Changing the Social Ethos is the Key

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An unspoken premise in the numerous discussions now taking place among economists concerning the future of capitalism is that we must accept people as they are and design new rules that will prevent bad results from occurring, given that premise. In the language of economists, preferences of individuals are fixed: the problem is to change the rules of the game so that, when every individual attempts to maximize his welfare given his information, the outcome or equilibrium will be a good one. Indeed, the Nobel prize in 2007 was awarded to three economists (Leonid Hurwicz, Eric Maskin, and Roger Myerson) who constructed theories which characterize exactly which outcomes (or more generally, welfare) can be implemented through some set of rules, regardless of what the preferences of individuals may be. The *variable* in this theory is the set of rules, and the objective is to achieve, by clever choice of these rules, an outcome deemed to be desirable in the sense that it appropriately balances the welfare of all individuals.

The theory shows that, indeed, some, but not all, desirable outcomes can be so implemented, but also that the set of rules that is required to implement a particular social outcome may be very complex. In the real world, we are limited to using simple rules—rules concerning exchanges on markets when traders trade at given prices, simple regulations of behavior of various large economic agents (firms, banks), simple rules of contract, and so on. Many of these rules are codified as laws enforced by government. However if the rules are not exactly right, very bad outcomes can result when individuals act in a self-interested way. For example, given the fact that the financial sector is run by intelligent people whose preferences are in the main greedy, if the rules are imperfect, it is not surprising that these individuals can act in ways which do not violate the rules but which engender bad social outcomes. The present crisis is an instance.

THE MARKET AS THE INVISIBLE HAND IS THE CLASSICAL EXAMPLE

Economists and others are now engaged in searching for new rules which will channel the actions of greedy individuals into outcomes that will, nevertheless, be socially desirable. Indeed Adam Smith's invisible hand is the locus classicus of the claim that free markets with

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private ownership of assets comprise the right set of rules, leading profit-maximizing and completely self-interested individuals to bring about an allocation of goods that is desirable, at least in the limited sense of being Pareto-efficient: that is, that no one can be made better off without making someone else worse off. Many now understand that the invisible-hand paradigm is flawed, because the premises required for the Smithian argument to work do not in fact hold in real economies (that all agents be price takers, that there be no public goods or externalities, and that a full set of insurance markets exists). History teaches that it is futile to seek any set of rules that could work in the sense described. The set of rules that would be required to bring about equilibrium behavior with a desirable social outcome (say, a world with constantly positive growth of welfare for all), no matter what the profile of citizen preferences over consumption and risk may be, is probably impossibly complex, if it exists at all.

IF PEOPLE ARE LESS GREEDY, SIMPLE RULES ARE EASIER TO DESIGN

What is the alternative? It is to recognize that the aim of designing rules which will deliver good outcomes *regardless of what the preferences of individuals may be* is too demanding. A less demanding aim is to construct rules that will deliver good outcomes if individuals have preferences that are not arbitrary and greedy, but put sufficient value on concern for others. If we follow a path leading to a society whose individuals are more solidaristic, then I believe it is much easier to design rules that will guarantee good outcomes.

Preferences of individuals are in large part determined by their social conditions, restricted to some unknown extent by evolution and the "human nature" it has produced: in the lingo, these preferences are endogenous to the set of rules chosen. As Karl Marx would have said, under feudal rules we get serfs who desire only to subsist; under capitalism, we get capitalists who desire to maximize their wealth. Each mode of production (set of rules) determines to a large extent the values and the social ethos of the people who live within it

There is of course no social engineer who can command either that people change their preferences, or who can impose a new set of rules. Because we value democracy, rules must ultimately be approved by the voters. Nevertheless, history may produce a path that would engender the desired change in preferences and rules. Suppose, for example, that America succeeds in implementing universal health insurance; that is, that voters in their majority demand it. A more pleasant society will then evolve: people will be under less stress from the fear of losing their health insurance when unemployed, or because they contract a major disease; emergency rooms will be less clogged with poor, uninsured persons; insurers will have incentives to urge people to undertake more healthy life styles (to keep costs down), and so on. There is a good chance that citizens generally will like these changes—not only because of their own increased financial security, but because civility will increase, and poverty will be, at least along one dimension, less glaring. Citizens may come to value equality of condition more than they previously did. This change in preferences may well render politically feasible other insurance innovations and increased financing of public goods—more support for the unemployed with job training, perhaps more direct income support for the unemployed, and more support for intensive education for the disadvantaged.

A sequential process of increased insurance and preference adaptation

Thus, I envision a sequential and incremental process, whereby increased social insurance generates a change in citizen preferences in a solidaristic direction, which then induces still more social insurance through the democratic process. This is the process, I conjecture, that brought Europe, and especially northern Europe, to where it is today, where countries have a significantly more egalitarian distribution of final income than in the United States, and yet where labor productivity remains approximately as high as it is here.

Homogeneous risk exposure is the key to simple public insurance

The stimulus for the first great public insurance program in America was the Depression, and the ensuing Social Security Act of 1935. In Europe the welfare state expanded greatly after the Second World War. Crises (wars and depressions) tend to induce greater social insurance. I believe one major reason is that a crisis tends to place all people in the same boat (or at least, it reduces the difference in the sizes of their boats), and if all people are in the same boat with respect to the risks they face, it is in each individual's *self-interest* to pass universal insurance. (If everyone in a population of risk-averse citizens faces, for example, a 10% probability of unemployment, then the optimal tax policy for each is to pay 10% of his/her income into the insurance pool when employed, and to collect 90% of his/her salary when unemployed.) Conversely, if people face very different degrees of risk (that is, the probability of a bad event is much higher for me than for you) it becomes politically much more difficult to arrange an insurance plan which is simple, and which all will find in their self-interest. If a crisis changes risk exposures so that all people become more similar in that respect, then the political obstacles to designing universal insurance decrease.

My argument is not that citizens immediately become more *solidaristic* because of a crisis—it is that with common risk exposures, it becomes the self-interest of all to implement universal insurance. The Depression in the U.S. placed a large number of citizens in the same boat; similarly, the Second World War significantly reduced wealth differences in Europe, thus making the former well-to-do much more similar to the former poor with regard to risk exposure, which facilitated the passage of social insurance.

I do not wish to imply that this is the only reason that crises induce social reform. Class struggle may also be magnified due to crises: for instance, those who fought and risked their lives as soldiers in World War II returned with a feeling of entitlement and became more demanding of redistribution and welfare-state benefits. This was certainly important in the post-war period in Europe. A more nuanced version of my thesis is that crises tend to homogenize the risk exposures of the working and middle classes, who then form a sufficient majority to pass social insurance, even should the capitalist class oppose it.

What are the laws of motion of preference adaption to increased equality?

I am not proposing an alternative to increasing regulation in the financial sector: of course this is necessary. My claim is that doing so is insufficient to end crises. With clever wealth-maximizing individuals running financial firms and employed in that sector, what will prevent either the erosion of those new regulations over time (as happened recently), or the discovery of new financial innovations which opportunistically exploit citizen gullibility and ignorance without actually violating the rules? The long-run solution is to implement increased insurance and other equality-increasing measures, which, I conjecture, will change citizen preferences in an equality-desiring way. A leading European capitalist, Jorma Ollilia, chairman of Nokia and Royal Dutch Shell, recently said (*Financial Times*, March 23, 2009), "We [the corporate world] need to think a lot about social solidarity." But jawboning by the occasional far-sighted capitalist is not a strategy that will be terribly effective in changing the behavior of corporate leaders.

More generally, it is utopian to believe that such a transformation in behavior will evolve simply by virtue of offering more ethics courses in business schools. History shows, however, that such a transformation may come about as a result of an initial stimulus to increase social insurance. One must recognize these laws of economic, political and psychological motion: crises homogenize risk exposures, creating a democratic demand for insurance (economics and politics), which then induces preference change in a socially-oriented direction (psychology), which then induces a demand for more insurance, and so on, until some new stable state is reached.

All this can transpire in market economies. I am not proposing to resurrect central planning as the solution to our current woes. What remains unsettled is the extent to which decentralized markets, which are doubtless necessary in our complex economies, can achieve stability and relative equality of condition. Although the right-wing argues that human nature requires inequality of outcomes to goad people to be productive, the northern European experience is a counter-example. Markets do induce unequal outcomes, but these can be transformed through redistributive taxation, Nordic-type schemes of wage solidarity, and the large-scale provision of public goods.

The Nordic countries have succeeded in this program to an extent unparalleled in history, and that has transpired through the incremental process of self-interested insurance legislation followed by preference change. The oft-heralded ethnic and religious homogeneity of the Scandinavians as the explanation of their redistributive policies is not the complete story: the salient homogeneity may have been their homogeneity with respect to risk exposure, which accompanies ethnic and cultural homogeneity, rather than the solidarity *directly* induced by ethnic and religious homogeneity.

"NEVER WASTE A CRISIS...."

Crises can homogenize risks, even when citizens are not so similar as the Swedes are (or were in the post-war era) to each other. To the extent that we believe that capitalism's problems can be solved without going through this dynamic process of social insurance followed by changing preferences—that is the social ethos—we ignore history at our peril.

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