Chapter 10. People’s capitalism

We can think of individuals entering the market with two primary types of endowments: first their “human capital,” in the form of abilities, skills, and knowledge that increases the productivity of their labour, and second their money capital, largely the product of inherited wealth. In our society, there is no reason to expect equality in the distribution of either form of initial endowment. Furthermore, there are many respects in which the operations of the market amplify these inequalities, such that slight differences in natural endowment can be translated into massive differences in ultimate reward – as in the case of winner-take-all-markets. Thus capitalism often exhibits what is called “justice according to St. Matthew” – to him that hath shall be given, to him that hath not shall be taken away. People who come into the market with a relatively rich endowment are able in increase their holdings, whereas those who come into it with little are often dispatched with even less.

Clearly there is not much that can be done about differences in natural ability, and even if there were, the idea that such inequalities should be redressed is highly controversial. With respect to the distribution of wealth, on the other hand, the case for a more egalitarian distribution is much easier to make. The accumulated capital of a given society (largely in the concrete form of investment goods) is clearly a product of cooperation on a vast scale, across multiple generations. Furthermore, there is a tremendous amount of sheer arbitrariness in the way that it is presently distributed. Many of the great family fortunes were acquired through force of arms, or else through business practices that are now considered unacceptable. It is not clear why the lucky heirs of these aristocrats and robber barons should continue to enjoy a life of leisure, thanks only to the unscrupulous conduct of their forebearers. Thus many have argued that this store of capital should be more equally distributed, and that such a redistribution would eliminate the most objectionable inequalities of the capitalist system. If capital were more evenly distributed, then even those who entered the market with a poor natural endowment would still be guaranteed a revenue stream adequate to meet certain of their basic needs.

According to this view, the basic problem with capitalism is that it does not produce enough capitalists (Gates 1998). Ownership remains highly concentrated in very few hands. A more egalitarian distribution of ownership would give everyone a stake in the system, along with a fair share of the rewards. Thus asset redistribution is often appealed to as a relatively non-disruptive way of promoting more egalitarian outcomes within a capitalist economy. Unlike more radical proposals, it does not seek to change the essential character of the property system, or of the “rules of the game” under which
marketplace competition occurs. The goal is simply to modify the starting-points – in the spirit of the Second Fundamental Theorem of Welfare Economics – so that the existing system will produce a more desirable distributive pattern as its outcome. Such a project is often referred to as people’s capitalism.

10.1 Savings and Investment

There are two basic ways of earning income in a market economy – through one’s labour, or through one’s investments. Throughout human history, the latter has always seemed more problematic to people than the former. It is not difficult to see why. Labour, which increases the stock of goods and services available to humanity, should also confer an entitlement to remove something from that stock. As we saw in §1.4, John Locke used this intuition as the foundation of his theory of property. Investment income, on the other hand, has often been the object of suspicion. Usury (the lending of money at interest) was traditionally prohibited by both the Christian and Islamic religious traditions, simply because it seemed parasitical – one person gains from doing nothing, while the other toils. Karl Marx was certainly not expressing any new sentiment when he wrote that, “Capital is dead labour that, vampire-like, only lives by sucking living labour, and lives the more, the more labour it sucks” (Marx, 1867 [1976], 342). The returns on investment are often described as “unearned income.”

Thus the general question arises: why should the stock of money that a person owns generate a return? The answer has to do with the relationship between investment and consumption. One of the primary reasons that Canadians are richer now than they were a generation ago, and much richer than they were two generations ago, is that they have an enormous stock of equipment that increases the productivity of their labour. In an underdeveloped country, you can see enormous workcrews of men digging a trench with shovels. In Canada, you will see just one person doing it with a backhoe. The availability of earthmoving equipment frees up all of the other people to do other jobs. The result is that it takes workers in Canada a fraction of the time to do a construction job that it does in poorer countries, and as a result, the economy as a whole produces much more. The same applies in every other sector.
It is easy to forget just how much machines simplify our lives. It takes approximately 30 men to generate one horsepower (which is equivalent to only 746 watts of power – less than half of what a typical hair dryer or microwave uses). Nowadays, a typical household lawnmower comes equipped with a 5-horsepower engine – equal to the labour of 150 grown men. The tiny 1.5 litre engine in a Toyota Echo Hatchback, one of the smallest cars sold in the North American market, puts out 108 horsepower, equal to the labour of 3240 men! Imagining the amount of food that over 3000 men consume, and comparing it to the amount of gasoline that a subcompact consumes, provides a helpful way of visualizing why life today is easier than it was 100 years ago.

Differences in productivity can be enormous even among relatively industrialized nations: to take just one example, in 1999 the average steel worker in China produced 41 tonnes of steel. Meanwhile, just across the border, the average worker at South Korea’s largest steel manufacturer produced 1,362 tonnes per year. Part of this productivity difference has to do with skills and training (“human capital”), some of it is institutional, having to do with workplace organization, but most of it is due to differences in equipment. These sorts of equipment are also known as capital goods.

The most important thing about capital goods is that they must all be replaced someday. Machines wear out. The engine in a typical car will provide about 10 years of good performance, maybe another 10 years of problematic performance with increasingly extensive repairs, and eventually will need to be thrown away. The same goes for all the other industrial equipment, computers, transportation infrastructure, communications devices, etc. that we use. This means that, as a society, if we want to maintain our standard of living, we cannot consume everything that we produce. We must dedicate only a portion of the economy to the production of consumption goods, while spending the rest of the time, energy, labour and resources on to reproduction of the stock of capital goods. Stylizing somewhat, this means that, on an annual basis, each individual must “put in” to the economy, in the form of labour, slightly more than he or she “takes out” in the form of actual consumption. The remainder – the portion that is not consumed – is what goes toward producing (and replacing) capital goods.

There are many ways in which a society can organize the reproduction of its capital stock. Note, however, that there is a potential collective action problem in this domain.
Individuals want to maximize their own consumption. Why should they work to produce capital goods that they themselves will derive little or no benefit from? Thus some care must be taken to ensure that society does not adopt a **depletionary investment policy**, one in which consumption is allowed to eat in to the capital stock. Generally speaking, some mechanism must be in place to ensure that people have an incentive to refrain from consuming everything that they produce.

There is a second problem. Almost everyone, to a greater or lesser degree, privileges their short-term over their long-term interests. Economists describe this tendency by saying that individuals **discount** future satisfaction. Offered a cheque for $100, cashable immediately, or a cheque for $150, cashable in a year’s time, many people will take the $100 immediately. They choose the object of lesser value only because it is available sooner. Thus the greater value of the $150 is discounted, because it is available only after a delay. Some of this discounting may reflect uncertainty about the future (“perhaps I’ll get hit by a bus in six months, and never be able to cash the cheque”), but some of it represents a pure time preference. We simply assign greater value to present satisfaction than we do to our own future satisfaction.

The standard way of representing this time preference is through use of a discount rate ($\rho$), which can be defined as the extra fraction of a payoff needed to make an agent indifferent between satisfying some desire now and satisfying it in one period. From the discount rate, we can define a discount factor $\delta = 1/(1+\rho)$ as the value in present payoffs of one unit of payoffs to be received one period in the future. It indicates, in other words, the present value of future satisfaction. So if a person is indifferent between $100 now and $110 in a year’s time, this means that she needs to be paid an extra $10 in order to compensate her for the hardship of deferring that much consumption for a year. Thus the present value to her of having $100 in a year’s time is only $91 (which, when added to the present value of the $10 extra, comes to $100). Thus the agent discounts the future at an annual rate of 10 per cent (or with a discount factor of .9 per year).

The same analysis can be generalized to cover satisfaction in more distant time periods. Having $100 two years from now will be worth $91 to her in one year, and is therefore is worth $83 in the present. Thus if $u_k(a)$ represents the expected payoff at time $k$ from some action $a$, the value of some stream of future payoffs is worth the following in the present (where $n$ is the total number of time periods):
(1) \[ d(a) = u_1(a) + \delta u_2(a) + \delta^2 u_3(a) \ldots + \delta^{n-1} u_n(a), \]

(Since the discount imposed at any given time period is an exponential function of the discount rate, this is referred to as an “exponential” discount function.)

Because people discount the future, they have a general aversion to deferring consumption, which in turn amplifies their tendency to consume everything they produce. Thus society, in order to reproduce its capital stock, must supply individuals with an incentive to forego consumption, one that is sufficiently great to overcome both the free rider problem and the problem of human short-sightedness.

One of the least painful ways of doing this is the use people’s savings as a source of investment funds. It is often the case that people, for one reason or another, do not want to consume everything that they have produced in a given year, but in fact would like to accumulate it so that they can consume it in future years. In particular, people who are young and healthy often want to work hard and consume less in the present, so that when they are older they can consume more than they are later contributing. One way to do this would be to purchase extra consumer goods when one is young, then “lay in stores” that can be consumed when one is older and no longer able to work. One can imagine workers accumulating basements of tinned food, in order to feed themselves during retirement. But if everyone was doing this, it creates an opportunity for an entrepreneur to come along and say “instead of working so hard to buy tinned food here and now, why not help me build a factory? I promise then to repay you when you’re retired with even more food.” Because of the gain in productivity to be realized in the new factory, this may be a credible offer.

Of course, in the real world we do not make these sorts of exchanges using concrete goods. It is all mediated through money. The worker, in the above example, would be “laying in stores” by earning more than she spends – in other words, she would be saving money. The entrepreneur would offer to borrow this money and repay it at a later date with interest. He would then invest the borrowed money, hiring other workers to produce the desired capital goods, run the factory, and generate the revenue needed to eventually repay the loan.
Thus the fact that some people want to defer their own consumption creates a certain amount of slack in the economy – a willingness on the part of some to put in more than they take out. The amount of money that is put aside in the form of savings gives a fairly accurate assessment of the magnitude of this “slack,” and this pool of savings is what we use to finance investment, and thus the replenishment of the capital stock. Furthermore, if society is not investing enough in capital goods (i.e. is consuming “too much” to sustain its own standard of living), then the number of profitable investment opportunities will increase, as will their average value. As a result, entrepreneurs should be willing to offer consumers more in the way of compensation for their willingness to defer consumption. On the other hand, when too much is being saved, the pool of profitable investment opportunities will begin to dry up. In theory, it is the interest rate that reflects the balance of the two – relative scarcity of investment funds drives up interest rates, giving consumers an incentive to save more; relative abundance of investment funds drives down rates, giving consumers an incentive to consume more. In practice this “market” does not function quite so smoothly, and so the state plays an important role in setting rates through the central bank.

Thus capitalism relies centrally upon private, voluntary savings as a way of generating investment – which is to say, as a way of reproducing the capital stock. (The other primary mechanism is savings by corporations, when they choose to reinvest earned income rather than distributing it out to shareholders in the form of dividends.) This is why accumulated wealth generates an income to individuals (primarily in the form of interest paid on loans and dividends paid on stock). Not only is this income necessary in order to induce individuals to refrain from consuming all that they produce, but it is also generated by the higher levels of productivity that the investment itself permits, through reproduction of the capital stock. The person who decide to forego a certain amount of consumption, and yet continue to work just as hard as before, generates a real benefit for society. The income earned from savings is the compensation paid to the individual in return for the provision of this benefit.
10.2 The Savings Puzzle

People who keep track of this sort of thing know that people who are relatively wealthy have a tendency to save a much larger fraction of their income than people who are poor. Put more technically, the marginal propensity to save is a positive function of income level. A poor person whose income increases by $100 per month is likely to spend it all, whereas a rich person is likely to put most if not all of it in the bank. As a result, the distribution of wealth in society is much more unequal than the distribution of income. People who already have a lot of wealth save a lot of their income, which increases their wealth. People who have very little spend everything they earn, and so find themselves unable to “get ahead.” These facts are so well known that we tend to regard them as self-evident. There is, however, something of an economic mystery underlying this common phenomenon.

As a consequence of the way that the capitalist economy rewards savings, everyone has the same incentive to save. It doesn’t actually matter how much you earn, the way to maximize your lifetime consumption is to save as large a portion of your income as you can (until you get old enough, and the probability of death becomes great enough, that you should start dis-saving). If a rich family can benefit from savings 10 per cent of its income, then a poor family can derive exactly the same – if not greater – relative benefit from saving 10 per cent of its income. Thus the fact that the poor don’t save actually requires some sort of special explanation, since it represents a deviation from the predictions of standard economic theory.

To see the benefits that saving confers, consider two people (for ease of identification, we will call them Thrift and Spend) (Frank 1999, pp. 98-99). Both start at age 40, earning $40,000 per year. Spend saves 5 per cent of his annual income and spends the rest, while Thrift saves 20 per cent. Assume that both earn a rate of return of 10 per cent on these savings, which then gets added to their income the following year. (And ignore all sorts of complicating factors, like variability in the rate of return, taxes, etc.) The impact on their annual spending is shown in Figure 10.1. At first, because he saves so little Spend has a lot more disposable income (he is able to spend $38,000 a year, versus only $32,000 for Thrift). This continues in the second year, where despite the fact that Thrift’s income overtakes Spend’s, because he is still saving 20 per cent his consumption remains much lower. At age 52, however, Spend’s consumption gets overtaken by Thrift’s (Thrift earns $50,729 and spends $40,583, while Spend earns $42,467 and
spends $40,343). By the time they are ready to retire, Thrift is spending $52,499 per year, while Spend is only able to spend $43,046. Furthermore, Thrift’s lifetime consumption will have exceeded Spend’s at that point. He did not really forego consumption in his 40’s, he simply deferred it until his 50’s and 60’s, at which point he was able to spend much more, because of the accumulated return on his investments.

Figure 10.1 Consumption over time

If one looks at things from the standpoint of wealth, things look even worse for Spend. Thrift has accumulated $269,367 in capital, whereas Spend has accumulated only $55,383 – thus Thrift will enjoy a retirement income at least five times higher than Spend’s (see Figure 10.2).
10.2 Accumulated wealth

Thus it is not too difficult to make an economic case for saving a portion of one’s money. The point is that this relationship obtains regardless of whether the incomes in question are $40,000 or $400,000. If anything, people who are poor should be more concerned to increase
their consumption, by whatever means possible, simply because the marginal utility associated with any increase in their income should be greater. And yet they save less. This is the phenomenon that requires explanation.

It is also a phenomenon that is of enormous importance from the standpoint of achieving greater equality under capitalism. It is tempting to imagine that the inequality in the distribution of wealth in our society is something that has its origins in a previous era (during the time of “robber baron” capitalism, or feudal aristocracy), and has simply been handed down to us from one generation to the next. If this view were correct, then all it would take to establish equality would be a single, one-shot redistribution, in order to establish a baseline of equality (much like the radical land-reform initiatives proposed, and often carried out, in underdeveloped countries). Once the allocation of property is “reset” in this way, one might think, it should go on reproducing itself as a system of relative equality, with only minor subsequent correction.

This view ignores the fact that the overwhelming majority of wealth in circulation today is of quite recent vintage. In a feudal society, in which the economy is almost completely agricultural, inequality in the distribution of land will tend to be at the basis of all other economic inequality, and so rigid inheritance rules for land will tend to reproduce that inequality over time. But in a market economy, vast wealth is conjured up out of the industrial process itself. So even though the distribution of income remains highly unequal, the sheer magnitude of the increase in wages in the 20th century has meant that labour income easily overshadows investment income in scale. Thus the working class could easily have bought out the capitalist class in a generation or two, had it chosen to do so, simply by investing a portion of its annual wage increases in the stock market. If one looks at typical patterns of working-class consumption, however, one sees a marked preference for increasing present consumption rather than acquiring an ownership stake in the capitalist system. Auto workers, for instance, generally use their generous wages to buy bigger and better automobiles or trucks, not stock in the corporations that manufacture automobiles and trucks.

Thus any proposal for a “people’s capitalism” must face an important initial difficulty. Recall that the goal is to create greater income equality by creating a more equal allocation of assets, and thus greater equality of investment income. Unfortunately, some people seem to be highly averse to holding any wealth, as witnessed by their spending patterns. This suggests that
those who have no wealth may not have it for a reason, and that any wealth redistributed to those
who have very little will simply be spent. If this happens, then asset redistribution will prove to
be a highly ineffectual way of achieving greater income equality. The initial redistribution will
increase equality, but within a few years things will revert back to the way they were before, as a
large percentage of the population spends the money that they receive, rather than holding it as a
source of investment income. People will kill the goose that lays the golden eggs.

The general problem is that the incentive to save provided by the possibility of earning
investment income – which in principle should have the same appeal for everyone – appears to
motivate only a fraction of the population. This could be due to quite superficial reasons. For
example, it could be that the poor do not save precisely because they are poor. If this were true,
then the mere fact that asset redistribution makes them richer would also change their spending
habits. Unfortunately, there is a lot of evidence to suggest that the relationship is more
complicated, and that a spendthrift does not immediately become frugal upon winning the
lottery. Thus the fact that the poor save less seems to be at least in part the result of a sorting
effect – a determinant of who winds up in poverty – than an effect of poverty itself.

A somewhat more plausible hypothesis is that much of the variation in savings rates
reflects variation in the agent’s underlying discount rate. People who save less simply assign
less weight to their own future satisfaction. Because the benefits of saving are temporally quite
far removed, they judge present consumption to be of greater value.

The problem with this hypothesis is that while people’s behavior would appear to
indicate that they assign little importance to their own future satisfaction, their expressed
preferences often suggest the opposite. In other words, very few people claim not to care about
future benefits, simply on the grounds that they are in the future. On the contrary, many people
know that they should save, claim that they want to save, and yet wind up saving nothing (or
worse, running up high-interest debt on credit cards). Yet if they merely discounted the future at
a very high rate, there would be no way to explain this inconsistency.

These reflections lead to a more troubling suggestion, which is that people who save very
little (or who incur consumer debt) may have what psychological George Ainslie refers to as a
“hyperbolic” discount rate. One of the features of the “exponential” discount rates normally
employed by economists is that they impose dynamic consistency on the agent’s preferences. An
agent who prefers the immediate lesser good to the delayed greater good will always do so, whenever the choice is presented. Thus the person who chooses a $100 cheque that can be cashed immediately over a $150 cheque that can only be cashed in a year should also choose a $100 cheque that can be cashed in six years over a $150 cheque that can only be cashed in seven years. Yet what Ainslie found is that people will often choose the lesser sum when presented with the first set of options, but the greater sum when presented with the second. It is as though they think, “if I have to wait six years to get the money, I might as well wait one more year and get the extra $50.”

In other words, many people (all of us to some degree), appear to suffer not just from impatience, but from heightened impatience in the near term. As a result, we are subject to **dynamic preference inconsistency**. A person who would prefer $100 right away, but nevertheless chooses the $150 cheque that can be cashed in seven years over the $100 cheque that can be cashed in six years, will come to regret that decision in six years. If fact, if offered the opportunity to revisit the decision, in six years’ time, he will change his mind, and go for the immediate cash.

This is something that David Hume observed long ago:

In reflecting on any action, which I am to perform a twelve-month hence, I always resolve to prefer the greater good, whether at that time it will be more contiguous or remote; nor does any difference in that particular make a difference in my present intentions and resolutions. My distance from the final determination makes all those minute differences vanish… But on my nearer approach, those circumstances, which I at first over-look’d, begin to appear, and have an influence on my conduct and affections. A new inclination to the present good springs up, and makes it difficult for me to adhere inflexibly to my first purpose and resolution.

This raises a question as to whether the standard “exponential” discount rates accurately reflect the way many people make decisions with regard to future satisfaction. Suppose, for the sake of argument, that the agent discounts the future in the following way:
Ainslie refers to this as a “hyperbolic” discount rate, because it is quite exaggerated in the near term. The value of the outcome drops off quite sharply with the first two or three periods of delay, but then becomes much more stable. What is important about this discount rates is that it will generate dynamic preference inversions. This is illustrated in Figure 10.3.

Both charts show the utility that the agent assigns to two events: \( p \), which is worth 10, and \( q \) worth 7, at different time periods. The twist in the story is that \( q \) is scheduled to occur one period sooner than \( p \). Each series shows the value of the two events at 7 periods removed, at 6 periods removed, etc. The fact that \( q \) will occur sooner is reflected in the fact that at \( t = 3 \), \( q \) is discounted only “once,” while \( p \) is twice discounted. With the exponential discount rate, \( p \) is always preferred to \( q \). With the hyperbolic discount rate, on the other hand, \( p \) is preferred to \( q \) when the two events are far away, but as the time approaches, \( q \) begins to look more attractive – not because it is “intrinsically” more desirable, but simply because it occurs sooner.
Here we can recognize the very common feature of human psychology that Hume described. We can decide “in advance” that $p$ is better than $q$, but then find that when the time comes to choose between the two, we prefer $q$.

Ainslie’s empirical research makes it clear that everyone in the population engages in hyperbolic discounting to a greater or a lesser degree. One group of economists estimates that the average American discounts the future at an annualized rate of 40% in the short term, and 4.3% in the long term. Research is still in its earliest stages, but there is also evidence that the “steepness” of these discount rates is correlated with socioeconomic class. One study of welfare recipients in the United States, for example, found corresponding discount rates of 57% in the short term and 8% in the long term. There is also the fact that certain characteristics that tend to be associated with heightened impatience in the near term, such as alcohol consumption and smoking, failure to use contraception, use of cheque-cashing services instead of banks, and failure to purchase life insurance, are distributed in a highly class-specific manner.

Naturally, one would expect that the lines of causality would run both ways. Being raised in disadvantages circumstances, and with a poor education, is likely to generate a more myopic orientation. Yet at the same time, having a very deeply bowed discount rate is also likely to promote downward social mobility. In other words, if being poor doesn’t give you a more hyperbolic discount curve, then having a very hyperbolic curve is good way to become poor. In particular, it makes the individual highly susceptible to addictive behaviors. Although it sounds unsympathetic, it has been observed that Americans basically have to do three things to avoid poverty: finish high school, marry before having a child, and wait until you’re at least 20 before having that child. Only 8 percent of families who do this are poor, whereas 79 percent of those who fail to do so are poor (Wilson, 1992). This suggests a strong link between hyperbolic discounting and poverty.
10.3 Lump sum redistribution

A number of different schemes have been proposed to achieve large-scale asset redistribution. The two most popular ideas by far are the “lump-sum” coming-of-age benefit and the inheritance tax, either separately or conjoined. Both of these have advantages and disadvantages:

1. The inheritance tax. Getting people to part with their money can often prove to be quite difficult. Furthermore, the most objectionable forms of wealth inequality have always been the ones that have been produced through inheritance, simply because the beneficiary has done absolutely nothing to earn the money, not even save. It is literally an accident of fortune. Thus a tax on large estates has always presented itself as an attractive way of achieving redistribution of wealth – the person who “owns” the wealth is no longer around to lay claim to it, or resist its confiscation, while the heirs who would otherwise be “in line” to receive it have an extremely weak moral claim to its ownership. If redistributions always involve win-lose transformations, then this seems like the closest to a “no-lose” transformation one can get, simply because the person whose endowment is reduced is dead, while the heirs cannot say that “their” endowment has been reduced, the most they can say is that their endowment has not been increased by as much as it might have been. The deceased might have chosen to spend most of the estate in the last days of his life, or to donate a large portion of it to charity – in such cases, we would not say that the heirs have been harmed by the decision, even though it does affect their interests. For the same reason, we cannot say that the heirs are harmed by estate taxes.

Inheritance taxes unfortunately are difficult to enforce, and so it is necessary to plug an enormous number of loopholes in order to prevent people from circumventing them. Historically, some states have experimented with very high inheritance taxes. In the United States, the top rate of taxation on the very largest estates was over 70 per cent throughout much of the 20th century – motivated in part by the desire to break up the enormous family fortunes like those of the Rockerfellers, Mellons, and so forth. The large foundations that carry these family names were created precisely in order to avoid paying these estate taxes. The reason is that a corporation, or a trust, never “dies,” and so its wealth never technically changes hands. Ownership of the firm can change hands, but there are various ways of making sure that this is untaxed (or lightly taxed).
Thus one way to avoid inheritance taxes is to avoid accumulating personal wealth, keeping it all in a firm, which will then dispense revenue to one’s heirs.

The other, more obvious way of avoiding inheritance taxes is simply to give away one’s assets to children and loved ones prior to death. The only intrinsic check on this is “Lear’s curse,” viz. the danger that one’s children will become significantly less tolerant of one’s presence after they cash their inheritance cheques. Nevertheless, there are ways around this through private contracting. Thus once inheritance taxes become sufficiently large, it is necessary to put restrictions on large gifts. First and foremost, the ability of parents to buy large items such as houses for their children must be curtailed – or more specifically, the gift must be taxed at the same rate than an inheritance would be. This is extremely difficult to enforce. With houses and cars, there is paperwork involved in the transfer of ownership, and so there is some possibility of keeping track of such gifts. But many others items, such as jewelry or cash, can change hands without any conceivable system of regulation. In Canada, where casino winnings are untaxed, a parent could go in with a child, then emerge having “lost” $50,000, while the child “won” $50,000. People can also transfer large sums to their children by taking out life-insurance policies, even when they know they are going to do. Finally, inheritance taxes give parents an incentive to transmit benefits “in kind” to their children. Expensive private-school education is one of the preferred ways of doing so.

In order to avoid these difficulties, some proponents of inheritance taxes have also recommended progressive “privilege taxes” on individuals throughout their working lives, based upon their parents’ income level. The assumption is that children from affluent family backgrounds will have acquired all sorts of advantages, many of them quite intangible. As Bruce Ackermann and Anna Alstott, who argue for such a tax, observe, “a son whose father’s income was in the bottom quarter of the income distribution has only a 39 per cent chance of earning more than the median income himself. But a son whose father’s income was in the top 5 per cent has a 76 per cent chance of earning more than the median and a 42 per cent chance of being in the top 20 per cent” (2000, p. 161). Much of this is due to educational advantage. Affluent families can afford tutors, private schools, and extracurricular activities. Scores on standardized aptitude tests are highly correlated with parental income. This gives students from affluent
backgrounds access to more prestigious colleges and universities, which greatly improves their chances of securing higher-paying jobs after graduation.

This proposal also raises a number of thorny questions: What to do with children of divorced parents? What about the in-kind benefits generated by stay-at-home caregivers? Does this not give women an incentive to stay home with the kids, rather than work? What about the very substantial benefits conferred upon children whose parents have very high education level, but little income? Does the plan not penalize children born to older parents (whose incomes would on average be higher)? What about children who are disowned, or who are simply denied many benefits by their own parents?

Finally, one does need to worry about the overall impact that inheritance and so-called “privilege” taxes would have on savings. Most elderly people have the option of consuming all of their accumulated wealth in the form of medical care, casino gambling, travel, and so forth. Insofar as they refrain from doing so, it is often because they want to leave something for their children. If inheritance taxes become confiscatory, it could have a negative impact on the overall savings rate. Yet it is important to recall that saving is, in general, a good thing, since it makes money available for investment, which in turn permits us to replace capital goods, improve productivity, and make it easier to generate greater wealth in the future. Furthermore, because of hyperbolic discounting, along with short-sightedness in general, people will not be as responsive to interest rates as they should, and so there will be a tendency in capitalist economies for the savings rate to be too low, rather than too high. Thus in general it is good public policy to encourage saving. The problem is that, because not everyone saves at the same rate, private voluntary saving tends to amplify economic inequality. As a result, there is sometimes a temptation to adopt policies that would discourage savings in general, in order to prevent the inequalitarian consequences of this amplification effect. Yet doing so creates a classic tradeoff scenario between equality and efficiency – precisely the type of situation that asset redistribution was intended to avoid.

2. Coming-of-age payments. It has often been suggested that a more equal distribution of wealth can be created by taking revenue generated from an inheritance tax, and providing it to the next generation in the form of equal lump-sum payments to individuals as they reach the age of
majority. Ackerman and Alstott, for instance, argue that each American citizen should receive a “stake” of US$80,000 upon reaching the age of 21, financed by a tax on wealth (the details of which remain unspecified), combined with a minimum flat tax of $80,000 on all inheritances. This is quite a substantial redistribution – total wealth in the United States is approximately $27 trillion dollars, which works out to only US$90,000 per capita.

There is some precedent for this sort of arrangement in states that receive significant resource royalties. In Alaska, for example, 25 per cent of revenues from oil royalties go to the Alaska Permanent Fund, which issues “citizens’ dividend” cheques on an annual basis to all residents of the state (usually between US$1,000 and $2,000). This differs from actual wealth redistribution in that the fund continues to be held in trust by the state for all citizens, and invested on their behalf. Thus strictly speaking it is only income generated that is distributed out. In the case of children, the money goes to their parents or guardians. However, there are some resource-dividend sharing arrangements – in particular on First Nations reservations – in which payments to children are withheld until their reach the age of majority. Among the Samson Cree in Alberta, for instance, accumulated oil and gas revenue-sharing payments are given to children in a lump sum at the age of 18.

The general problem with these sorts of arrangements is that young people tend to treat the lump-sum payments as windfall gains. Rather than preserving them as “nest eggs” or sources of revenue, they typically use them to finance immediate consumption. (It is also difficult to keep children from spending their payments prior to the age of majority, since they can always try to secure loans using the anticipated lump sum payment as collateral. Such contracts would have to be made unenforceable under any redistribution scheme, but that does not mean a robust black market for credit would not arise.) There is strong evidence of this among the Samson Cree, where most teenagers receiving lump sum payments use them to purchase a brand new truck. Ackermann and Alstott suggest that this problem can be addressed through more effective education programs, explaining the long-term benefits of saving and the miracle of compound interest. Yet if the problem is the underlying discount rate, then simply supplying people with more information is not going to solve the problem – any more than the problem of obesity can by solved by supplying consumers with more information about appropriate diet.
It is perhaps for this reason that residents of Alaska have consistently voted down proposals to have the capital in the Alaska Permanent Fund divided up and paid out (it would generate a one-time lump-sum payment of approximated US$40,000 per person). There is clearly a self-binding mechanism at work in their decision to have the state invest the money on their behalf – they can’t trust themselves not to spend the money in one shot, so they delegate the task to the state, in order to secure the income stream.

The United Kingdom has recently adopted a more modest program to create “coming-of-age” payments, called the Child Trust Fund (CTF). Once the birth of a child is registered, parents receive a voucher worth £250, which can be used to open a CTF account. Low income parents receive an additional top-up of £250 when then create the account. Once the child's savings account is open parents, grandparents, relatives and friends will all be able to pay in up to a total of £1200 each year, tax free. The accumulate amount cannot be withdraw by the child until he or she reaches the age of 18 (upon which time there are no restrictions on how the money can be used). The goal is of course to give each child a “nest egg” to finance education, the purchase of a house, etc., but also to promote financial education – in part so that each child comes of age seeing quite clearly the benefits of saving and compound interest.

It remains to be seen how successful the British plan will be. However, it is certain that an incremental plan of this type has far greater chances of success that the sort of massive redistribution advocated by Ackermann and Alstott. Because the “nest egg” is created at birth, and has 18 years to grow, the amount that must actually be redistributed in order to achieve a rather substantial payment at age 18 is much lower. Furthermore, insofar as such schemes are able to change people’s attitudes toward saving, it is more likely that this will occur incrementally, across time. It may be that only after a few generations, when the consequences of “blowing” one’s savings versus keeping them invested have become clear, that preserving the investment will come to be seen as the more attractive option by the majority. If so, then the program can also be steadily ramped up over time – with the government slowly increasing its contribution as the culture of savings begins to take hold.
10.4 Employee Stock Ownership Plans

The goal of lump-sum redistributions is to create a more equal division of wealth, so that investment income will be more equally shared within the population. The problem is that giving people cash offers no guarantee that they will not simply spend the money, rather than keep it in the form of savings (i.e. they may use it to finance current consumption, rather than holding it in the form of an investment and using the revenue stream to finance their consumption).

Furthermore, the fact that certain people have no wealth itself strongly suggests that they will have a propensity to spend any transfers that come their way – since if they didn’t have such a propensity, they would not be without wealth in the first place. Yet if people spend their transfers, rather than saving them, wealth redistribution will do very little to combat inequality in the long run. Furthermore, redistribution takes large segments of wealth that otherwise would have been saved and invested (by the rich) and uses it to finance current consumption (by the poor). Thus redistribution would tend to depress the overall savings rate, at the expense of future generations.

As a result, proponents of asset redistribution have often favored plans that contain a paternalistic element, i.e. that redistribute assets in a form that prevents the beneficiaries of these redistributions from liquidating them in order to finance present consumption. Rather than giving people cash, which they might simply spend, the goal is to give them some kind of “locked in” asset, which they are forced to hold as an investment. Thus they are able to spend the revenue stream that their capital generates, but they cannot deplete the capital itself.

Once of the most popular vehicles for this is the Employee Stock Ownership Plan (or ESOP). The basic idea is to give employees, in partial lieu of salary, shares in the firm that they work for – shares that carry with them some type of restriction on when and how the employee can sell them. (Again, there is much evidence that if one simply gives the employees shares, an overwhelming majority will immediately sell the shares and use the proceeds to finance current consumption.) Thus a typical ESOP prevents employees from selling their shares as long as they remain employees of the firm. Typically, the shares are held in a trust, which has to hold a majority of the shares issued to employees.

There are several problems with the standard ESOP. The first is that restricting employees from selling their shares until they leave the firm generates a perverse incentive for
them to leave. The more serious problem is that not only does it prevent employees from diversifying their capital holdings, it actually amplifies the risk that they are exposed to. If the firm goes bankrupt, not only do workers lose their jobs, but they lose their investments as well. (Enron, for instance, had a very progressive ESOP, and also offered inducements for employees to purchase company stock in their individual retirement plans. At the time of bankruptcy, employees owned about $1 billion in company stock, none of which they are likely to recover.) It is important to remember that shareholders are *residual claimants* in the firm – they get what is left over after everyone else – employees, suppliers, creditors, etc. – have been paid. The firm is under no obligation to pay dividends to shareholders, and the value of shares can rise and fall. Thus they take on considerable risk, but in return, there is no upward limit on the potential returns they may enjoy. Compare that to the case of creditors: someone who extends a loan to the firm will often demand collateral (goods they can seize in the even of non-repayment). Furthermore, creditors are first in line for repayment if the firm declares bankruptcy (indeed, it is creditors that normally push a firm into filing for bankruptcy protection). Thus the creditor is exposed to much less risk than the equity investor, but in return, the creditor has fixed terms of repayment, and never receives more than the interest rate that was agreed upon when the loan was extended. Equity holders, on the other hand, can earn windfall profits, but they can also lose their entire stake.

Because equity holders are exposed to such high levels of risk, investors in the stock market are usually encouraged to reduce this exposure by diversifying their holdings (most primitively, by buying stock in a large number of different firms). Employees with significant holdings in an ESOP will be unable to do so. It is worth noting that the total market capitalization of firms on the New York Stock Exchanges is about US$15 trillion, which works out to about $50,000 per U.S. citizen. This means that even under ideal conditions, employees with a reasonably large stake in their own firm would not have that much left over to invest elsewhere.

The problem is compounded by the fact that employees face labour-market risks on top of the risks that they face as investors. Ideally, they would use their investments to “hedge” these risks. For example, if they bought shares in a rival firm, under the assumption that any setback to their employer would benefit the competition, then any loss of wage income would be partially
offset by an increase in value of the investment portfolio. Yet an ESOP forces them to do the precise opposite.

It should also be noted that a standard ESOP generally falls short of full “worker ownership,” since workers generally sell their shares, when they do so, to outsiders. Nor it is reasonable to expect that the development of ESOPs could move the overall ownership pattern of society in that direction. In a typical industrial economy, certain sectors will have average capital-to-labour ratios that are 50 times higher than in others. So while it may be reasonable to expect that employees in a restaurant or beauty salon might acquire ownership of the firm, including all its productive assets, the same cannot be said for workers at the steel mill or a petroleum refinery (where there may be several million dollars in assets for every worker). Even if the workers had that much money, it would be unreasonable to expect them to keep it all tied up in that one asset.

Thus in order to achieve self-ownership, more fundamental reforms would be required. The buying and selling of shares on the stock market would have to be prohibited, and the shortfall in equity financing for heavily capitalized industries would have to be made up for with bank credit.

It is sometimes thought that the superior incentive effects of employee ownership would generate productivity gains, which would in turn compensate workers for any of these difficulties experienced. The naïve version of this claim is based upon the thought that, because workers become the residual claimants, extra effort on their part will be rewarded by increased profits. According to this view, employee ownership creates a system of performance pay. The problem with this view is that it ignores the collective action problem confronting employees. Since profits are pooled, then paid out equally to all stockholders, any extra work effort on the part of a single employee generates primarily positive externalities for other workers. At any reasonably large firm, the extra profit enjoyed by any individual worker as a consequence of her own efforts would be extremely small, and unlikely to outweigh the disutility associated with greater effort.

The more sophisticated version of the argument appeals to the fact that workers are able to monitor one another’s effort levels much more easily than managers can (Bowles and Gintis 1998, 37). Thus there is less likely to develop a “culture of shirking” (in which workers collectively conspire to conceal their low effort levels from supervisors) in employee-owned
firms. Yet while this may be true, complaining about one’s fellow workers is unlikely to make one popular amongst one’s peers. If workers are unwilling to snitch on coworkers, or if authority structures are not in place to remedy the problem once reported, workers may “retaliate” independently, by lowering their own work levels (so that at least they will not be “suckered”).

The task of anticipating the incentive effects of employee stock ownership is therefore a difficult one. United Airlines, which has to date been the largest employee-owned corporation, provides a cautionary tale. In 1994, facing bankruptcy, United shareholders agreed to give employees 55 per cent ownership of the firm, in return for US$4.88 billion in wage concessions. In 2002, United did finally file for bankruptcy protection. What went wrong? With over 85,000 employees, there was clearly very little change in the incentives that each employee faced with respect to work effort. Most importantly, the adversarial culture of the workplace was not fundamentally changed by the transition to employee ownership. Part of this was due to the fact that the pilots, mechanics, and ground crew remained members of separate unions, each of which continued to bargain aggressively with the firm for wage increases. In particular, the mechanics’ union resisted wage cuts that would have allowed the firm to stave off bankruptcy until it was too late (the slogan adopted by many members: Full Pay to the Last Day!). Some described this as irrationality on their part; more likely it was simply the result of a prisoner’s dilemma between the unions.

10.5 A Coupon Economy

The central dilemma faced with ESOPs is that one must either force workers to hold their assets in the stock of their employer, in which case they cannot diversify their holdings, or else permit them to place the investment elsewhere, in which case they can liquidate their holdings and use the revenue to finance consumption. It is possible to get around this difficulty with retirement savings, where investments can be “locked in” until the age of 65. The problem is that there is no way, within the existing framework of capitalist institutions, of getting individuals to hold investments that will generate an income flow in the medium term. The ideal solution would be to make stocks non-redeemable, so that they would generate income flows paid in ordinary cash, but could not themselves be sold for money. That way, once a person assumed
ownership of a stock, he would have no choice but to hold on to it, or sell it for another stock, which in turn he would have no choice but to hold on to. Either way, wealth of this sort could not be converted to cash, and so could not be used to finance consumption – there would be no way to kill the goose that lays the golden eggs.

The economist John Roemer has made one proposal for a system of “market socialism” with precisely these characteristics. (Although he calls it a form of “socialism,” I classify it here as a type of people’s capitalism, since it leaves most features of the market economy unchanged, save for the way in which equity financing is achieved.) His idea is to reform the stock market so that shares could no longer be purchased with ordinary cash, only with coupons that would be issued for this specific purpose. These ownership coupons would initially be distributed out equally (which is how individuals would initially acquire them). Companies would compete with one another to attract investors, they would pay out cash dividends to investors (just as they do now), and stock prices would rise and fall (just as they do now). The difference is that when a company sold a share to an individual investor, in return for a certain number of coupons, these coupons could not be used to buy productive inputs. Instead, firms would take these coupons to the treasury, which would convert them to money at some fixed rate. Firms would then use this money to buy inputs, employ labour, and ultimately pay dividends to the coupon investor.

The advantage of this system is that it retains the flexibility of both equity and credit financing. However, because individuals would be unable to purchase equity directly from their savings, all financing would go through the banks – with the central bank using some portion of the deposits to pay for coupon redemptions to firms, and the other portion for ordinary credit. Thus, even though a portion of an individual’s savings would be used for equity-type investments, the individual would only have title to the bank deposit at some specified rate of return. Any dividends earned would be from the coupons she owned. These would initially be distributed out equally to all individuals. Holdings would naturally change over time, as the value of stocks rose and fell. However, upon death, each individual’s shares and coupons would revert to the state, which would then redistribute them to the next generation as a coming-of-age benefit.

There are two problems with this proposal. The first is that certain firms may be created as “cash cows,” whose sole function is to take in coupons, convert them to cash and pay out as
much of that cash in the form of dividends as possible. The second is that individuals who
discount the future too severely will assign little value to the income flow generated by their
investments, and so take wild risks that promise substantial short-term rewards (e.g. speculation),
or else engage in aggressive day-trading. Older people in particular, facing a reversion of their
assets to the state, would have an incentive to do whatever possible to maximize immediate
return, regardless of the impact on the value of their holdings. Roemer’s response is to suggest
that all investments be channeled through mutual funds, whose managers would be required by
law to maintain a balanced portfolio, along with a balanced customer base. By pooling together
older and younger customers, Roemer claims, the firm would be prevented from investing in “get
rich quick” schemes (by the interests of its younger customers).

Figure 10.4 shows the way in which cash and coupons flows in such an economy. Mutual
funds receive coupons, invest them in firms, receive dividends in the form of cash, which they
then disperse to their investors. The primary difference is that cash cannot flow from investors to
firms. Instead it takes the circuitous route of being deposited in the bank, where it is exchanged
for coupons in a centralized fashion by the treasury.

Figure 10.4 Equity financing in Roemer’s coupon economy
**Key Words**

asset redistribution
capital goods
central bank
depletionary investment policy
discounting
dynamic preference inconsistency
interest rate
people’s capitalism