Shrinking Capitalism

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

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

Tools for doing this have been provided by the incomplete contracts and behavioral economics revolutions, which overthrew the vision of the firm and social interactions in Arrow-Debreu general equilibrium theory. Here we deploy these recent developments in economics to outline a framework for a well-functioning economy under contemporary conditions consonant with values summarized by a broad concept of freedom that goes considerably beyond a fair distribution of rising living standards, and is better able to support a more just, democratic and sustainable society.

I. Ethical values, economic models and policy paradigms.

Successful policy paradigms combine a set of ethical values with a model of how the economy works, a property of which is that the pursuit of those ethical values contributes to the performance of the economy as represented in the model. Classical liberalism rested on commitments to order, anti-paternalistic liberty, autonomy and rule-utilitarianism, which were synergistic with its economic model characterized by competitive markets, division of labor, specialization, Ricardian growth and cardinal utility.

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

In like manner, what has come to be called neoliberalism advanced a normative framework of negative freedom and procedural justice based on a complementary economic model. Cementing neoliberalism's philosophy to its economics was the shared individualistic and amoral view of what people are like and a representation of how we interact in the economy that is confined to exchange under complete contracts on competitive markets. Extending the assumption of self-interested agents to the public sphere led to a view of public choice in which governments and other collective actors such as trade unions are simple special interest rent-seekers. In this model of the economy, the limited government advocated on philosophical grounds was also a necessary condition for a well-functioning economy.

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

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

II. Framing economic interactions as a morality-free zone.

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

As a result, this model granted a kind of moral extra-territoriality to economic interactions that suspends ordinary ethical judgements within its compass. The moral philosopher David Gauthier describes it well:

> ... the presumption of free [market] activity ensures that no one is subject to any form of compulsion, or to any type of limitation not already affecting her actions as a solitary individual. ... [Thus] morality has no application to market interaction under the conditions of perfect competition (Gauthier 1986):93,96-7.

Ethical concerns and the public interest in economic matters were thus reduced to eliminating government interference in economic decisions, sustaining competition and ensuring just procedures for acquiring assets. Kenneth Arrow writes:

> Any complaints about [the market system's] operation can be reduced to complaints about the distribution of income ...[but] the price system itself determines the distribution of income only in the sense of preserving the status quo.(Arrow 1971):6

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

Contrary to the apolitical conception of the firm in Arrow-Debreu theory, its political nature as a system of authority – a mini-planned economy – was established eighty years ago by Ronald Coase. He asked his readers to "note the character of the contract" governing employment: the worker "for certain remuneration agrees to obey the directions of the entrepreneur." Indeed, Coase *defined* the firm by its political structure:

If a workman moves from department Y to department X, he does not go because of a change in prices but because he is ordered to do so… .the distinguishing mark of the firm is the suppression of the price mechanism. (Coase 1937):387, 389

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

III. The economics of "solved political problems" in retrospect

While the Coasian firm was good economics, it was awkward for those wishing to wield the yardstick of freedom in defense of capitalism. Coase himself (in his Nobel lecture) recalls at the beginning of his career wondering:

How did one reconcile the views expressed by economists on the role of the pricing system and the impossibility of successful central economic planning with the existence… of these apparently planned societies, firms, operating within our own society(Coase 1992):715?

There was definitely something to democratize in the Coasian firm; and perhaps this helps explain why his idea never became part of the conventional late 20th century economic paradigm.

Long before Coase, for Joseph Schumpeter establishing that employers exercise no asymmetrical powers over their employees became "a fundamental task of economic theory." (Schumpeter 1934 [1911]):20-21 As Oliver Hart observed, assumption of complete contracts in the labor market did the job. "What does it mean", he rhetorically asked, "to put someone 'in charge' of an action or decision if all actions can be specified in a contract (Hart 1995)?"

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

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

The intellectual environment constituted by the complete contracts assumption and the apolitical view of economic interactions that it supported had political consequences. It made advocating an expansion of workers' voice in the conduct of their place of employment as difficult as it would have been to press the cause of unemployment insurance and other income replacing transfers in the aftermath of the Great Depression, had the concept of aggregate demand not become part of the economic vernacular. The same would be true of advocating a libertarian stance towards government in the absence of the perfectly competitive economic model that provided support for the idea of Smith's invisible hand.

As a result, the left side of the political continuum took up social democracy by default, laying primary emphasis on distributive justice, an end that social democratic parties and unions pursued to great effect. But a casualty was the once-vibrant critique of the social structure of the workplace as both a violation of commonly held democratic norms that power should be accountable and limited, and as an impediment to the development and flourishing of human capacities.

Whether narrowing of the economic lens was a bug or a feature of the model depended on one's political interests. Referring to a contractual relationship as an 'economic transaction,' here is Abba Lerner's ledger:

> An economic transaction is a solved political problem ... Economics has gained the title Queen of the Social Sciences by choosing solved political problems as its domain. (Lerner 1972):259.

On the cost side of Lerner's ledger was the already small and increasingly restricted domain – the world of complete contracts – over which the Queen ruled. This is occurring in part because fewer workers are employed in producing physical objects where determining the quality of the object exchanged or the task done is relatively easier than in many services. (Agriculture, mining and manufacturing now employ less than one in seven in the U.S.).

Modern information processing including surveillance technologies are permitting more complete contracts, as in ride hail, delivery and other parts of the gig economy where compensation approaching piece rates is feasible. But from an empirical standpoint these new opportunities for more complete contracting are minor compared to the massive shift of work into caring, educational, security, knowledge production and distribution, and other services in which it is particularly difficult to contractually link pay to the worker's contribution to output.

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

IV. Bringing power and social norms back into economics.

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

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

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

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

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

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

The resulting allocations are inefficient. The Nash equilibrium resulting from profit maximization by the principal and utility maximization by the agent is both Pareto-inefficient and technically inefficient. There exist different outcomes (in the labor market for example different levels of wages and work effort) in which both principal and agent would be better off (and no one affected would be worse off). And taking the Nash equilibrium as the status quo it would also be possible to revise the employer's labor discipline strategy – reducing monitoring and raising wages, for example – such that the same output could be produced with less of one input (monitoring) and not more of any input. These market failures arise from information asymmetries rather than from the usual sources of limited competition or environmental spillovers.

The salience of power and social norms in principal-agent relationships does more than make the exchange process political and social as well as economic; it provides the basis of new demands and institutional designs. For example, the workplace (and by extension much of the rest of the economy) becomes an arena in which a new paradigm could press the claims of democratic accountability –

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

ranging from enhanced individual rights of workers to employee ownership – in the context of what Robert Dahl termed the "arbitrary and sometimes despotic power of the rulers of economic enterprise"(Dahl 1977).

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

V. Expanding the space for critique and alternatives.

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

This expanded space is shown in Figure 1, where the blue line illustrates the state space of policy and institutional options in the conventional restrictive "more or less government" menu of policy choices. A location in the space provided by the third pole – civil society – has the same meaning as one on the bi-polar blue line.[2] Alternative paradigms and the institutions that they advocate are located on the triangle with those closer to a given vertex placing greater emphasis on the aspect associated with that vertex. Thus, laissez faire would appear at the upper right, central planning at the upper left and a communitarian paradigm at the bottom.

The problem with the single blue line is not what is there – markets and governments

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

will remain essential – as what is entirely missing. From a descriptive standpoint this includes the essential role of the private exercise of power and of social norms in undergirding a modern economy.

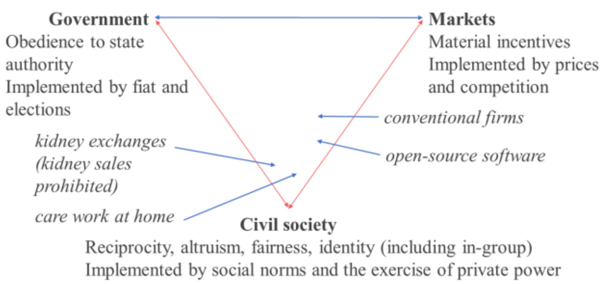

Figure 1. An expanded space for critique and alternatives.

From a normative perspective the single blue line is limiting because it provides no space for the critique of and design of alternatives to the exercise of unaccountable power in institutions that are neither states nor markets, namely firms, families and other private bodies. Elucidating the ways in which the pursuit of a broader concept of freedom – absence of domination – and the cultivation of the associated norms of solidarity, fairness and reciprocity would enhance the functioning of a modern economy cannot be done along the government-market dimension.

Exploring the non-government non-market dimensions of our institutional and policy options provides the basis for integrating a set of democratic, egalitarian, and sustainability values with an economic model consonant with today's economy.

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Appendix to Bowles and Carlin, "Shrinking Capitalism," *American Economic Review Papers and Proceedings*, May 2020.

Policy paradigm	*Normative foundations (Level 1)*	*Provenance of normative foundations*	*Economic model (Level 2)*	*Provenance of economic model*	*Emblematic policies (Level 3)*	*Vernacular economics (Level 4)*
Classical liberalism	Order, rule utilitarianism, liberty, autonomy (contra social hierarchies and paternalism), equal dignity	Hume, Smith, Paine, Bentham, J.S. Mill.	Division of labor, specialization, competitive markets, comparative advantage, Ricardian growth; precursors of mechanism design; cardinal utility	Mandeville, Hume, Smith, Ricardo, Bentham	Free trade, anti-monopoly, complementarity of state-provided infrastructure and private investment	"It is not from the benevolence of the butcher, the brewer, the baker that we expect our dinner, but from their regard to their own interest. … Nobody but a beggar chooses to depend on the benevolence of his fellow citizens" Additivity of "moral sentiments" and material interests
Keynesian social democracy	Solidarity, security, fairness	Tawney, Beveridge B. Webb, S. Webb, T.H. Marshall	Aggregate demand, paradox of thrift, solidarity wages, theory of the second best	Pigou/ Marshall, Keynes, Robinson, Kaldor, Meidner/ Rehn	Demand management, tax, transfer and public goods redistribution, egalitarian supply-side policies	Well-paid workers sustain demand. Saving is prudent for a family but not for a government when the economy is in recession.
"Neo liberalism"	Negative (formal) freedom, procedural justice	Von Mises, Hayek, Nozick, Gauthier	Self-interest (individuals & government officials) and competitive markets. No interpersonal comparisons of utility. Pareto criterion.	Marshall/Walras, Buchanan, Becker, Friedman	Laissez-faire, school vouchers, "negative income tax"	"The government that governs best, governs least." Labor unions are special interest groups. "There is no such thing as "society". You get what you pay for.
A new paradigm in the making	Undominated social relations, voice, equal dignity, community, sustainability	Harrington, Dahl, Sen, Pettit, Van Parijs, Anderson	Social preferences and power in principal agent models; identity economics; increasing returns, declining costs and multiple equilibria; networked economy; enhanced mechanism design. Cardinal utility.	Marx, Schumpeter, Coase, Hayek, Akerlof, Stiglitz, David, Ostrom	Wealth redistribution to support justice and inclusive innovation. Home price insurance to reduce risk exposure; Workplace rights and voice. Competition *for* the market via corporate governance reform. Substantial weakening of IPR.	Cooperation works. Success of open source software and the kidney exchange. Complementarity of "moral sentiments" and material interests.

Figure 1. Paradigms in political economy. Influential paradigms comprise an integrated set of normative foundations, an economic model, emblematic policies, and characteristic way of everyday discussions of the economy, which we term its vernacular economics. Entries are illustrative, not exhaustive of course. Economic developments or events undermining the first three paradigms are: for classical liberalism, the emergence of the hierarchical capitalist firm, growing inequality and the Great Depression; for Keynesian social democracy, stagflation, supply side constraints and the limitations of restricting policy to a one dimensional state vs market dimension; and for "neoliberalism" climate change, growing inequality, and the global financial crisis of 2007-8.