliani is primarily interested in a bequest motive that focuses on the passage of resources at the termination of one generation, but excludes transfers that are made while generations overlap. The Summers and Kotlikoff definition includes all payments to children over age 18 (all payments to children below the age of 18 are considered as consumption expenditures of the parents); notice that this includes parents’ expenditure on their children’s education. For our purposes, this definition is preferable. In fact, it may be an underestimate of the value relevant for a theory of justice, since that may well include all expenditures, and certainly gifts, to children. Another difference in the definition is that they quite properly include in intergenerational transfers not just the bequest but the interest earned on it over this generation. (That is, life-cycle saving is the difference between labor income and consumption.) These two effects account for the bulk of the difference between the two estimates.

The results need not imply that the motivation is altruistic—it is simply the amount of saving that cannot be accounted for by life-cycle needs. Many explanations other than altruism were given. For example, it may be due to precautionary saving that did not have to be called on or its function may be to guarantee
that children behave properly toward their parents with the potential inheritance being the club— with the now-classic observation that children are more likely to visit parents the greater the amount of bequeathable wealth.28

If currently intergenerational transfers are such a major factor in the generation of savings and the passage of wealth, then isn’t any discussion of justice incomplete without more attention to these issues? Once again, informational and incentive concerns come to the fore. If we imposed substantial taxes on inheritances people would have a strong incentive to buy annuities (after all, it is the absence of the wide use of annuities that would be expected for life-cycle reasons that forms a major part of the rationale for a bequest motive) and to invest in their children’s human capital. If we wish to minimize inherited wealth and maintain savings, we will have to rely on monetary and fiscal policy to generate the savings.

**The International Economy**

It is of course a platitude to say that we are now part of an increasingly integrated world economy. This realization has had a profound impact on work in economics, so that many widely held beliefs about monetary and fiscal policy as well as about the relation of domestic savings and investment have had to be reformulated. Here I will examine a few of the issues that it poses for our understanding of the relation of markets and justice.

One would expect that any theory of consequential justice would argue for a radical redistribution of income between the inhabitants of rich and poor countries. Whatever may be said about the degree of inequality in any one country, the variance for the world as a whole is much greater and, one would think, the demands of justice greater. Historically, a major source of the demand for economic justice was not so much inequality as the fact that people were living in extreme poverty. In the developed world we are much richer now, so that our poverty level is well above the average income in the rest of the world, much of which does live in extreme want. As Tullock puts it in commenting on Rawls, “If you actually do not know who you are, and you think therefore the likelihood of your being a
citizen of India or of Communist China is as great as the likelihood of your being an American citizen, you would be in favor of very drastic transfers of funds away from American citizens. The best policy would be removing at least two-thirds of the present after-tax income of American citizens and giving it to the poorer parts of the world, and very likely 80 percent would be a more reasonable figure. Swedes, even if members of the socialist party, or members of the British Labour Party, etc., all would find themselves impoverished.”

Tullock even goes further. Using a second-best argument he claims that it may well be counterproductive to aim for justice in one country. If we tax the high-income people in the high-income countries to obtain economic justice there, strong incentive effects will arise that will lower worldwide output and hence hurt the poor in the poor part of the world.

In terms of some of the incentive arguments we made earlier, international transfers at more modest levels might have fewer distortionary incentive effects than if carried out in one country. (A quick look at per capita income levels would be convincing that some modest transfers from the wealthy countries would materially improve the living standards of the poorer countries.) Consider the incentive model we discussed earlier. Suppose residents of high-income countries were taxed with a transfer to low-income countries; large incentive effects are unlikely since very few residents of countries like the United States would then choose to move to countries like Bangladesh. In addition, increases in productivity in the poorer countries might come from improvements in health and nutrition made possible by the transfers.

I could continue giving the arguments for the merits of international redistribution and the reader will surely know that whatever its merits, it has far less chance than movements toward justice in a single country. This does have an important lesson: Since our moral theories lead to implications so contrary to any likely behavior, they clearly omit important considerations and we should be skeptical about their cogency.

This lesson can be further seen in examining two pressing issues that are more likely to have a direct policy impact, namely trade and immigration. While free trade and immigration are likely to increase the world’s output and efficiency, they are also
likely to have differential impacts on labor and capital in different countries.

As Bronfenbrenner points out, for many years now we have been aware of Samuelson's factor-price equalization theorem that argues that competitive international trade markets will tend to equalize the rates of compensation of factors between countries, and that in particular, for a capital-intensive country like the United States, it will tend to raise the return to capital and lower it for labor. As tariff barriers have fallen and with the increased integration of the world economy, this change in factor returns becomes a more important issue. Today, many observers see international trade as a major force in restraining the wages of American workers. Labor is further squeezed when this is combined with international capital mobility, which tends to equalize after-tax rates of return to capital so that capital might well move if it is taxed or wages raised. Of course, during this same process wage rates are increased in the rest of the world. On the other hand, other groups, including those with national and not international market power, will be made worse off by the new competition. These are all the results of the international extension of markets. Once again, how notions of justice are to inform our judgments depends strongly on the degree to which we count the welfare of non-Americans.

The question of immigration raises similar problems. Borjas makes the argument that the more inequality in the distribution of income in the U.S., the better quality of immigrants we will get. This is because high-ability people will prefer to move to a place where they can make the most use of their skills and ability, while low-income people will be afraid of falling too low. If we have a more equal distribution of income it will mean a lower quality of immigrants, though we will also be lessening the negative effects of the brain drain on the countries from which they emigrate.

Melvin Reder, in a discussion of Chicago economics, points out that freedom of immigration should be defended by economists of that tradition on grounds of both efficiency and ethics. Yet here we find a great inconsistency. Even Henry Simons, who is widely regarded as the intellectual godfather of many of today's leading conservative economists, strongly opposed free immigration. (Reder considers his vehemence on this point as
Friedman argues against free entry to countries having welfare programs that provide a minimum level of income that does not depend on productivity, as most of the richer countries do. Reder recognizes that resistance to international income equality through levelling is not consistent with free-market principles. He concludes, "Both freedom of opportunity and world wide efficiency of economic organization require freedom of choice in location. Intellectual defense of resistance to the implied redistribution of income and (possibly) of political power requires a quite sharp reformulation of the normative principles of traditional liberalism and the associated goal of an open society." 34

These examples illustrate that when we include global issues difficult questions arise both for those concerned with justice and for traditional defenders of free markets.

CONCLUDING COMMENTS

In this chapter I have tried to highlight some recent theoretical and empirical developments that should inform our discussion of justice and markets. This is not the place to continue the longstanding debate about the degree to which knowledge in the social sciences is independent of the politics and ethos of its times. I believe, however, that there is wide agreement that the issues focused on, though not necessarily the validity of the arguments, often reflect the social issues of the period. As we have seen, the theoretical developments based on incentives and information that have dominated much of the recent work in economic theory raised serious questions about the implementation of end-state theories of justice. While these problems have raised concern before, these theorists may well have picked up and emphasized the greed and lack of public concern that has been widely commented on as so common in our society. 35

A striking example of this change of ethos is the changed attitude toward scholarship policy at academic institutions. Friends of mine, now in their 50s, were told by their parents not to accept fellowships to graduate school because others might have a greater need. Today, as schools have tried to focus on need—free admissions policies, a move to the more just society of their
parents—these same friends hire consultants who tell them the best way to structure their assets and present their financial statements so as to minimize college costs. Since I strongly support these new policies I am quite disturbed by this new attitude. However, there may be another reason for the change in attitude: These redistributive policies have markedly increased the costs of sending non-financially aided students to college, which may make parents feel that they have been taken advantage of. Thus this behavior may not be caused by increased greed, but may merely be a reaction to what is perceived as too much redistribution.

In a broader context, this recent emphasis on the possible use of individual advantage even when it works against social norms has served to reinforce some long-held views. A just economy may require a substantial reduction in output and efficiency. An alternative to this pessimistic outcome is that people be willing to forgo some individual advantage to make the system work even in situations of moral hazard and adverse selection; this is most likely when the procedures, if not the outcomes, are widely acceptable. While we can assume that another generation of economists will focus on other perspectives, the cautionary results reported here should serve as a brake for those who will be overly sanguine about the ease of implementing a just society.

A number of new theories and developing anomalies in the standard theory are changing our notions of the functioning of markets. These alternatives attack the textbook version of the behavior of markets and so will have a major, albeit indirect, impact on this discussion. A few of the ideas that are likely to have this impact are: a clear recognition of path-dependence, that previous history strongly shapes our current institutions; the dependence of quality on price, with efficiency-wage theory as a prime example where employers pay above the market-clearing wage to keep, attract, and discipline workers; the analysis of anomalies in the theory of rational behavior, many of them introduced to economics by psychologists, that are beginning to be taken up by economists; and the further development of non-profit-maximizing theories of the firm. Currently, there is a great deal of flux and no uniform new view has emerged, at least in the sense that it has become the new
standard textbook version. All of these developments do, however, tend to cast doubt on the earlier arguments for the optimality of the market arrangement. This poses problems for political theorists who wish to discuss the market and its ethics, since they would like economic theory to stand still for a while. As I see it, much of the work I have surveyed as well as new material that has not yet been integrated into the debate will lead us to a more realistic sense of the potential and pitfalls in the use of markets for implementing our vision of economic justice.

NOTES

1. Martin Bronfenbrenner, in “Income Distribution and ‘Economic Justice,'” The Journal of Economic Education 17 (1986): 36, gives the view of the economists of the 1930s who made the strong case for a more equitable distribution of income and who argued that there would be only small incentive effects. (Needless to say, he now rejects these views and the point of the essay is to make clear why he was wrong.) This 1930s view might be contrasted with an anecdote told by Samuelson, who in the late 1950s asked another eminent economist about a paper he had written advocating the abolition of rent control in Japan. “I inquired indelicately about the income redistribution thereby implied. ‘Oh’ he said, on the run, ‘if that is an issue, all that needs to be done is to compensate all the losers out of the enhanced gains of the winners made possible by the efficiency of market-clearing rentals.' I tell the complete story as it happened.” Paul A. Samuelson, “How Economics Has Changed,” The Journal of Economic Education 18 (1987): 109.


3. In economics much of the work has been carried out in a highly mathematical context. This literature has been surveyed in Kenneth J. Arrow and Michael D. Intriligator, eds., Handbook of Mathematical Economics, vol. 3 (Amsterdam: North-Holland, Elsevier, 1986), which includes “Social Choice Theory,” by Amartya Sen and “The Theory of Optimal Taxation,” by J. A. Mirlees.

4. There is little doubt that when compared with the population as a
a whole, economists strongly defend markets as part of the decision-making process. See Bruno S. Frey, "Economists Favour the Price System — Who Else Does?" *Kyklos* 4 (1986): 537–63, for the results of surveys in which he shows that economists in both the United States and western Europe tend to prefer allocative arguments that depend on markets, though those employed by the government are somewhat less enamored than are academics.


7. Thus Varian concludes "all welfare maxima are competitive equilibria, and all competitive equilibria are welfare maxima for some welfare function." See Hal R. Varian, *Intermediate Microeconomics*, (New York: Norton, 1987), 537. The important point is that welfare maxima can be obtained as competitive equilibria. I find no normative significance in a competitive equilibrium maximizing some welfare function.

8. For example, instead of emphasizing that banks prefer to lend to those more willing to pay higher rates, now the argument is that they might be more reluctant because firms that are more likely to become bankrupt will be those willing to pay the higher rates. A good introduction to the flavor of this literature is Joseph E. Stiglitz, "The Causes and Consequences of the Dependence of Quality on Price," *Journal of Economic Literature* 25 (1987): 1–48.


11. See Baumol, *Superfairness* 71–74 for a history of fairness theory.
15. Thomson and Varian, “Theories of Justice Based on Symmetry,” 120.
17. Much of my general discussion is based on Burtless and Haveman, “Taxes and Transfers: How Much Economic Loss?”
23. “In 1980, the average married man’s real after-tax return to savings through a Treasury bill fund was -1.37 percent. In 1985, the after-tax real return was 3.66 percent if marginal saving was channeled into an IRA and 2.32 percent if through taxable channels.” Even greater benefits were available to upper-income groups. Yet the National Income Accounts personal savings rate, which was 8.7 percent from 1971–75 and 7.1 percent from 1976–80, fell to 6.2 percent from 1981–85. Similar results occur if the stock market boom is included. See Jerry A. Hausman and James M. Poterba, “Household Behavior and the Tax Reform Act of 1986,” *The Journal of Economic Perspectives* 1 (1987): 117–18.


30. Of course, it is possible to oppose this redistribution on the grounds that it might impede development (that is, using arguments analogous to those that focus on the reduction of self-reliance on welfare recipients) or just be redistributed to the members of the upper and middle class of the recipient country. I do not believe that these arguments explain much of the opposition.


34. Ibid., 31.

35. These disturbing results can also be the unintended consequences of behavior. One year I was in Washington renting a house. I had never owned a house or mowed a lawn. I did not mow the lawn of my rented house either; one day one of my neighbors came and mowed it for me. Was it a signal? If I had ignored it, would they have found other ways to prevent my imposing costs on them?


37. Economists have a similar problem with philosophers who work on methodology. There was a time when they gave economists important guidelines, and in fact some of the most important work of this century, including Samuelson’s Foundations of Economic Analysis, were developed as a response to the positivist program. Problems arose as the field of methodology in philosophy developed a dynamic of its own and economists could not be sure of its prescriptions, so they simply ignored it.