"Summary of article by Kenneth Arrow: Distributive Justice and Desirable Ends of Economic Activity" in Frontier Issues in Economic Thought, Volume 3: Human Well-Being and Economic Goals. Island Press: Washington DC, 1997. pp. 269-272

Social Science Library: Frontier Thinking in Sustainable Development and Human Well-being

"Summary of article by Kenneth Arrow: Distributive Justice and Desirable Ends of Economic Activity"

The purpose of the economy is the welfare of the consumers, public and private. In no sense is mere production as such a proper measure, rather it has to be production for the ends that people want. Output, income, and consumption are important aims and preconditions for achieving other goals of individuals; that is, they are only a part of what people live for. (134)

Economic policy must address the aspects of consumer welfare that depend on factors that lie outside of the economy, as well as the three goals that are endogenous to a market system: economic stability, the efficient allocation of resources, and egalitarian income distributions. The last of these has been relatively neglected in modern economic analysis. It is the principal focus of this paper, which concludes that the need for government intervention and collective responsibility is suggested by market failures which prevent just distribution.

JUSTICE, EQUALITY, AND FREEDOM; THE TRADEOFF BETWEEN EFFICIENCY AND EQUITY

Modern neoclassical general equilibrium theory can be used to argue that efficiency and equity are distinct goals. It assumes that, if some significant conditions are met, independent private decisions coordinated through the market will achieve a Pareto efficient allocation, employing all available resources, especially labor. However, this definition of efficiency implies nothing about the justness of a given allocation.

Desirable income distributions cannot be achieved through the automatic workings of the market system. The price system fails to provide a defensible income distribution mechanism and ignores the fact that low income restricts freedoms in important ways. In addition to constraining the freedom to consume, poverty also restricts job opportunities and limits influence in a political setting that favors ideas acceptable to the rich. Unequal distributions of power and money result in the curtailment of many aspects and types of liberty. Justice therefore requires equality -- in both wealth and power -- as well as liberty.

THE CASE FOR REDISTRIBUTION

The theory of social choice aims at providing a normative rationale for making social decisions when a society's individual members have different preferences. The central problem for the theory is how to define a social optimum by aggregating individual preference orderings,

Reprinted with permission from Island Press, © 1997.

including, for example, preferences regarding one's own consumption, social attitudes, and perspectives on the provision of public benefits to others. In spite of the lack of generalizable conclusions, and in spite of uncertainty as to how to define equality, the desirability of redistribution policies to redress inequality can be defended on the strength of the following five points.

First, it is clear that ethical judgments lean towards equality in income distribution. Economists William Vickerey and John Harsanyi, along with philosopher John Rawls, show that members of society would choose social arrangements that lead to equal outcomes if they were placed in an "original position" where individuals know all the possible social conditions (including circumstances of wealth and of talent) they might be born into, but do not know which particular role they will, in fact, be given. When all members are presented with similar sets of possible scenarios, it is predicted that the group will arrive at a mutually beneficial contract of sharing, in which those who turn out to be more fortunate will give to the less fortunate. The ethical judgments that emerge from this approach suggest a moral obligation to redistribute income and other goods more equally.

The choices made from Rawls' original position can be expected to converge on a system that would, in effect, insure against disaster. This implies an allocation of awards that is independent of individual productivity levels. To a certain extent this approach rejects the productivity principle, which asserts that an individual is entitled to what he or she creates. Our second point has to do with the limitations of the productivity principle, recognizing, for example, that it ignores the dependence of an individual's marginal product on complementary or substitute factors beyond his or her control, as well as on inborn talents or family advantages. Being, thus, less than fully responsible for their marginal products, individuals do not have a just claim on the full value of their product.

A concern for incentives seems to support the productivity principle, on the grounds that people will create less if they do not expect rewards for what they create. However, this confuses rents with incentives. In fact, there is no reason to believe that the able scholar or artist requires a higher incentive payment than the mediocre one. Most very high incomes found in capitalist systems do not necessarily represent incentive payments; they are more likely to represent a form of rent than to be a reflection of productivity. (The failure of competition to eliminate such high incomes may be due to monopolistic elements or uncertainty.) Our third point, therefore, is that appropriate redistributions need not diminish performance incentives.

The fourth issue to be addressed is the tradeoff between efficiency and equity considered across generations. Here the fundamental concern is the problem of how much one generation should save in order to increase the welfare of the next generation. Market economies score reasonably well on this overall, generating levels of aggregate investment (public and private) that approximate a just and efficient intertemporal allocation. However, when we look at the composition of investment we see that uncertainty reduces the willingness of lenders to give credit, especially for the critical functions of human capital formation and technical development. This observation leads to the conclusion that transgenerational equity can be improved by appropriate tax-based redistribution, even if growth and aggregate savings are hurt by the attendant market distortions.

Reprinted with permission from Island Press, © 1997.

For instance, taxes levied on high incomes will reduce wealth concentrations and lower total savings, but the poor who benefit from these taxes will have a greater incentive to invest in their own human capital formation and will increase their future income. However, private investment by the poor will only go so far. Redistribution should also focus on improving social capital to raise their productivity -- e.g., technical education, healthcare and housing. A larger role for the government in the development of basic civilian technology will also increase both equality and efficiency. Because of market imperfections, large pools of capital are usually required to bear the risk of technical progress. When government supplies the capital for such investments, the resulting technical progress can be made available on a more equitable basis.

Our fifth point addresses the question: "To what extent does the nature of capitalism, its institutions, its functioning, or its ideology facilitate or inhibit the achievement of justice?" (144)

The ideology, and to a considerable extent the practice, of the capitalist system do encourage equality of opportunity. But since the opportunities have a strong element of uncertainty about them, this very equality of opportunity is apt to lead to inequality of outcomes. As stressed earlier, inequalities of present possessions in turn impede equality of opportunity; wealth achieved from earlier success increases opportunities for oneself and one's children both directly and through family influences and connections. (151)

Unemployment, private property, lack of social responsibility by corporations, and investment speculation all contribute to unequal incomes. Most income inequality is due to inequality in the returns to labor, but the ability to acquire profits through property income also increases inequality. The capitalist drive to maximize profits tends to suppress the expression of altruistic motives, even though competition itself depends on an intricate network of reciprocal obligations.

MARKET FAILURES AND COLLECTIVE RESPONSIBILITY

According to textbook theories, any economic actor in a well-functioning economy is able to conduct any transaction at a given set of prices. In reality, this is not the case. For instance, workers are often unable to sell all the labor they want, and are restricted to selling that labor for which there is effective demand. This kind of serious macroeconomic failure points to an irreducible need for collective decision-making or government intervention. Government stimulation of insufficient demand is preferable to letting valuable resources, such as unsold labor, remain idle. The private sector cannot solve the problem of market failure, the inefficiencies of unemployment, or the equitable redistribution of incomes. Progress toward these goals can only be achieved by a mixed economy that makes sufficient room for government and for social institutions.

Reprinted with permission from Island Press, © 1997.