

Capitalism, wages and inheritance

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Outline

1. Capitalism, feudalism, socialism and the mixed economy
2. Big strategic issues: Adam Smith and John Rawls
3. Flows of income: the wage/profit relationship
4. Stocks of wealth: taxes and takings
5. Some agenda options

Comparative economic systems

- Capitalism came into its own in the industrial era
- Superseded feudalism because
 - A rentier ruling class operating as a political oligarchy was less technically progressive and allocatively less efficient than an entrepreneurial capitalist class built on upward social mobility
 - The arms-length wage-labour relationship was productively superior to pre-capitalist arrangements of artisans, putting-out, serfdom etc
 - The impersonal market mechanism put competitive disciplines on business that performed a weeding-out function (though business continually strives to subvert those disciplines and to acquire and wield market power)

Industrial capitalism's negative side

- Tendency for business to acquire market power and subvert competitive outcomes
- Wage/profit tradeoff meant wage bargaining was a bilateral exercise of countervailing power with a perpetual tendency for employer power to prevail

One response:

- The concept of socialist planning threatened the legitimacy of the capitalist market as society's central organising principle
- But twentieth-century debates concluded that planning had only a restricted domain of effective application

- Adam Smith laid out clearly the doctrinal basis for the twentieth-century welfare state.
- The issue for the “statesman” was to balance the constructive and the predatory aspects of capitalism
- Smith’s admiration for the creative power of the market economy, and his arguments for laissez-faire, were cast within a strong framework of moral philosophy and targeted regulatory interventions
- Consider this key passage from *The Wealth of Nations*:

All systems either of preference or of restraint, therefore, being ... completely taken away, the obvious and simple system of natural liberty establishes itself of its own accord. Every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man, or order of men....

According to the system of natural liberty, the sovereign has only three duties to attend to; three duties of great importance, indeed, but plain and intelligible to common understandings:

- first, the duty of protecting the society from violence and invasion of other independent societies;
- secondly, the duty of protecting, as far as possible, every member of the society from the injustice or oppression of every other member of it, or the duty of establishing an exact administration of justice; and,
- thirdly, the duty of erecting and maintaining certain public works and certain public institutions which it can never be for the interest of any individual, or small number of individuals, to erect and maintain; because the profit could never repay the expence to any individual or small number of individuals, though it may frequently do much more than repay it to a great society.

That pretty much gives you the welfare state and the mixed economy

- The elimination of “systems of preference or restraint” points to equalising taxes and transfers and potentially to expropriation of unjustifiable concentrations of wealth and power
- The “exact administration of justice” clearly extends to protection of captive consumers against predation by monopolists
- The words “protect every member of society from the injustice or oppression of every other member of it” extend almost inevitably to issues such as abolition of slavery, rights of women, regulation of monopoly, and redistribution of income and/or wealth.
- “Public works and ... institutions” go beyond roads and bridges to health and education systems and potentially social housing

A century of debate

- Ricardo and Marx: the ‘iron law of wages’ and the ‘rising rate of exploitation’
- Neoclassical economics: under competitive conditions each factor of production is paid its marginal product => the wage rate reflects worker productivity, not a subsistence floor
- But utilitarian theory applied not only to the distribution of factor rewards amongst wages, profit and rents, but equally to the personal income distribution; here the implications were radical.
- Pigou: the maximum utility of society as a whole will be reached when the distribution of income is completely equal - unless the rich and the poor have very different utility functions
 - Wages, profits and rents set by the market don’t produce optimal distribution of the social product if the outcome was inequality across individuals

So two broad options

- Ensure that each individual has an equal share of society's total land, labour, capital, and talent, and thus earns the same amount as every other individual => sweeping socialist proposals for asset expropriation and redistribution
- Tax the rich and transferring the money to the poor until the income distribution reached the optimal approximation to full equality => the twentieth-century social-democratic welfare state
- Either outcome was unwelcome to the rich and powerful, but once faced with the choice they opted for the latter

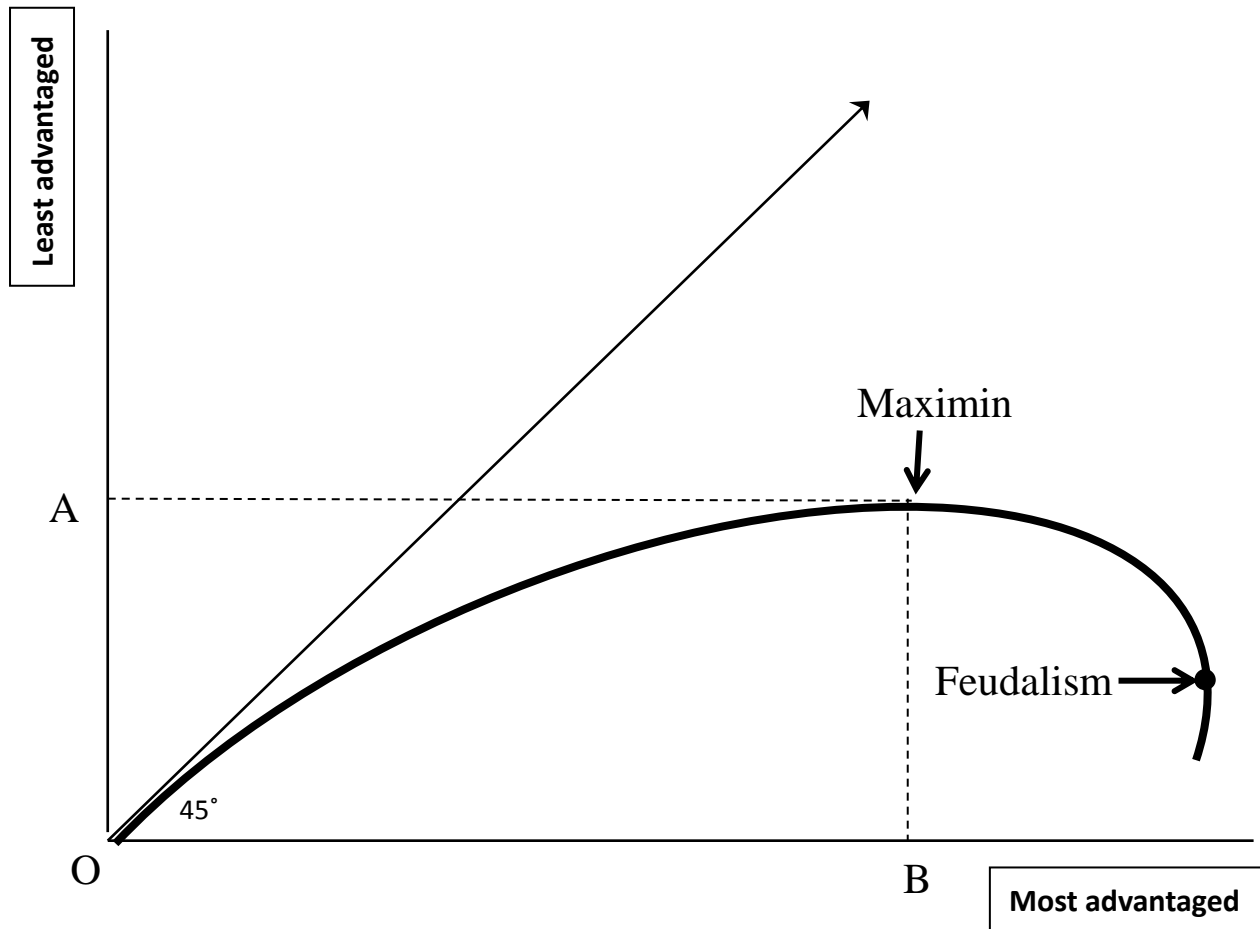
The mixed economy and the welfare state short-circuited the class struggle

- Collective institutions and practices accommodated alongside individualistic private-sector business (cf Weststrate 1961 on NZ)
- Tendency to increase the rate of exploitation of labour was compensated for by
 - Legitimacy for labour movements and establishment of institutions for wage-setting in relation to income targets and cost of living
 - Safety net of welfare benefits combined with substantial state-provided elements of the social wage
- Tendencies towards macroeconomic instability checked by monetary, fiscal and structural policy
- But the welfare-state/social democrat consensus broke down in the face of the Hayekian revival of anti-state, pro-market neoliberalism

Neo-liberalism => neo-feudalism?

- The transformative power of capitalism in its market-competition guise has been astounding
- So it is with a sense of shock and some disbelief that one sees unfolding under the a neoliberal policy agenda, early signs of a neo-feudal order built around finance and property:
 - rise of a new order of entrenched, and in due course inherited, wealth and privilege
 - retreat from the arms-length wage-labour relationship to the pre-capitalist system of putting-out (or as it is described these days, contracting-out) with employers transformed into exploitative patrons of a self-employed, atomised workforce
 - wielding of political power and influence by an oligarchic elite
 - erosion, under pressure from that elite, of statutory protections for the weak against the powerful and of the poor against the rich
- Immediate qualifications:
 - these trends have gone less far in New Zealand than in the older industrial societies of Britain and the USA,
 - their novelty shouldn't be overstated
 - electoral democracy still promises the prospect of countervailing policy

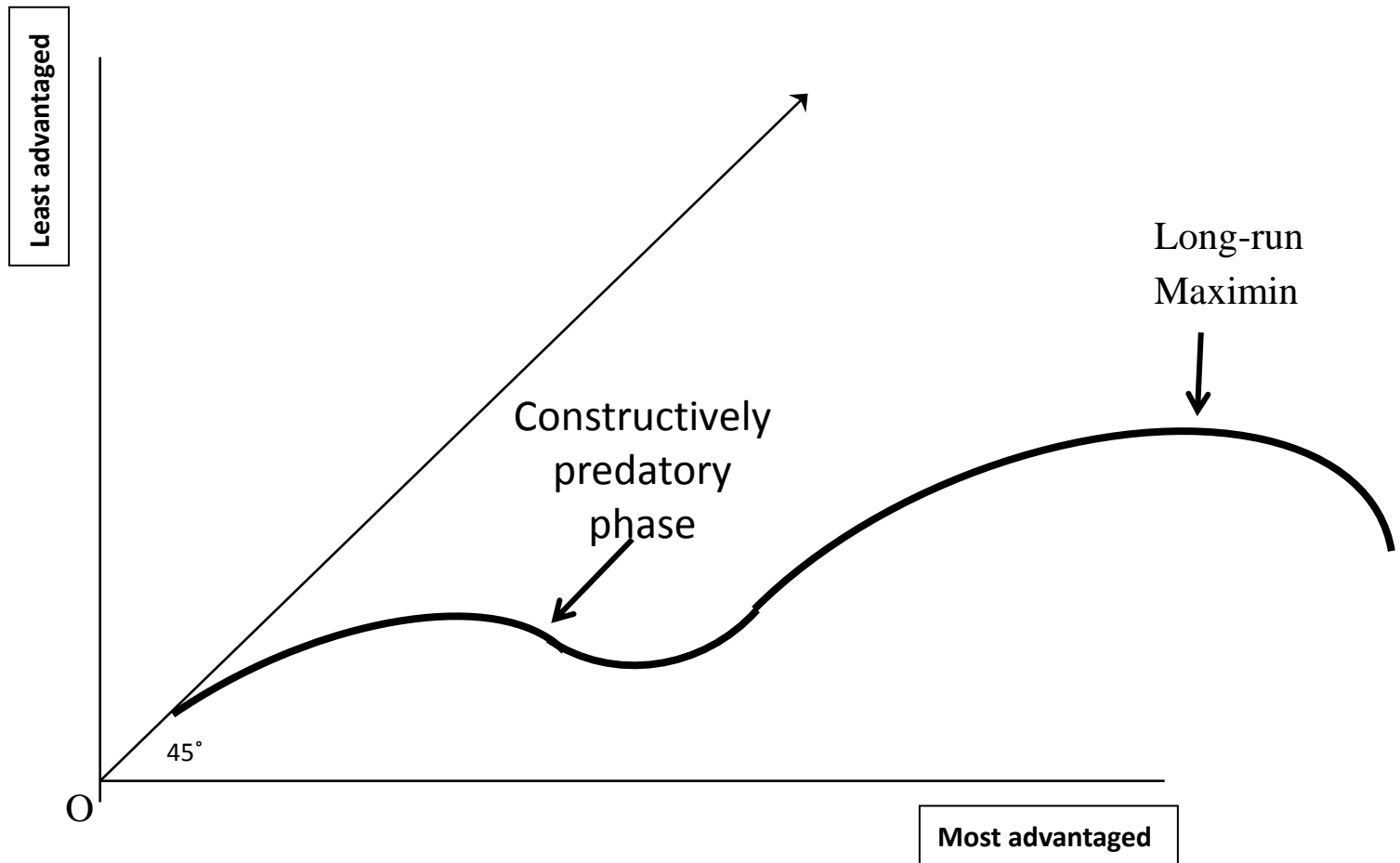
Rawls's "difference principle" diagram



Adapted from John Rawls, *A Theory of Justice* Cambridge Mass: Harvard University Press 1971, p.76 Figure 6 and p.77 Figure 8; and *Justice as Fairness: A Restatement*, Harvard 2001, p.62.

- In a two-person setup, an equal distribution (on the 45-degree line) is to be preferred unless there is a non-equal distribution (such as the “maximin” distribution at OB, OA) that makes both persons better-off. Inequality thus can be justified only by clear-cut pareto gains in general welfare
- In a dynamic version, this would be modified to take account of productive investment by a progressive ruling class – not easy to do in the simple diagram
- “A society should try to avoid the region where the marginal contributions of those better off are negative, since, other things equal, this seems a greater fault than falling short of the best scheme when these contributions are positive. The even larger difference between rich and poor makes the latter even worse off, and this violates the principle of mutual advantage as well as democratic equality” (Rawls 1971 p.79).

Rawls's "difference principle" diagram



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On the downward-sloping segment of Rawls' curve,
anti-social wealth transfers are occurring

- The economic development literature points to the negative long-term consequences of unproductive predation
 - Douglass North, Anne Krueger, James Buchanan, Gordon Tullock, Ed Prescott and Stephen Parente, Daron Acemoglu and Simon Robinson.... [none of them left wingers!]
 - “Nations fail” when rent-seeking and predatory practices and institutions gain dominance
 - Capitalism delivers on its constructive promise when predation is tamed and competition works democratically

The neoliberal agenda inexplicably incorporates promotion of financial-sector predation and unproductive wealth transfers from poor to rich

- Thus the NZ Treasury in 1992*, and the New Zealand Commerce Commission in 1994**, argued that “a transfer of wealth from suppliers to consumers would constitute a net benefit to acquirers, [but] the increase in consumers’ wealth is matched by a reduction in suppliers’ wealth (resulting in zero net public benefit)”.
- This public benefit test pushed policymakers to treat all transfers not as a matter for political judgment, but as conclusively neutral [though the fine print still reserved them the right to use “judgment”]
- Adam Smith would not have stood for that

* Ministry of Commerce, The Treasury, Department of Justice, and Department of Prime Minister and Cabinet, *Review of the Commerce Act 1986*, 1992

** Commerce Commission, *Guidelines to the Analysis of Public Benefits and Detriments*, October 1994 (revised December 1997), Wellington

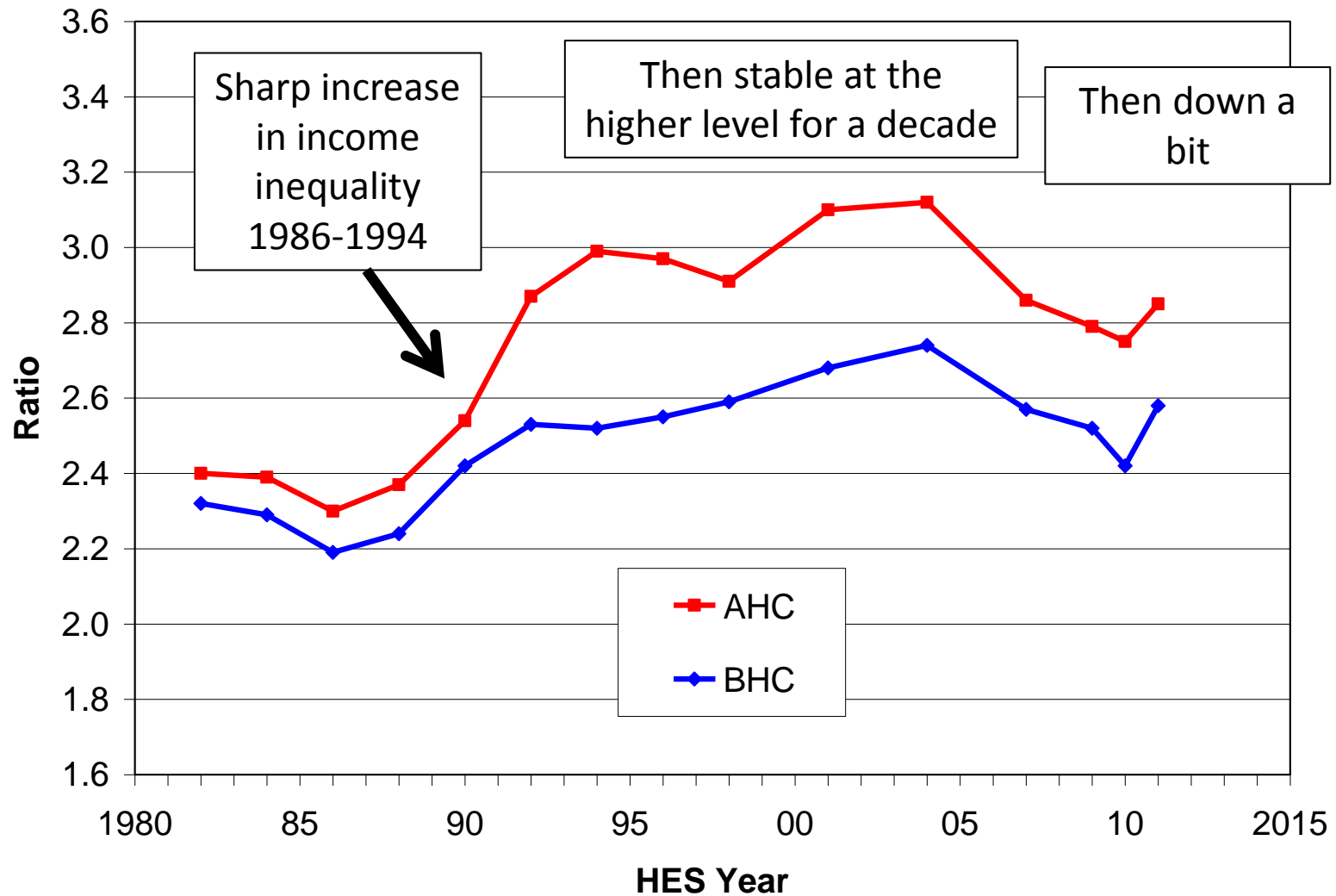
If wealth transfers were really welfare-neutral....

- Under the Robbins/Hicks rules, it is impossible to prove that a revolutionary overthrow of the ruling elite, and seizure of society's wealth by the poor, involves any reduction of social welfare; it may well increase welfare.
- If in fact economics can't measure social welfare, one has to resort to other criteria to judge whether any particular income and wealth distribution is better than any other

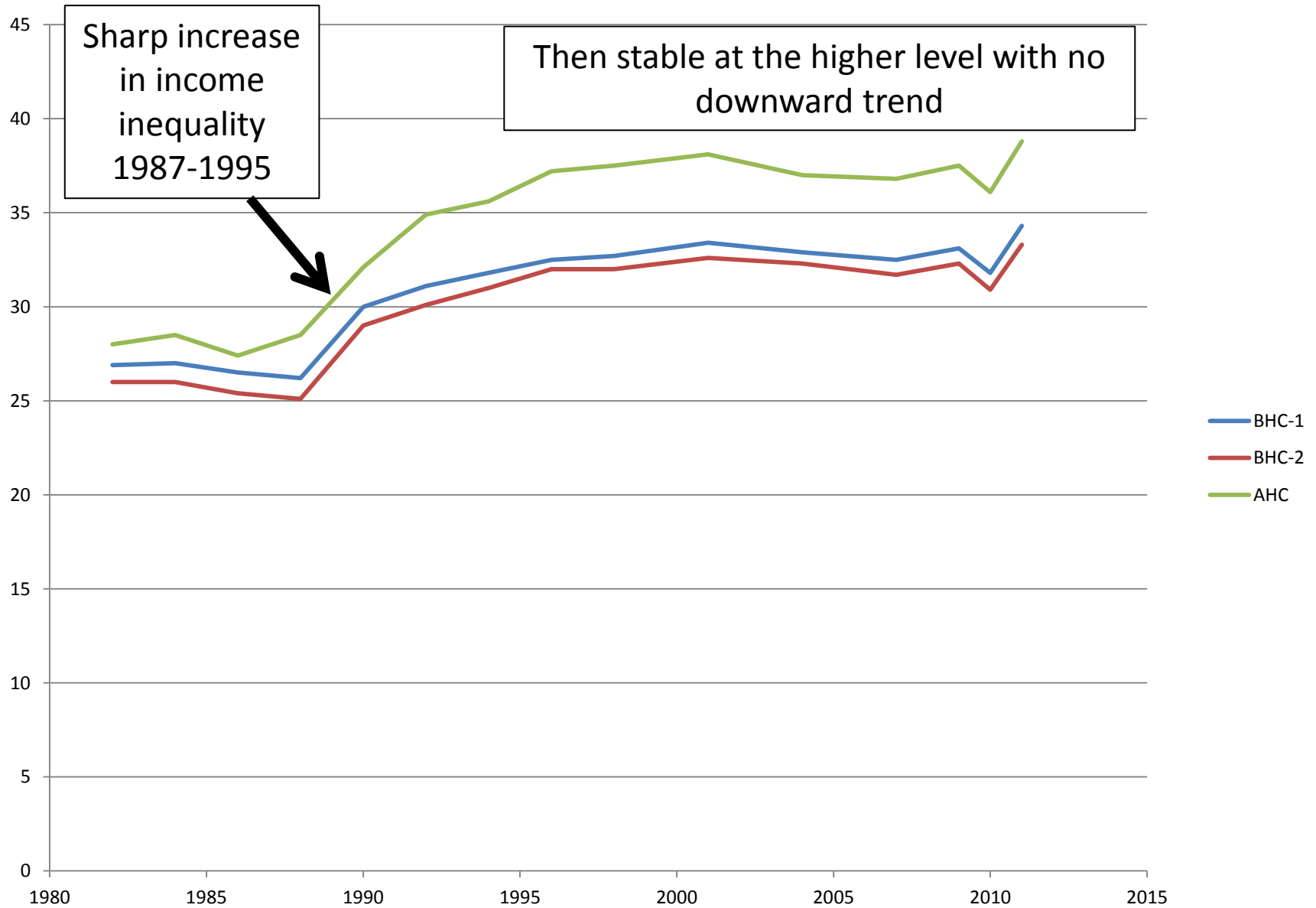
Important to distinguish the dynamics of income inequality from those of wealth inequality

Figure D.16

Income inequality in New Zealand: the P80/P20 ratio, 1982 to 2011, total population



Gini coefficient, three versions



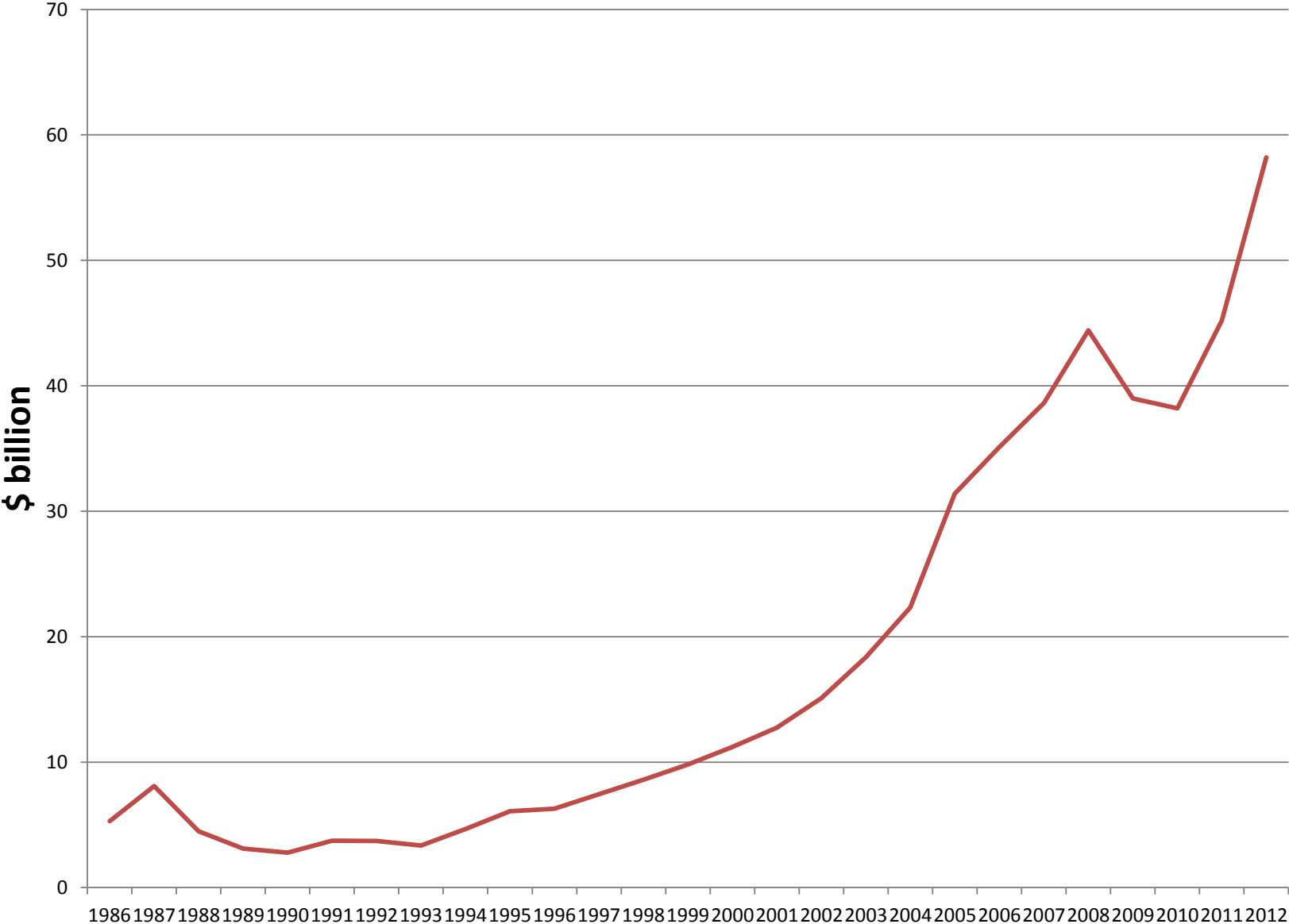
It's good that the 1986-95 trend didn't continue

- But a sharp one-off shock to inequality in income flows casts a long and persistent shadow in inequality of stocks of wealth
- That shadow doesn't fade simply because the P80/P20 ratio later eases a bit
- It becomes embedded in a new generation of super-rich winners from the period of the shock and from the ongoing greater income inequality

One place to see this is the NBE “rich list”

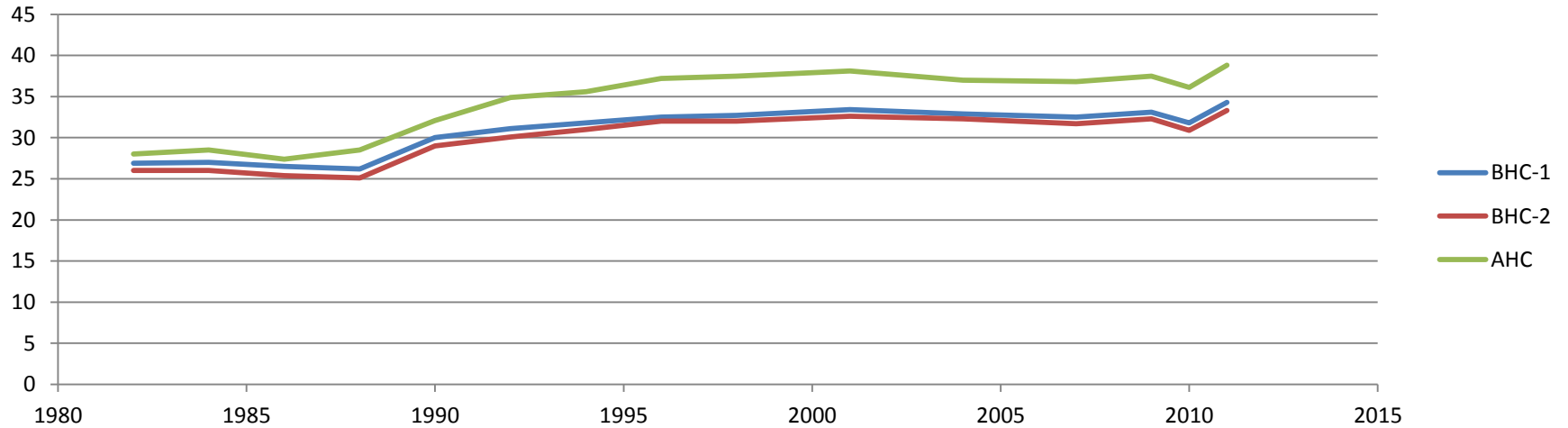
- Not a rigorous census methodology, but trends are unequivocal
- Finance and property play a central role
- Wealth increases to a considerable extent through (untaxed) capital gains which are not captured in the HEIS

NBR Rich List Total Wealth

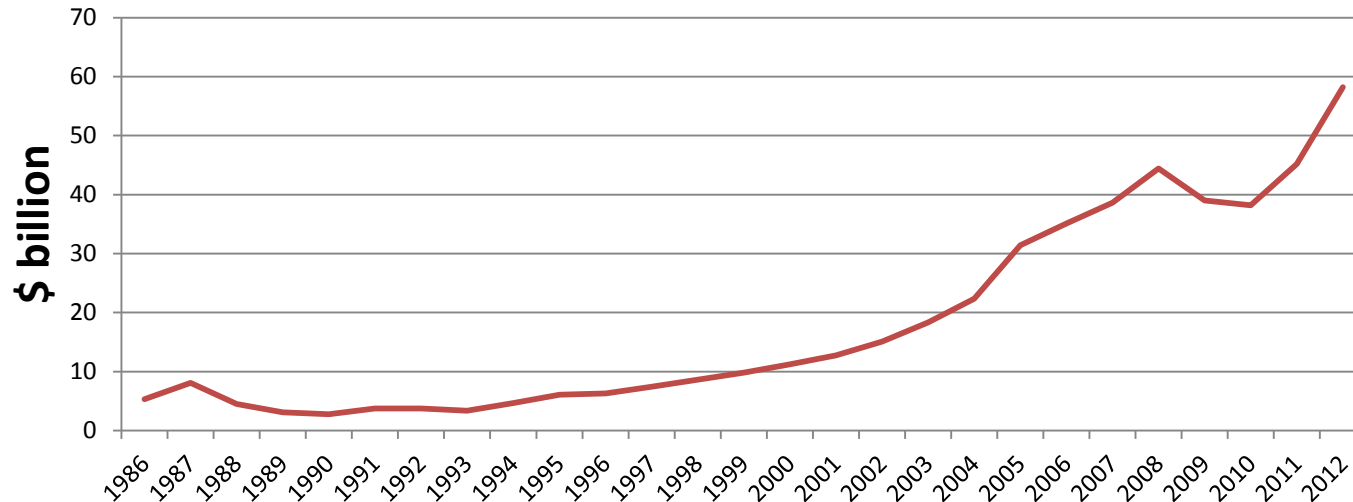


Compare the two trends: the big wealth takeoff is after the inequality shock

Gini coefficient, three versions



NBR Rich List Total Wealth



- Proposition: the record of rising inequality with below-trend productivity growth in New Zealand since the mid-1980s suggests that this country has been pushed, by big business and neoliberal policy, onto the downward-sloping segment of Rawls' chart, albeit there is be a long way to go yet to reach his fullblown feudalism.
- Therefore it is worth asking what the first form of response might look to accomplish – to sketch, in other words, the legislative programme of a future regime attuned to the dangers of neo-feudalism.

1. Regulation and the common law

- Amend the Commerce Act to clarify pro-consumer purpose and to outlaw monopolistic pricing: target “the great Kiwi rip-off” as *North and South* described it (April 2013)
- Thus restore the consumer surplus standard to central place in antitrust policy
- Rescue the doctrine of prime necessity from *Transpower v Vector*
- Get Parliament to make its intentions clear in its regulatory legislation

2. Move the labour market towards a higher-wage equilibrium

- Revive the rights to representation, collective bargaining, and union membership, where these have been stripped back for wage workers
- Put institutional mechanisms in place to move real wages up at the bottom of the distribution: minimum wage needs to come up and “living wage” needs to become mandatory [cf the old awards system]
- Address the fragmentation and disempowerment of labour in contracting-out situations (cf the CTU’s forestry campaign) – whether by legislated protections of working conditions and contract terms, or by encouraging organisation and collective bargaining
- Get away from simplistic labour-demand-curve arguments
- Nudge the salary distribution via target top/bottom ratios
 - Government contracts
 - Honours esp knighthoods
 - Cf tobacco companies and no-smoking zones....

3. Re-emphasise the social-equity drivers of taxation vs “efficiency”

- Progressivity in the income tax scale has a lot of room to increase
 - On alleged disincentive effects see Fieldhouse’s review paper*: in closed-economy setting the revenue-maximising top tax rate is nearly 70%
 - On open-economy tax avoidance by the rich, watch the OECD space
- The new wealth inequality demands a new look at wealth-transfer taxes

* Andrew Fieldhouse, *A review of the economic research on the effects of raising ordinary income tax rates*, EPI and Century Foundation, Washington DC, April 2013.

Wealth-transfer taxes

- Churchill 1924: an effective estate tax is estate tax as “a certain corrective against the development of a race of idle rich”.
- NZ abolished estate duty in 1992 and gift duty in 2011, opening the way to Warren Buffet’s “lucky sperm club”

Three key points about wealth-transfer taxes

- They should ideally be charged on wealth transfers received rather than on wealth given (cf *The Economist* October 25 2007. <http://www.economist.com/node/10024733>)
 - the transfer is treated (appropriately) as part of the recipient's life-cycle income, to be taxed along with income from other sources (including, ideally, capital gains tax).
 - the UK/US/New Zealand approach of charging tax on the donor's estate or gift, rather than on the consequent income gain for the recipient, invited the sort of avoidance that proliferated.
- They should be motivated primarily by considerations of social equity and of forestalling the evils of feudalism/oligarchy with a self-perpetuating rentier ruling class, and should avoid blocking 'small to medium' family bequests
- They should therefore discriminate so far as possible between life-cycle motives for saving versus preference for wealth per se (that is, greed and the quest for undue power, influence, status etc).

“Whatever the administrative problems, a good intellectual case exists for increased reliance on wealth transfer taxes.... Outside the utilitarian framework.... an additional basis for taxing both wealth and wealth transfers exists if wealth independently confers economic, social or political power.... To the extent that large and durable concentrations of economic power are regarded as antithetical to economic and social mobility, taxes can be used to hinder the transfer of such advantages across generations.”

Henry J Aaron and Alicia H. Munnell, “Reassessing the role for wealth transfer taxes”, *National Tax Journal* 45(2):119-143, p.139:

These are examples of agenda items for the new debate

- Good things take time
- Tide already turning in the public mind?
- Ultimately society's negative-feedback loops probably outweigh the short-run positive feedbacks of the financial bubble era
- But a solid nudge to the debate can't do any harm...